

Other Litigation and Legal Activity

The Office of General Counsel provides legal services to the Commission concerning its law enforcement, regulatory, legislative, and adjudicatory activities. The office represents the Commission in appeals and in defense of civil litigation, and provides technical assistance to Congress on legislative initiatives.

What We Did

- Played a lead role in developing new rules on selective disclosure of information by public companies and revising auditor independence rules.
 - Played a significant role in negotiations leading to the enactment of the Commodity Futures Modernization Act of 2000.
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Significant Litigation Developments

Insider Trading

In *SEC v. Sargent*,¹⁰⁰ the court reversed a judgment for defendants in an insider trading case, ruling that the Commission could rely on circumstantial evidence to establish the violation, that the alleged tipper owed his partner a duty to keep the tipped information confidential even though it did not relate to the business of the partnership, and that the defendants could violate rule 14e-3

even if they did not know that the information they received related to a tender offer, as opposed to some other means of corporate acquisition.

Materiality

In *Ganino v. Citizens Utilities Co.*,¹⁰¹ the court of appeals agreed with the Commission's brief *amicus curiae* that the district court erred in using a numerical benchmark to determine whether a misstatement on a financial statement was material, and relied in part on Staff Accounting Bulletin No. 99, which explained that qualitative factors such as a company's desire to meet analyst's expectations or to smooth annual earnings may cause quantitatively small misstatements to be material.

Duty to Disclose of Municipal Securities Professional

In *SEC v. Cochran*,¹⁰² the court of appeals reversed a grant of summary judgment for the defendant in a yield burning case, holding that a municipal securities professional who managed an underwriting was entrusted to temporarily invest the proceeds of bond offerings, provided financial assistance to issuers, and represented an issuer in negotiations with a firm where the proceeds were invested could be found to have a fiduciary or similar relationship with the issuers, such that it would be securities fraud for the defendant not to disclose the fact that his firm received large payments from institutions in which the proceeds were temporarily invested, assuming that the fact of the payments was material.

Compliance with Industry Practices as Defense to Fraud Claim

In *SEC v. Dain Rauscher, Inc.*,¹⁰³ the Commission challenged the grant of summary judgment in favor of a defendant who was the lead investment banker for

a series of municipal note offerings, urging that the district court erred in holding that the industry norm for disclosure rather than the securities laws defined the standard of liability against which the defendant's conduct should be measured, regardless of whether that standard was reasonable. While compliance with industry norms might be evidence that the defendant was not negligent or reckless, such compliance is not dispositive.

Fraud Liability of Corporate Official Signing Document Filed with Commission

In *Howard v. Everex Systems, Inc.*,¹⁰⁴ the court of appeals agreed with the Commission's friend of the court brief that when a corporate officer signs a document filed with the Commission, and knows or is reckless in not knowing that the document contains material misrepresentations, that officer is not merely an aider and abettor of the fraud but can be liable in a private action as a primary violator of section 10(b) even if he was not involved in the preparation of the document.

Broker-Dealer Disclosure of Payments From Third Parties

In *Press v. Quick & Reilly, Inc.*,¹⁰⁵ the court of appeals agreed with the Commission's friend of the court brief, that broker-dealers may rely on money market fund prospectuses to satisfy their obligation under Exchange Act rule 10b-10 to disclose the nature and amount of fees paid to them by funds into which they sweep investor money, and that the disclosure made in these cases was sufficient to satisfy the requirements of the rule.

Aiding and Abetting Customer's Fraudulent Trades

In *Graham v. SEC*,¹⁰⁶ the court of appeals affirmed the Commission's decision sustaining the National Association of Securities Dealer's (NASD) disciplinary action and finding that a registered representative of a brokerage firm aided and abetted a customer's fraudulent trading in his margin account. The court held that the customer's wash trades were fraudulent because they were not bona fide and were for the purpose of obtaining a float from brokerage firms.

"Willful" Registration Violations

In *Wonsover v. SEC*,¹⁰⁷ the court of appeals affirmed a Commission order imposing sanctions on a registered representative for "willfully" violating the registration provisions of section 5 of the Securities Act. The court held that "willfully" in this context did not require, as petitioner claimed, that he knowingly or recklessly disregarded the registration requirement, but instead that he "intentionally committed the act which constitutes the violation."

Remedial Orders Under the Investment Advisers Act

In *Valicenti Advisory Services, Inc. v. SEC*,¹⁰⁸ the court of appeals upheld the Commission's order requiring the petitioners, an investment advisory firm and its owner, to deliver a copy of the Commission's disciplinary decision to all present clients and to potential clients for one year. The court held that the delivery requirement was authorized by the remedial provisions of the Investment Advisers Act, and also that it was justified by the Commission's objectives of informing clients of petitioners' misconduct and of deterring petitioners from future violations.

Litigation Under the Private Securities Litigation Reform Act

The Commission addressed the state of mind pleading standard under the Private Securities Litigation Reform Act

of 1995 (Reform Act) in friend of the court briefs filed in the Fifth, Sixth, and Eighth Circuits.¹⁰⁹ These briefs took the position that the pleading standard does not eliminate recklessness as a basis for liability and that, in interpreting the pleading standard, courts should rely upon the pre-Reform Act Second Circuit tests, under which a plaintiff may allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness or facts that show that the defendant had both a motive and an opportunity to commit fraud. In *Novak v. Kasaks*,¹¹⁰ a case in which the Commission had previously filed a brief, the Second Circuit agreed with all five other Circuits to consider the issue that recklessness, in some form, continues to suffice for liability. In *Novak*, the Second Circuit also joined at least three other Circuits that allow reliance upon the pre-Reform Act Second Circuit tests in at least some circumstances.

The Commission addressed the Reform Act's provision for the selection and retention of lead counsel in a friend of the court brief in *In re Cendant Corp. Litig.*,¹¹¹ a case in which the district court had conducted an auction to select lead counsel and establish a benchmark for attorney fees. The brief recognized that an auction could be a way in which a district court can exercise its traditional discretion to protect the interests of the class. However, the brief urged that a district court should not take the responsibilities for selecting and retaining lead counsel away from the lead plaintiff unless the circumstances clearly and substantially depart from the Reform Act model of large, active, and effective institutional and individual lead plaintiffs or unless the lead plaintiff's counsel proposal is inadequate under general class action standards.

Issues Under the Investment Company Act

In *Marquit v. Williams*,¹¹² the court of appeals agreed with the Commission's friend of the court brief, that investment companies, and not just their

shareholders, have an implied private right of action for director breach of fiduciary duty involving personal misconduct under section 36(a) of the Investment Company Act.

In *McLachlan v. Simon*,¹¹³ the Commission filed a friend of the court brief explaining that rule 15a-4 under the Investment Company Act permits the directors of a mutual fund to approve an interim advisory contract for no more than 120 days following the termination or non-renewal of an existing contract without first obtaining shareholder approval, and that the rule does not require unforeseen circumstances (such as the death or incapacity of the existing adviser) as a precondition to such approval. The Commission also urged that adoption of the rule was a valid exercise of the Commission's exemptive authority under section 6(c) of the act. Finally, the Commission argued that there is an implied private right of action under section 36(a) of the act for a fund director's breach of fiduciary duty involving personal misconduct.

Liability for Short-Swing Profits Under Section 16(b)

In *Feder v. Frost*,¹¹⁴ the court of appeals, relying on the view's expressed in a friend of the court brief the Commission filed at the court's request, reversed the district court's dismissal of a complaint seeking recovery of short-swing profits under section 16(b) of the Exchange Act. The plaintiff alleged that the defendant, an insider of a public company, realized profits when he purchased the company's stock within six months of sales of such stock by a second public company in which the defendant had a substantial ownership interest and a controlling influence by virtue of a shareholders' agreement to which he was a party. Rejecting the lower court's view that a defendant must have cash in hand to be deemed to have realized short-swing profits, the court of appeals held that the defendant had an indirect

pecuniary interest in his proportionate share of the stock sold by the second company and therefore was the beneficial owner of that stock within the meaning of the Commission's rule 16a-1(a)(2), which defines "beneficial owner" for this purpose to include an insider who has an "indirect pecuniary interest." The court of appeals held that the Commission had authority to adopt a definition that includes indirect interests.

In *Morales v. Quintel Entertainment, Inc.*,¹¹⁵ the Commission filed a friend of the court brief addressing the question of who is an insider subject to the section 16 reporting and short-swing liability provisions by being a ten percent beneficial owner of a company's securities. The Commission took the position that, in appropriate circumstances, lock-up provisions may demonstrate an agreement to hold or dispose of securities for purposes of deciding whether shareholders acted as a group such that the shares owned by all group members should be aggregated for purposes of determining whether the ten percent threshold of section 16 has been crossed. In *Schaffer v. CC Investments, LDC*,¹¹⁶ the Commission responded to a request from a district court for a friend of the court brief and took the position that it did not exceed its authority when it promulgated rule 16a-1(a)(1), which adopts, for purposes of determining who is a ten percent beneficial owner under section 16, the definition of beneficial owner in section 13(d).

Challenges to Rule 102(e)

In *Clark v. SEC*,¹¹⁷ a CPA serving as a corporate officer filed a declaratory judgment action in federal district court challenging the Commission's authorization of a rule 102(e) proceeding against him. In Clark's view, the rule should only be applied to those who appear before the Commission in adjudicative proceedings and engage in misconduct. Clark subsequently dismissed his action after agreeing to a suspension under rule 102(e) as part of a settlement of the

Commission's pending injunctive and rule 102(e) proceedings against him. In *Marrie v. SEC*,¹¹⁸ the district court granted the Commission's motion to dismiss an injunctive action filed in 1999 by two respondents in a Commission administrative proceeding brought under rule 102(e). Plaintiffs alleged that application of amended rule 102(e) to their pre-amendment conduct violated the Ex Post Facto Clause, that the amended rule was void for vagueness, and that promulgation of the 1998 amendments to the rule exceeded the Commission's authority.

Actions to Enforce NASD Restitution Orders

Pursuant to section 21(e)(1) of the Exchange Act, the Commission, working with the NASD, filed applications seeking court orders requiring payments of fines and restitution imposed as NASD disciplinary sanctions that were affirmed by the Commission. Obtaining court orders enabled the NASD to enforce the disciplinary sanctions by collecting the fines and restitution. The Commission filed 11 section 21(e)(1) applications in 2000, and in each of those cases the Commission obtained a court order requiring payment or the NASD received payment from the respondent.

The "In Connection With" Requirement

In *SEC v. Zandford*,¹¹⁹ the court of appeals reversed a lower court order granting summary judgment for the Commission on the basis of collateral estoppel in a case against a stockbroker who had stolen funds from a customer account. The court of appeals found that Zandford's fraud was not sufficiently connected to a particular securities transaction to come within the scope of section 10(b) of the Exchange Act. The court of appeals also concluded that the Commission failed to satisfy the "identity of issues" requirement of collateral estoppel. The Commission has appealed this decision to the U.S. Supreme Court.

Equal Access to Justice Act (EAJA) Cases

In *SEC v. Dambro et al.*,¹²⁰ two respondents applied for an award of their attorney's fees and expenses on the ground that the Commission was not "substantially justified" in seeking to enforce subpoenas for their personal financial records and date books. The district court denied the application, agreeing with the Commission's arguments that the Commission cannot be liable for attorney's fees for enforcement of an investigative subpoena, and that in the absence of a final judgment respondents could not be deemed prevailing parties and thus were not eligible for a fee award. The Fifth Circuit affirmed the district court's denial of EAJA fees.

In *In the Matter of Rita C. Villa*,¹²¹ Ms. Villa applied for more than \$200,000 in attorney's fees and expenses allegedly incurred in successfully defending against charges that she violated reporting and recordkeeping provisions of the Exchange Act. After an administrative law judge (ALJ) ruled in her favor, the Commission, on review, reversed the ALJ, on the grounds that the ALJ had failed to conduct an independent inquiry into whether the Division of Enforcement was substantially justified in filing the case initially. The Commission conducted its own inquiry and concluded that the Division had satisfied the "substantially justified" test.

Application of the Work Product Doctrine to Work Product Shared with the Commission

The Commission filed a friend of the court brief in a private securities action in state court to explain that disclosure of attorney work product to the Commission pursuant to a confidentiality agreement does not waive work product protection. The Commission stated that the work product doctrine should not be waived because the Commission's ability to obtain work product pursuant to confidentiality

agreements plays an important role in the Commission's enforcement of the securities laws. The action is pending.

Confidentiality of Documents from Foreign Governments

The Commission filed a friend of the court brief in a Commodity Futures Trading Commission (CFTC) administrative proceeding regarding the interpretation of a Memorandum of Understanding (MOU) the Commission and the CFTC have with United Kingdom authorities. The Commission argued that the MOU prohibits disclosure of investigative reports and correspondence from the United Kingdom authorities. The Commission filed the brief in support of the CFTC's Division of Enforcement after an administrative law judge ordered production of documents from United Kingdom authorities and held that the MOU did not provide that the reports were confidential.

Requests for Access to Commission Records

The Commission received 106 subpoenas for documents and testimony. In certain of these cases, the Commission declined to produce the requested documents or testimony because the information sought was privileged.

The Commission received 2,834 requests under the Freedom of Information Act (FOIA) for access to agency records and 10,418 confidential treatment requests from persons who had submitted information to the Commission. There were 51 appeals to the Office of General Counsel from initial denials by the FOIA Officer. One of these appeals resulted in district court litigation challenging a decision to withhold personal identifying information contained in consumer complaint letters. A magistrate has recommended to the district that the case, *Registered Representative Magazine v. SEC*,¹²² be dismissed as the Commission did not improperly withhold records.

Actions Under the Right to Financial Privacy Act

Several actions were filed against the Commission in federal district courts under the Right to Financial Privacy Act seeking to quash Commission subpoenas to financial institutions for bank account records. In *Ogden Murphy Wallace P.L.L.C. v. SEC*,¹²³ a law firm moved to quash a subpoena issued to a bank for records related to the interest a law firm earned on its trust account, contending that compliance would reveal client information that the law firm had a fiduciary duty to protect. The district court denied the motion to quash the subpoena.

Significant Adjudication Developments

The Commission issued 18 opinions and 42 orders, and the staff resolved by delegated authority an additional 65 motions. Appeals from decisions of Commission ALJs constituted over 20 percent of the cases decided by the Commission in 2000, more than double the 1996 percentage (but less than the 30 percent level of 1999). We anticipate that the number of appeals from law judge decisions will continue at a heightened level because of the Commission's increased use of the administrative enforcement authority granted it by Congress in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.

Highlighted are some of the significant opinions issued by the Commission in fiscal 2000.

- In *The American Stock Exchange, Inc.*,¹²⁴ the Commission declined to consider the AMEX's appeal of a decision by the Consolidated Tape Association (CTA). The opinion holds that, under Exchange Act rule 11Aa3-2(e)(1), Commission review of any action taken or failure to act by any person in connection with an effective national market system plan is discretionary. The

CTA had concluded that the AMEX had entered into a contractual relationship granting the AMEX the exclusive right to trade Diamonds, a derivative product, and therefore was not entitled, under the revenue-sharing provisions of the CTA's national market system plan, to have revenue generated from the sale of Diamonds transaction information counted in the calculation of the AMEX's annual share of revenue. The AMEX disputed this finding of exclusivity. The Commission found that its review of the CTA's action was discretionary, and, further, that it would not exercise its discretion and review the AMEX's appeal. The issues raised implicated neither the broad objectives of the national market system—the public interest, the protection of investors, or the maintenance of fair and orderly markets—nor the Commission's role in facilitating the establishment of a national market system. Rather, at stake was an ordinary commercial dispute.

- In *The Cincinnati Stock Exchange (CSE)*,¹²⁵ in contrast, the Commission found that its review of the CSE's appeal from a CTA decision was mandatory under the Exchange Act. At issue was the decision of the CTA, a registered securities information processor, to charge CSE specialists a "market data display device" fee for use of Consolidated Tape data. Section 11A(b)(5) of the Exchange Act mandates Commission review, on petition of an aggrieved person, of any limitation on access to the services of a registered

security information processor. The Commission determined that the CSE had made its case that charging fees to its specialists was a limitation on access to the CTA's services.

- The Commission in *Jeffrey Ainley Hayden*¹²⁶ concluded that the New York Stock Exchange's (NYSE) disciplinary action should be set aside because the inordinate amount of time between the conduct charged and the initiation of the Exchange's disciplinary proceeding violated fundamental fairness principles. The Commission concluded that the NYSE had not met its statutory obligation to ensure the fairness and integrity of its disciplinary proceedings. The NYSE had brought the *Hayden* proceeding some fourteen years after the first act of alleged misconduct and over six years after the last incident. Two years elapsed between the NYSE's receipt of an enforcement referral and the start of the NYSE's investigation, and the NYSE investigated the matter for three years before bringing its charges.
- Acting under rule 102(e) of its Rules of Practice and under the Exchange Act in *Russell Ponce*,¹²⁷ the Commission barred the former certified public accountant and auditor for American Aircraft Corporation (AAC) from appearing or practicing as an accountant before the Commission, with the right to reapply in five years. The Commission also ordered Ponce to cease and desist from violations of the antifraud, issuer reporting, and issuer books and records provisions of the Exchange Act.

Ponce had improperly certified financial statements that falsely overvalued a license the company owned and falsely capitalized tooling and prototype costs that should have been expensed as research and development costs. By this certification, Ponce willfully aided, abetted, and caused AAC's filing of misleading financial reports and AAC's failure to correct misleading financial reports. Ponce also failed to act with due professional care in performing his audit of AAC's financial statements and falsely certified that AAC's financial statements were presented in conformity with Generally Accepted Accounting Principles. In the Commission's view, the fact of unpaid fees for previous audits affects both the independence of an auditor and the public's perception of the auditor. Throughout the period Ponce prepared statements for AAC, AAC owed Ponce money for services for prior year audits. Further, Ponce did not comply with the independence requirement under Generally Accepted Auditing Standards.

Legal Policy

The General Counsel's responsibilities include providing legal and policy advice on SEC enforcement and regulatory initiatives before they are presented to the Commission for a vote. The General Counsel also advises the Commission on administrative law matters, and has substantial responsibility for carrying out the Commission's legislative program, including drafting testimony, developing the Commission's position on pending bills in Congress, and providing technical assistance to Congress on legislative matters.

On the regulatory front, the General Counsel played a significant lead in the agency's drafting of selective disclosure rules (Regulation FD), as well as in revising the Commission's auditor independence rules. In the legislative area, the General Counsel played a significant role in major financial services legislation enacted early in the fiscal year, the Gramm-Leach-Bliley Act of 1999, and has participated in implementation of the Act, including assisting in the interagency development of financial privacy rules required by Title V of the act. In addition, the General Counsel played a significant role in electronic signature legislation (the Electronic Signatures in Global and National Commerce Act).

Significant Legislative Developments

In fiscal 2000, Congress passed the following bills affecting the work of the SEC.

- *Gramm-Leach-Bliley Act of 1999.* An important bill for the Commission and securities firms, the Gramm-Leach-Bliley Act, was enacted early in fiscal 2000. This major financial services reform legislation has a substantial impact on the Commission and securities firms. The act:
 - permits financial services companies to own banks, securities firms, and insurance companies;
 - repeals the blanket "bank" exemptions from broker and dealer regulation under the Exchange Act and repeals the blanket "bank" exemption under the Investment Advisers Act for banks that advise investment companies;

- provides for SEC umbrella regulation of investment bank holding companies, such as broker-dealers that own financial institutions other than banks; and
- contains significant financial privacy provisions.
- *Electronic Signatures in Global and National Commerce Act.* The act facilitates electronic commerce by recognizing contracts using electronic signatures and promotes electronic record creation and retention. Consumers must consent to receiving records electronically.
- *SEC Appropriation.* The Consolidated Appropriations Act of 2001 establishes the SEC's fiscal 2001 appropriation at \$422.8 million in funding authority for 2001.

The Commission testified on 20 occasions in 2000. The 106th Congress held hearings regarding changes in the structure of U.S. capital markets. Hearings explored the impact of electronic trading and electronic markets and the future of the National Market System for securities.

The Commission also testified at congressional hearings on the following matters:

- SEC rulemaking in the area of auditor independence;
- decimal pricing in the securities and options markets;

- securities law amendments in the proposed Competitive Markets Supervision Act;
- proposals to facilitate netting of financial contracts and to improve hedge fund disclosure;
- organized crime involvement in Wall Street;
- proposals to repeal the Public Utility Holding Company Act;
- reuniting lost security holders with their assets; and
- appropriation of the SEC for 2000, including the issues of Internet fraud and SEC staff retention.

Corporate Reorganizations

The Commission, as a statutory adviser in cases under Chapter 11 of the Bankruptcy Code, seeks to assure that the interests of public investors in companies undergoing bankruptcy reorganization are protected. During the past year, the Commission entered a formal appearance in 38 Chapter 11 cases with significant public investor interest.

Official committees negotiate with debtors on the formulation of reorganization plans and participate in all aspects of a Chapter 11 case. The Bankruptcy Code provides for the appointment of official committees for stockholders where necessary to assure adequate representation of their interests. The Commission formally supported motions for the appointment of a stockholders' committee in two cases.

A Chapter 11 disclosure statement is a combination proxy and offering statement used to solicit acceptances for a reorganization plan. The bankruptcy staff commented on 182 of the 203 disclosure statements it reviewed during 2000. Recurring problems with disclosure statements included inadequate financial information, lack of disclosure on the issuance of unregistered securities and insider transactions, and plan provisions that contravene the Bankruptcy Code. Most of the staff's comments to debtors or plan proponents were adopted; formal Commission objections were filed in 16 cases.

The Commission was able to eliminate provisions in 24 plans that improperly attempted to release officers, directors, and other related persons from liability. This is a significant issue for investors because in many cases debtors improperly seek to use the bankruptcy discharge to protect officers and directors from personal liability for various kinds of claims, including liability under the federal securities laws. In 10 cases, the Commission was able to block plan provisions that would have resulted in an asset less public shell company that could have been used for stock manipulation purposes. The Commission was also able in 16 cases to prevent improper use of the Bankruptcy Code exemption from Securities Act registration.