

## Other Litigation and Legal Activity

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*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 in enforcement cases and provides technical assistance on legislative initiatives.*

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### What We Did

- Played the lead role in developing disclosure rules relating to corporate audit committees.
  - Testified regarding, and played a significant role in negotiations leading to, the enactment of the Glass-Steagall reform legislation, the Gramm-Leach-Bliley Act.
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### Significant Litigation Developments

#### Disciplinary Authority over Securities Professionals

In *Teicher v. SEC*,<sup>130</sup> the court of appeals upheld the Commission's authority under the Investment Advisers Act to bring a disciplinary proceeding against a person who was

associated with an unregistered investment adviser at the time of the person's wrongdoing, and to bar such a person from future association with an unregistered adviser. As urged by the Commission, the court found that nothing in the language of the disciplinary provision of the statute "remotely suggest[ed]" that its application was limited to persons associated with *registered* investment advisers. With respect to another respondent, however, the court of appeals held that the Commission lacked the authority under the Exchange Act to impose a "collateral" bar. According to the court of appeals, the Commission cannot bar a person who is associated with a broker-dealer, but not with an investment adviser, from future association with an investment adviser. Instead, the Commission must wait until the person actually becomes or seeks to become associated with an investment adviser and then bring a proceeding under the Investment Advisers Act based on the earlier wrongdoing.

### Excessive Markups

In *Press v. Chemical Investment Services Corp.*,<sup>131</sup> the court of appeals agreed with the views expressed in the Commission's friend of the court brief that there is no percentage safe harbor below which markups as a matter of law could not be excessive. Rather, each transaction must be considered individually and in light of all relevant circumstances. With respect to a separate alleged fraud, the court held, as urged by the Commission, that the "in connection with the purchase or sale of any security" element of the antifraud provisions of section 10(b) of the Exchange Act does not require that the misrepresentation concern the security itself or its value. The "in connection with" requirement is satisfied when the misrepresentation induces the purchase or sale of a security.

## Duty to Disclose under Antifraud Provisions

In *SEC v. Cochran*,<sup>132</sup> the Commission appealed a decision dismissing in part its complaint against an officer of an underwriter of municipal bonds who did not disclose to the issuers that his firm received secret fees from persons he selected to invest bond proceeds. The Commission argued on appeal that the defendant owed the issuers a duty of disclosure because, in addition to managing the underwriting of bonds, he provided financial advice to the issuers about where to place the funds, wielded dominant influence over selecting the institutions with which the funds would be placed, and represented an issuer in contract negotiations with one of the third parties.

## Interests in Commodity Pools

In *SEC v. Unique Financial Concepts, Inc.*,<sup>133</sup> the court of appeals held that interests in a commodity pool—in this case a pool of foreign currency options—are securities. The court also concluded that the Commodity Exchange Act's exclusivity provision did not divest the Commission of authority in this case, agreeing with the Commission that its authority over the capital-raising functions of a commodity pool is concurrent with the Commodity Futures Exchange Commission's jurisdiction over other aspects of a commodity pool's operations.

## Primary Violator Liability

In *Howard v. Everex Systems, Inc.*,<sup>134</sup> the Commission filed a friend of the court brief in the court of appeals taking the position that a corporate official who knowingly or recklessly signs a document filed with the Commission that contains material misrepresentations can be liable in a private action as a primary violator of section 10(b) notwithstanding his lack of involvement in the preparation of the filing. This question arose after the Supreme Court decided in *Central*

*Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*<sup>135</sup> that private actions cannot be brought against persons who aid and abet violations of the antifraud provisions, but only against primary violators. In taking the position that officials who, acting with scienter, sign corporate filings can be liable as primary violators, the Commission noted that full and honest reporting is crucial to the proper functioning of the securities markets and that corporate officials play an important role in assuring that reports filed with the Commission are complete and accurate.

### Private Right of Action under the Proxy Provisions

In *Koppel v. 4987 Corp.*,<sup>136</sup> the Commission filed a friend of the court brief at the request of the court of appeals arguing that there is a private right of action under proxy rule 14a-4, which requires a separate vote on each matter that is submitted for shareholder approval. The court agreed with the Commission's analysis that a private right of action under rule 14a-4 is consistent with Supreme Court cases holding that there is a private right of action under section 14(a) of the Exchange Act to enforce Commission rules intended to assure fair corporate suffrage.

### Private Actions under Section 11 of the Securities Act

In *Hertzberg v. Dignity Partners, Inc.*,<sup>137</sup> the Commission filed a friend of the court brief taking the position that a private action under section 11 of the Securities Act for misrepresentations in a registration statement is not limited to persons who bought their securities in the public offering or during the prospectus delivery period. The court of appeals agreed with the Commission and held that any person who purchased a security issued under the relevant registration statement may sue under section 11 so long as the case is brought within the time set by the statute of limitations.

## 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 in the Courts of Appeals for the First, Second, Fifth, Ninth, and Eleventh Circuits.<sup>138</sup> The Commission took the position that the Act's pleading standard does not eliminate recklessness as a basis for liability and that courts should rely upon the Second Circuit tests in interpreting the pleading standard. All courts of appeals to rule on the issue have held that some form of recklessness suffices for liability, and all but the Ninth Circuit have allowed use of the Second Circuit tests in at least some circumstances.

The Commission also addressed the Reform Act's provisions for the selection of lead plaintiff and lead counsel in friend of the court briefs in one court of appeals<sup>139</sup> and five district courts.<sup>140</sup> The Commission urged that district courts should limit a proposed lead plaintiff "group" to a small size so that it can actively oversee the conduct of the litigation and monitor the effectiveness of counsel for the protection of the class. The Commission also urged that district courts should actively exercise their traditional discretion to review proposals for multiple lead counsel. The courts that have ruled in these cases have largely agreed with the positions taken by the Commission.

In *P. Schoenfeld Asset Management LLC v. Cendant Corp.*,<sup>141</sup> the Commission filed a friend of the court brief taking the position that the defendant company's statements that it expected to restate its prior financial statements as a result of accounting irregularities and its estimates about the extent of the possible restatement were not "forward-looking" statements and therefore not protected by the Reform Act's safe harbor provision for forward looking statements or by the "bespeaks caution" doctrine.

In *Harris v. Ivax Corp.*,<sup>142</sup> the Commission filed a friend of the court brief taking the position that the safe harbor provision for forward-looking statements in the Reform Act does not protect a company that issues a projection with actual knowledge of hard facts that render its projection false or misleading. The Commission explained that the safe harbor was not intended to allow issuers who make projections to conceal known hard facts that would, if disclosed, materially alter the projections. The objective of the safe harbor is to protect issuers who speak about contingent or uncertain events, and who adequately caution investors of the risks that they are in error.

### Commerce Clause

In *A.S. Goldmen & Co. v. N.J. Bureau of Securities*,<sup>143</sup> the court of appeals agreed with the position, urged by the Commission in a friend of the court brief, that New Jersey did not violate the Commerce Clause of the United States Constitution by applying its securities registration statute to sales made from the state exclusively to non-residents.

### Challenges to Rule 102(e)

Two lawsuits were filed against the Commission challenging the Commission's authority to sanction accountants who practice before the Commission under rule 102(e) of the Commission's rules of Practice. In *Marrie v. SEC*,<sup>144</sup> the respondents in an administrative proceeding under rule 102(e) brought an action in district court to enjoin the administrative proceeding. The respondents allege that rule 102(e) is unconstitutional because application of amended rule 102(e) to pre-amendment conduct violates the Ex Post Facto clause, the rule is void for vagueness, and promulgation of the amendments to the rule exceeded the Commission's authority. In *SEC v. Walker*,<sup>145</sup> a Commission enforcement action in district court, a defendant filed a counterclaim contending that the Commission does not have

authority to use rule 102(e) to address professional misconduct unrelated to its adjudicative processes. The Commission has moved to dismiss the claims in both claims, and those motions are pending.

### Actions to Enforce NASD Restitution Orders

The Commission brought its first action pursuant to section 21(e)(1) of the Exchange Act to enforce a National Association of Securities Dealers (NASD) restitution award. In *SEC v. French*,<sup>146</sup> the Commission sought an order requiring the defendant, a former registered representative who had been permanently barred from association with any NASD member firm, to pay \$50,000 as required by an NASD decision that was affirmed by the Commission in a July 8, 1996 order. The district court entered the order, and the customer who was to receive the restitution is pursuing a collection action against the defendant based on the court order.

### Actions Seeking Relief from Commission Injunctions

Courts have denied relief in two actions in which persons sought relief from injunctions imposed in Commission enforcement actions. In *SEC v. Gellas*,<sup>147</sup> the Second Circuit affirmed a district court decision denying a motion to vacate an administrative order barring the respondent from association with any broker-dealer. The movant argued that the order was void because the Commission had agreed not to bring an administrative proceeding in a prior consent judgment. The court found the Commission had made no such agreement. In *SEC v. EDP of California*,<sup>148</sup> the district court refused to vacate an obey-the-law injunction entered in 1992 despite the defendant's argument that she did not intend to re-enter the securities field and the injunction placed a "shadow" over her life. The movant's appeal to the Ninth Circuit is pending. A third case seeking relief from an injunction is also pending. In that case, *Approved Mortgage*

*Corp. v. SEC*, Civ. No. 98-764 (W.D. Pa.), the enjoined party contends the Commission tacitly approved the securities he issued and whose issuance was the basis for his injunction.

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

The Commission filed an *amicus* 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 court held that the corporate defendant had not waived work product protection by producing work product from an audit committee internal investigation.

### Requests for Access to Commission Records

In 1999, the Commission received 112 subpoenas for documents and testimony. In some of these cases, the Commission declined to produce the requested documents or testimony because the information sought was privileged.

The Commission received 2,985 requests under the Freedom of Information Act (FOIA) for access to agency records and 8,765 confidential treatment requests from persons who had submitted information to the Commission. There were 41 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 a draft letter from the NASD regarding NASD proposed rule 1150.<sup>149</sup> The court dismissed the complaint as moot because the Commission later produced the letter. The court, however, allowed the plaintiffs to file a

motion requesting attorneys' fees. Plaintiffs have not yet filed such a motion.

### Actions Under the Right to Financial Privacy Act

In 1999, 26 actions were filed against the Commission in federal district courts pursuant to the Right to Financial Privacy Act (RFPA) seeking to quash Commission subpoenas to financial institutions for bank account records. In each of the cases decided, the court enforced the subpoena. In one case, *Exchange Point LLC v. SEC*,<sup>150</sup> the court held that limited liability companies have no standing to challenge a subpoena for their financial records because they are not "customers" as that term is defined in the RFPA.

## Significant Adjudication Developments

The staff submitted to the Commission 69 draft opinions and orders resolving substantive motions. The Commission issued 43 opinions and 28 orders, and the staff resolved by delegated authority an additional 67 motions. Appeals from decisions of Commission administrative law judges constituted 30 percent of the cases decided by the Commission in 1999, while three years ago (1996) that number was less than 10 percent. We anticipate that this percentage will continue to grow as the Commission continues to utilize more fully the administrative enforcement authority granted it by Congress in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990. In addition, the enforcement activities of the NASD have been totally reorganized over the last three years, and, as a result, NASD is bringing more complex cases. For example, in the last year, the Commission has begun to see appeals in several complex fraud and manipulation cases brought by the NASD—in the past the NASD's enforcement efforts have focused on more technical rule violations. We

anticipate that this trend will continue in 2000 and beyond, as the results of NASD's stepped-up enforcement program work their way through the appeals process.

### Statutory Disqualification

In *Jacob Adoni*,<sup>151</sup> the Commission set aside NASD action denying a registered broker-dealer's application to employ Adoni as a registered representative. The NASD had denied the application after it determined that Adoni was subject to a statutory disqualification based on a federal court order enjoining him from violating rules that prohibit the falsification of books and records. The Commission held, however, that the injunction did not subject Adoni to a statutory disqualification because it did not enjoin a conduct or practice "in connection with" the purchase or sale of a security within the meaning of Exchange Act sections 3(a)(39) and 15(b)(4). The complaint in the injunctive action did not allege, and the record did not support a finding, that false or misleading information reached the public as a result of Adoni's conduct. Adoni had improperly booked sales of unshipped goods as revenue, but these inflated revenue figures were never incorporated into a public filing or otherwise disseminated to the public.

### Amount of Disgorgement

The Commission in *Joseph J. Barbato*<sup>152</sup> found that Barbato, a former salesperson with a now defunct registered broker-dealer, committed fraud. The Commission barred Barbato from associating with any broker or dealer, but reduced the disgorgement amount imposed by an administrative law judge from \$623,020, an amount that reflected the commissions Barbato earned from all of his customers during his entire tenure at the broker-dealer, to \$45,142.20, the amount of commissions Barbato earned from the seven customers he defrauded.

## Due Process

In *Scattered Corporation*<sup>153</sup> the Commission dismissed the Chicago Stock Exchange, Inc.'s (CHX) action against respondents because there was not adequate separation of prosecutorial and adjudicatory legal functions during the disciplinary proceeding. CHX had hired an outside private law firm to perform all its legal functions, and one of the law firm's partners was appointed General Counsel of CHX. The law firm represented CHX in numerous lawsuits to which CHX and respondents were parties, sometimes in adverse positions. The law firm initiated the investigation that resulted in this disciplinary action, and a partner from the law firm was appointed as counsel to the CHX Hearing Examiner. (While the law firm hired a second law firm to prosecute the disciplinary proceeding, it reviewed all of the bills of the second firm prior to their submission to CHX.) The Commission held that procedural fairness requires appropriate separation between an exchange's adjudicatory function and other functions that conflict with the adjudicatory role. The Commission found that CHX had not taken adequate measures to preserve separation among those persons within the law firm working on the various functions and thus deprived the applicants of a fair proceeding before a fair tribunal.

## Fraud

The Commission in *Valicenti Advisory Services, Inc.*<sup>154</sup> found that respondents, an investment adviser firm and its president, distributed two pieces of misleading sales literature to prospective clients. The Commission stated that the literature presented a false portrayal of the firm's past performance and a misleading comparison of that performance with the performance of other money managers. The Commission noted that the sales literature purported to show the rates of return realized by a

“composite of [the firm’s] discretionary accounts with a balanced objective” over a five-year period. However, only a portion of the firm’s accounts were actually reflected. The Commission stated that, where an adviser’s sales literature states that the rates of return it is advertising are based on the combined performance of certain specified accounts, the plain meaning of that statement is that the rates reflect the performance of all accounts falling within the stated criteria, not merely a few chosen by the adviser. Respondents were censured, fined, ordered to cease and desist from further antifraud violations, and required to send a copy of the Commission’s opinion and order to all existing clients and, for one year, to all prospective clients.

## **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 role in drafting rules to require disclosure from audit committees. In the administrative area, the General Counsel took a lead role in coordinating the preparation of reports to Congress on the year 2000 readiness of the securities industry. In the legislative area, the General Counsel played a significant role in the enactment of the Gramm-Leach-Bliley Act.

## Significant Legislative Developments

In 1999, Congress passed four bills affecting the work of the SEC.

### Glass-Steagall Act Reform: Gramm-Leach-Bliley Act

The most significant enactment for the Commission and securities firms was S. 900, the Gramm-Leach-Bliley Act, which was largely considered and negotiated during fiscal 1999, but enacted early in fiscal 2000 when President Clinton signed the Act into law on November 12, 1999 (Pub. L. No. 106-102, 113 Stat. 1338 (1999)). This historic financial services reform legislation has substantial impact on the Commission and securities firms. The act permits financial services companies to own banks, securities firms, and insurance companies effective 120 days from enactment.

The act repeals, effective 18 months from enactment, the blanket “bank” exemptions from broker and dealer regulation under the Exchange Act. The act also repeals, effective in 18 months, the blanket “bank” exemption from regulation under the Investment Advisers Act when they advise investment companies. The act provides for SEC umbrella regulation of investment bank holding companies, such as broker-dealers that own financial institutions other than banks. Financial privacy provisions represent another significant aspect of this comprehensive legislation. The act requires financial institutions to provide customers with the opportunity to opt out of sharing certain nonpublic customer information with third parties. The act also strengthens investor protections in the bank mutual funds area.

### Y2K Computer Errors: Y2K Litigation Legislation

The second piece of legislation passed in 1999 of significance to the SEC was H.R. 775, the Y2K Act, which

seeks to limit the impact of lawsuits filed against companies due to complications that might arise from a computer glitch associated with the century date change. The act provides companies 90 days to address Y2K problems before lawsuits can be filed against them and limits the damages companies may be required to pay due to complications arising from Y2K associated computer problems. President Clinton signed this act into law on July 20, 1999 (Pub. L. No. 106-37, 113 Stat. 185 (1999)). This legislation does not, however, affect the Commission's regulatory and enforcement actions and largely preserves private securities claims.

### Emergency Steel and Emergency Oil and Gas Loan Guarantee Boards

The third piece of legislation passed in 1999 affecting the SEC was H.R. 1664 (Pub. L. No. 106-51, 113 Stat. 252 (1999)), establishing the Emergency Steel Loan Guarantee Board and the Emergency Oil and Gas Loan Guarantee Board. The Boards are comprised of the Chairman of the Federal Reserve Board, or another member of the Federal Reserve Board that he designates, the Chairman of the SEC, or another member of the Commission that he designates, and the Secretary of Commerce. Congress authorized the Emergency Steel Loan Guarantee Board to guarantee up to \$1 billion in loans extended to qualified steel companies that have experienced layoffs, production losses, or financial losses since January 1998. Congress authorized the Emergency Oil and Gas Loan Guarantee Board to guarantee up to \$500 million in loans extended to qualified oil and gas companies that have experienced layoffs, production losses, or financial losses since January 1, 1997. President Clinton signed the legislation establishing the Boards on August 17, 1999.

## SEC Appropriation

The fourth piece of legislation passed in 1999 affecting the SEC was the Consolidated Appropriations Act (Pub. L. No. 106-113 (1999)), which established the Commission's fiscal year 2000 appropriation. The legislation provides the Commission with \$367.8 million in funding authority for 1999. From the beginning of fiscal 2000 (October 1, 1999) until final signing of the Consolidated Appropriations Act, the Commission and other parts of government for which appropriations had not been enacted were allowed to continue operations under seven continuing resolutions signed by the President that provided interim funding.<sup>155</sup>

## Commission Congressional Testimony

The Commission testified on 25 occasions in 1999.<sup>156</sup>

The Commission testified concerning the Glass-Steagall reform legislation (S. 900, enacted as the Gramm-Leach-Bliley Act) and issues of financial privacy and bank accounting for loan loss reserves addressed in that legislation.

In addition, in 1999, the 106th Congress held hearings regarding issues related to technology and the impact of technology on the structure of the United States capital markets. Hearings explored the impact of on-line trading and day trading, as well as the introduction of electronic markets and the possibility of "demutualizing" registered exchanges.

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

- market data misappropriation and dissemination;

- bond market transparency legislation;
- securities transaction fee legislation;
- proposals to repeal the Public Utility Holding Company Act of 1935;
- disclosure of tax consequences of mutual fund investments and charitable contributions;
- day trading and internet fraud issues;
- providing information to small businesses concerning the process of “going public;”
- bankruptcy reform legislation;
- reauthorization of the CFTC; and
- Report of the President’s Working Group on Financial Markets on hedge funds, leverage and the lessons of Long-Term Capital Management.

## **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 reorganizations are protected. During the past year, the Commission entered a formal appearance in 56

Chapter 11 cases with significant public investor interest. The Commission formally supported motions for the appointment of a stockholders' committee in two cases.

The bankruptcy staff commented on 116 of 154 disclosure statements it reviewed during 1999. 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 were adopted; formal Commission objections were filed in 12 cases.

The Commission was unable to eliminate provisions in 15 plans that improperly attempted to release officers, directors, and other related persons from liability—including possible liability under the securities laws. In six cases, the Commission was able to block plan provisions that would have resulted in an assetless public shell company that could have been used for stock manipulation purposes. The Commission was also able in 20 cases to prevent the improper use of the Bankruptcy Code exemptions from Securities Act registration.