Other Litigation and Legal Activities

Overview

"The Commission's job is looking out for investors. This includes, particularly after the Sarbanes-Oxley Act, calling for greater accountability by all categories of gatekeepers, including securities firms, banks and other financial intermediaries. As Chairman Donaldson has regularly emphasized, the Commission would like to see high ethical and legal standards become part of the DNA of all participants in our financial markets."

Giovanni Prezioso
SEC General Counsel

111 staff in the Office of General Counsel and 13 staff in the regional and district offices:

- Provided analysis and advice to the Commission on 1,481 enforcement recommendations and 303 rulemakings.
- Successfully defended the Commission in 131 judicial and administrative proceedings.
- Opened 331 litigation cases and closed 332 cases.
- Drafted 90 adjudicatory opinions and 21 substantive draft orders responding to motions.

Key Results

Issue	Result
Sarbanes-Oxley Act	Played a lead role in coordinating the agency's implementation of the landmark Sarbanes-Oxley Act of 2002, facilitating the adoption of 15 rules and the launch of the Public Accounting Oversight Board (PCAOB).

Issue	Result
Promulgation of Rules of Attorney Conduct	The Commission adopted rules establishing standards of professional conduct for attorneys appearing and practicing before the Commission.
Enactment of the Accountant, Compliance and Enforcement Staffing Act of 2003	Provided substantial technical assistance to congressional staff and drafted agency testimony on legislation designed to give the SEC streamlined authority to hire accountants, economists, and examiners.
SEC v. Edwards	Supreme Court, as urged by the Commission, agreed to review a court of appeals decision holding that an investment scheme is excluded from the term investment contract in the definition of security if the promoter promises a fixed rather than variable return.
Domestic Securities, Inc. v. SEC	Court of appeals, agreeing with the Commission, refused to set aside two Commission orders allowing implementation of NASDAQ's SuperMontage electronic trading system.

Main Activities	Fiscal 2003	Fiscal 2002	% Change
Litigation Cases:			
Opened	331	291	+14%
Closed	332	293	+13%
Adjudicatory Matters Completed	69	39	+77%
Advisory Memoranda on Enforcement Matters	1,481	1,419	+5%
Corporate Reorganizations:			
Disclosure Statements Reviewed	274	288	-5%
Disclosure Statements Commented On	171	204	-16%

Significant Litigation Accomplishments

Definition of a Security

The Supreme Court granted the Commission's petition for Supreme Court review in *SEC v. Edwards*[108] to decide whether an investment scheme is excluded from the term investment contract in the definition of security if the promoter promises a fixed rather than variable return or if the investor is contractually entitled to a particular amount or rate of return. In *SEC v. ETS Payphones, Inc.*,[109] the Court of Appeals for the Eleventh Circuit held that certain payphone sale/leaseback/buyback agreements were not investment contracts, and thus not securities, under *SEC v. W.J. Howey, Co.*,[110] which described an investment contract as "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter"or a third party. The court of appeals ruled that because the lease payments were fixed they did not constitute profits. The court further held that even if the fixed payments were profits, another element of the Howey test was not met because the lease payments were not derived from the efforts of others since they were contractually guaranteed.

In its brief in the Supreme Court, the Commission argued that the court of appeals' holding on fixed returns is wrong under the Howey decision, which specifically refers to income as being a form of profits and cites with approval decisions under state Blue Sky laws that involved fixed returns. In addition, the Commission argued that the alternative holding—that any profits involved were not derived from the efforts of others because they were contractually guaranteed—is wrong because the efforts of others language turns on whether, as represented to potential investors, it is the

investors or the promoters who are to manage the enterprise expected to generate the profits, not on whether the profits are provided for by contract. The case is awaiting decision.

Insider Trading

In *SEC v. Yun*,[111] a case involving the tipping of non-public material information by the spouse of a corporate insider and trading by the tippee, the court of appeals held, agreeing with the Commission, that a duty of confidentiality sufficient to support insider trading liability exists where there is an express agreement to keep business information confidential or a history or practice of sharing business confidences. The court of appeals also held, disagreeing with the Commission, that a tipper benefit is required in cases brought under the misappropriation theory of insider trading.

Duty to Disclose Information That Is Not Firm-Specific or Is Publicly Available

The Commission filed a friend of the court brief in *Kapps v. Torch Offshore, Inc.*[112] urging, in an action under Section 11 of the Securities Act of 1933 for untrue statements and omissions in a registration statement, that, contrary to the holding of the district court, it is not an absolute defense to an action under Section 11 that the omitted information is not specific to the firm issuing the securities or is publicly available. The Commission also argued that the disclosure of trends required by Item 303 of Regulation S-K is not limited to trends that are firm-specific or that are not available to the public.

Securities Act Registration

Agreeing with a friend of the court brief filed by the Commission in *DeMaria v. Anderson*,[113] the court of appeals held that an issuer whose prospectus is subject to Rule 3-12 of Regulation S-X, which provides that no interim financial results are required from an issuer that has filed a registration statement containing an audited financial statement as of a date within 135 days, must nevertheless report interim financial results if the failure to do so would amount to a material omission rendering what has been disclosed false or misleading. The court of appeals also agreed with the Commission that even though information in a printed prospectus is deemed part of the electronic prospectus filed under EDGAR, if the information is left out of the electronic prospectus, the fact that it is included in the printed version does not necessarily insulate the issuer from Section 11 liability. The court agreed with the Commission's position that liability could exist if the correct information might not be obvious to a reasonable investor, and that since a reasonable investor might only read the incomplete electronic prospectus, the correct information in the printed prospectus might not be obvious to a reasonable investor.

In *Stolz v. Daum,* [114] the Commission filed a friend of the court brief in response to a request from the court of appeals. The court asked for the Commission's views as to "what event triggers the running of the three-year period of repose established in [Section 13 of the Securities Act] with respect to liability created under [Section 12(a)(1) of the Act], which prohibits the sale of unregistered securities." The Commission argued that the three-year period is triggered when the security is first bona fide offered to the public. The Commission further argued that the phrase bona fide offered to the public in Section 13 also means that the three-year period is not triggered while an offering is conducted as a private offering.

NASDAQ's SuperMontage Trading Platform

In *Domestic Securities, Inc. v. SEC*,[115] the court of appeals denied a petition for review of two orders of the Commission pertaining to implementation of the NASDAQ's SuperMontage electronic trading platform. The petition, filed on October 7, 2002, was dismissed as untimely insofar as it challenged the "decrementation" feature of the National Association of Securities Dealers' (NASD) rules for the trading system, which had been approved as final by the Commission on January 19, 2001. The court also affirmed as supported by substantial evidence the Commission's August 29, 2002 order, which held that SuperMontage could begin operation because the NASD had created the required Alternative Display Facility, rejecting the petitioner's claim that the ADF was not adequate.

Antitrust Immunity

The Commission filed a friend of the court brief in *In re Initial Public Offering Antitrust Litigation*,[116] at the request of the district court, in which it argued that the antitrust laws are impliedly repealed, with respect to the conduct challenged in that case, due to the Commission's pervasive regulation. This is so, the Commission argued, whether or not the conduct alleged to have violated the antitrust laws also violates the securities laws. The district court recently ruled in favor of the position urged by the Commission and dismissed the antitrust class action.[117]

Securities Investor Protection Corporation Coverage

At the request of the court of appeals, the Commission filed a friend of the court brief in *In re New Times Securities Services, Inc. and New Age Financial Services, Inc.*,[118] a case involving the reimbursement of customers of a failed broker-dealer firm by the Securities Investor Protection Corporation (SIPC) under the Securities Investor Protection Act (SIPA). The firm sold customers fictitious securities, and the firm sent confirmations or account statements reflecting that the customers made securities purchases. The Commission argued that the customers' claims for reimbursement under SIPA were claims for securities within the meaning of Section 9(a) of SIPA, and therefore entitled to SIPC coverage up to $500,000, rather than a claims for cash, for which coverage is limited to $100,000. The Commission also argued that the customers' claims for reimbursement under SIPA are measured not by the fictitious value of the security (and fictitious dividends on the security) set forth by the firm on the customers' account statements but, rather, by the amount of money paid by the customers to the firm to purchase the security. The appeal is pending.

Arbitrations Conducted by Self-Regulatory Organizations

In Mayo v. Dean Witter Reynolds, Inc.,[119] the district court agreed with the Commission's position, expressed in a friend of the court brief, that California's recently adopted disclosure requirements for arbitrators, and companion rules providing for disqualification of arbitrators and vacation of an arbitral award if those requirements are not met, cannot be applied to securities arbitrations conducted by securities industry SROs. The Commission argued that, in light of the Commission's comprehensive oversight of the SROs under the Securities Exchange Act of 1934 (Exchange Act), only the Commission could decide what disclosure and disqualification standards are appropriate for the protection of investors in SRO arbitration, and can ensure that those standards are part of an effective national system. Thus, the California requirements, as applied to SRO arbitration, are preempted by federal law. The court also agreed with the Commission that the California requirements are preempted by the Federal Arbitration Act. The Commission reiterated these views in two later cases, which are still pending.[120]

In *Howsam v. Dean Witter Reynolds, Inc.*,[121] the Supreme Court, agreeing with the position urged by the Commission in a friend of the court brief, held that arbitrators, rather than courts, should initially apply the six-year eligibility requirement of the NASD for arbitrations conducted under its Code of Arbitration Procedure. The six-year rule is the sort of procedural issue that should be decided by arbitrators where the parties' arbitration agreement does not state otherwise.

The Commission filed a friend of the court brief in *Smith v. Dean Witter Reynolds, Inc.,*[122] taking the position that, where an arbitration agreement provided that disputes between a securities firm and its customer would be settled by arbitration, the customer did not lose the right to pursue in court, within the period allowed by the applicable statute of limitations, a claim that was ineligible for arbitration under the New York Stock Exchange's six-year eligibility requirement. The appeal is pending.

Other

In *SEC v. McCarthy & SEC v.Vittor,* the Ninth Circuit and the Eleventh Circuit both allowed the Commission to bring summary proceedings under Section 21(e)(1) of the Exchange Act against persons who had not paid fines or restitution awards imposed by SROs and affirmed by the Commission.

In *Production of Work Product to the Commission Pursuant to a Confidentiality Agreement*, we filed four *amicus curiae* briefs explaining why corporations that produce work product to the Commission pursuant to a confidentiality agreement should not lose work product protection for documents produced.

Significant Legal Policy Developments

The Office of the General Counsel played a key role in the implementation of the Sarbanes-Oxley Act. This Act created a new oversight board for the accounting profession, mandated new measures intended to promote auditor independence, added new disclosure requirements for public companies, and strengthened both civil and criminal penalties for securities fraud. It also contained numerous directives for the Commission to promulgate rules and complete studies. During fiscal 2003, the Commission completed the bulk of the Act's required rulemakings and studies, with January 2003 being the most prolific month for rulemakings in Commission history. The Office of the General Counsel assisted in this effort by coordinating implementation and advising the Commission on complex legal and policy issues.

Significant Adjudicatory Developments

During the year, the Office of the General Counsel prepared for the Commission final action on 90 substantive matters: 69 adjudicatory opinions and 21 orders resolving substantive motions. As a result of this effort, at fiscal year-end, the office's adjudication docket had no pending cases that had not been sent to the Commission from years prior to fiscal 2003. This effort will facilitate effective implementation of the time frame adopted by the Commission in its revision of the Rules of Practice.

Opinions

During fiscal 2003, we prepared opinions for the Commission's consideration stating that:

- In administrative proceedings that follow the entry of a consent antifraud injunction, the Commission would rely on the factual allegations of the injunctive complaint in determining appropriate remedial action and would not permit a respondent to contest, or deny, those factual allegations (*Marshall E. Melton*).

- In proceedings under Commission Rule of Practice 102(e), the Division of Enforcement must prove that an auditor respondent was reckless with respect to the violation of professional standards, not that the auditor engaged in a type of recklessness approximating an actual intent to aid the fraud being perpetrated by the audited company (*Michael J. Marrie).*

- An offer to purchase a class of securities from current shareholders cannot exclude shareholders who cannot provide the prospective purchaser with a proxy to vote at an upcoming shareholders' meeting (*WHX Corp).*

We also prepared three opinions for the Commission addressing what must be disclosed to investors or prospective investors regarding the risks pertaining to certain investment vehicles known as derivatives; the three opinions addressed a specific type of derivative that is related to interest rates known in the investment industry as an inverse floater (*Kenneth R. Ward/Fundamental Portfolio Advisers, Inc./ Piper Capital Management, Inc).*

Significant Bankruptcy Developments

During fiscal 2003, the Office of the General Counsel was:

- Successful in persuading debtor companies to eliminate provisions in 36 plans that were designed to protect officers, directors, and other related persons from claims of public investors for violations of the federal securities laws.
- Successfully blocked 10 plans' provisions that would have resulted in the creation of shell companies.
- Prevented in 6 cases the improper use of the Bankruptcy Code exemption from Securities Act registration.

Outlook for 2004

Our main objectives are to:

- Advise the Commission on developments relating to the implementation of the Sarbanes-Oxley Act and other areas of heightened focus for the Commission, including market structure.
- Advise the Commission on enforcement, rulemaking, and legislative developments relating to recent allegations of misconduct in the mutual fund industry.
- Monitor progress on pending legislation concerning, among other things, enhancement of the Commission's enforcement authority, class action reform, bankruptcy and derivatives, Commission appropriations, and repeal of the Public Utility Holding Company Act of 1935.
- Assist the Commission in considering alternative "reporting-out" proposals for possible addition to the recently implemented attorney conduct rules.
- Bring additional proceedings under Section 21(e)(1) of the Exchange Act to obtain court orders requiring payment of fines and restitution awards imposed by SROs and affirmed by the Commission.
- Assist the Commission in matters implicating adjudicatory issues, including a new source of administrative appeals, the PCAOB.
- Continue to monitor the high level of bankruptcy activity due to the large backlog of cases and high level of new proceedings.