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UNITED STATES DISTRICT COURT FOR
THE SOUTHERN DISTRICT OF NEW YORK

MAC HERBST, et al., :
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 Plaintiffs, :
 :
 v. : 66 Civ. 3216-CBM
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 CHARLES R. ABLE, et al., :
 :
 Respondents. :

MEMORANDUM OF THE SECURITIES AND
EXCHANGE COMMISSION AS AMICUS CURIAE

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STATEMENT

This is a class action under the federal securities laws in which the plaintiffs allege fraud arising out of the offer and sale of certain debentures by defendant Douglas Aircraft Company pursuant to a registration statement that became effective July 12, 1966. Plaintiffs allege that the prospectus, which is a part of the registration statement, contained untrue statements of material facts and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. Specifically, plaintiffs allege that a statement on page six of the prospectus, which read: "Therefore, it is very likely that net income, if any, for fiscal 1966 will be

nominal," was misleading in that the defendants knew, or should have known, that the company would incur "staggering losses" in fiscal 1966. Plaintiffs also allege that certain of the accounting methods used by the defendants in the prospectus "implied that the company had already fully accounted for all anticipated losses during the current fiscal year," while, in fact, those losses were "only beginning."

In answer to certain of plaintiff's interrogatories, defendants have indicated their intent to rely upon oral statements allegedly made by Commission staff personnel approving of certain aspects of the registration statement. Plaintiffs are seeking a pretrial order barring defendants from introducing evidence of any staff conferences.^{1/}

The defendants' memorandum observes (p. 3) that in connection with the preparation of the registration statement "the opinions of a number of SEC staff personnel, including the Chief Accountant, were sought and obtained." They quote an attorney who had met with the staff^{2/} (pp. 3-5) to the effect that

"the S.E.C. took the position that the accounting treatment presented by Ernst & Ernst was very, very good; and they were in agreement with it."

^{1/} Alternatively, should that evidence be admitted, plaintiffs seek permission to notice and to attempt to secure pretrial testimony of all or some of the eight staff members of the Commission whom the defendants have stated were at the conferences.

^{2/} Deposition of Ralph L. Jones.

He continued:

". . . I specifically called the attention of the branch chief to that section [predicting nominal income for 1966]. And I told him that while it was in the nature of a prediction which was against their philosophy, particularly at that time, the company thought it was a material fact that should go in.

"And he said they would raise no objection."

* * * * *

". . . I do remember the production of documents and discussions to satisfy them of the company's earnings predictions and methods."

The Commission submits this memorandum to urge the court to exclude from its consideration the purported evidence of Commission staff "approval" or acquiescence in these matters. The Commission takes no position with respect to any other issue raised in this case.

ARGUMENT

The Securities Act of 1933 requires that a registration statement covering securities to be publicly sold must be filed with the Commission in advance of its effective date. Section 8(a), 15 U.S.C. 77h(a). Under the statute the Commission may pursue formal remedies if it appears to the Commission that a statement is false or misleading: it may initiate administrative "stop order" proceedings in which, after notice and hearing, it can determine the adequacy of the statement, Section 8(b) and (d), 15 U.S.C. 77h(b) and (d); or, it may seek injunctive relief in an appropriate district court pursuant to Section 20(b) of that Act, 15 U.S.C. 77t(b). Because the Commission realized that it would be impossible as a practical matter for it to take formal action in any

substantial number of cases,^{3/} there evolved informal practices, including consultation between the staff and registrants, as well as staff preparation of a deficiency letter or letter of comment, in which the staff would indicate to the issuer the corrections it might make before the statement should become effective.^{4/}

However useful these procedures might be to the Commission in the administration of the Act, they merely permit the staff to determine whether the registration statement on its face and in light of other readily available information appears to conform to the standards of fair and accurate disclosure required by the statute. Time does not permit a more thorough review. No independent investigation is normally undertaken to verify the accuracy of statements filed.^{5/} In the fiscal year during which most of the staff's examination of the defendants' registration statement occurred, 1697 registration statements

^{3/} Report of the Committee on Administrative Procedure, Administrative Procedure in Government Agencies, S. Doc. No. 8, 77th Cong., 1st Sess. 40 (1941).

^{4/} The rendering of informal staff or Commission advice through such procedures has been commended as an "excellent practice in administrative procedure." Commission on Organization of the Executive Branch of the Government, Task Force Report on Legal Services and Procedures (1955), p. 189. See also, Report, supra n.3, pp. 39-40.

^{5/} The Commission is, of course, authorized under Sections 8(e) and 20(a), 15 U.S.C. 77h(e) and 77t(a), to employ compulsive process to determine whether a stop order proceeding should be initiated or other formal steps taken because the Act may have been violated.

were filed, but only seven formal examinations and investigations were commenced.^{6/} In J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964), the Supreme Court recognized the limitations inherent in the comparable informal review of proxy material by the Commission and its staff, stating:

"Time does not permit an independent examination of the facts set out in the proxy material and this results in the Commission's acceptance of the representations contained therein at their face value, unless contrary to other material on file with it."

The defendants (Memo p. 5) disclaim any intention to

"contend that the SEC staff passed on the accuracy of the actual figures used in or underlying the . . . Prospectus or the accuracy of the factual statements made in the registration statement."

They purport to recognize the plain import of Section 23 of the Securities Act, 15 U.S.C. 77w, which provides in part:

"Neither the fact that the registration statement for a security has been filed or is in effect nor the fact that a stop order is not in effect with respect thereto shall be deemed a finding by the Commission that the registration statement is true and accurate

^{6/} See Securities and Exchange Commission, 32d Annual Report (Fiscal year 1966), 27, 30 (1967). Only four stop order proceedings were actually commenced that year. Id. at 28. Of course, the mere initiation of formal proceedings could cause serious problems in selling the securities. See Report, supra n. 3, at p. 40:

"[T]he securities must be sold upon prospectuses which command public confidence. . . . [T]he mere institution of proceedings which criticize the completeness or accuracy of a statement is, as a practical matter, a serious and probably fatal blow to the proposed offering."

In recognition of this fact, the Commission will generally initiate formal administrative proceedings only if it appears that there was a deliberate attempt to mislead investors. Cf. 17 CFR 202.3(a).

on its fact or that it does not contain an untrue statement of fact or omit to state a material fact" 7/

And they seemingly acknowledge that the principle stated in this section applies to bar reliance upon staff commentary--as well as Commission inaction--as to factual issues. But defendants focus too narrowly upon Section 23 as only preventing use of "the fact of SEC review as a selling tool in inducing investors to purchase the security" (Memo p. 6). It is implicit that having sold the security, the defendant may not rely on the fact of Commission review as a matter of defense.

The defendants' principal argument attempts to avoid any claim of approval as to facts. Thus they assert

"that the SEC's approval went to matters of accounting procedure and methods and to the policy decision which favored the inclusion of the statement that 'it is very likely that net income, if any, for fiscal year 1966 will be nominal.'" (Memo pp. 5-6.)

But the claim of approval given by members of the Commission's staff concerning "accounting procedures and methods" is no different than a claim of approval as to facts, when those procedures and methods are alleged to have had false and misleading consequences. Likewise,

7/ Section 26 of the Securities Exchange Act, 15 U.S.C. 78z, contains a similar provision with respect to statements or reports filed under that Act, and states in addition:

"No action or failure to act by the Commission . . . in the administration of this . . . [Act] shall be construed to mean that the . . . [Commission] has in any way passed upon the merits of or given approval to . . . any transaction or transactions."

alleged approval of a "policy decision" to include a statement with respect to probable net income for the fiscal year 1966, where the statement is claimed to be false and misleading, is in substance a claim that the factual statement itself was approved. The law is violated when false or misleading statements are made and when material facts are omitted. It is irrelevant what procedures were followed, what methods were employed and what policy decisions were made; and it is likewise irrelevant whether they were "approved" or not by members of the Commission's staff.

As Judge Weinfeld stated in Boruski v. Division of Corporation Finance of the United States Securities and Exchange Commission, 321 F. Supp. 1273, 1276 (S.D. N.Y., 1971):

"The responsibility for submitting an adequate statement that purports to comply with the disclosure and other requirements of the law is upon the issuer and it cannot be shifted to the Commission or its staff"

Compare Securities and Exchange Commission v. Henwood, CCH Fed. Sec. L. Rep., ¶91,125 (S.D. Cal., 1961), modified on other grounds, 298 F. 2d 641 (C.A. 9), certiorari denied, 371 U.S. 814 (1962), at p. 93,713-7:

"It is the inescapable obligation of the contestants [in a proxy fight] themselves to make certain that all material facts are set forth in their communications to stockholders in a straightforward and understandable manner. This obligation cannot be shifted to the SEC or to its staff."

Similarly, in Securities and Exchange Commission v. Lake Havasu Estates, ['71-'72 Transfer Binder] CCH Fed. Sec. L. Rep., ¶93,348 (D. Minn., 1972), the court held: "'approval' of a registration

statement is not within the power of the Commission or its staff." On that basis it ruled:

" . . . all testimony and other evidence introduced on behalf of Lake Havasu concerning conferences and other communications between its representatives and the Commission's staff with respect to the staff's review or non-review of Lake Havasu's registration statement are deemed immaterial"

^{8/}
Id. at p. 91,885.

Even if Commission inaction might be considered by the courts (but see Section 23 of the Securities Act, supra), the defendants rely solely upon statements attributed to the members of the Commission's staff. ^{9/} The Commission has made clear by its rules, however, that

^{8/} The defendant in an enforcement action brought by the Commission had counterclaimed for "an injunction directing the Commission 'to process, comment upon, or approve' its registration statement" Id. at p. 91,883.

^{9/} Of course, if the Commission were to hold formal proceedings pursuant to Section 8(b) or (d) of the Securities Act, 15 U.S.C. 77h(b) and (d), to review or to suspend the effectiveness of a registration statement, the conclusions reached in that adversary context would and should be given great weight by the courts. On the other hand, a Commission decision to take no enforcement action--which is at most what is involved in the case at bar--is not the kind of administrative ruling to which courts should defer, even if Section 23 did not mandate such a result. Cf. Klastorin v. Roth, 353 F. 2d 182, 183 n.2 (C.A. 2, 1965); Subin v. Goldsmith, 224 F. 2d 753, 774 (C.A. 2), certiorari denied, 350 U.S. 883 (1955). As Judge Learned Hand pointed out:

" . . . the position of a public officer, charged with the enforcement of a law, is different from one who must decide a dispute. If there is a fair doubt, his duty is to present the case for the side which he represents, and leave decision to the court. . . upon which lies the responsibility of decision Since such rulings need not have the detachment of a

(continued)

"opinions expressed by members of the staff do not constitute an official expression of the Commission's views" 17 CFR 202.1(d). As Judge Frank, dissenting in part in Subin v. Goldsmith, 224 F. 2d 753, 767 (C.A. 2), certiorari denied, 350 U.S. 883 (1955), aptly observed in a comparable context: ". . . those subordinates cannot bind the Commission, and do not speak for it without its approval, not given here."^{10/} The vast majority of registration statements are permitted to become effective by the Director of the staff Division of Corporation Finance, acting pursuant to delegated authority. 17 CFR 200.30(a)(5)(i). In view of competing demands upon limited time, no aspect of a registration statement would likely receive more than passing consideration at higher staff levels or by the Commission. No court should assume that the Commission or even the Division Director has considered a question merely because that question was at some time posed to a subordinate staff member.

In Securities and Exchange Commission v. Culpepper, 270 F. 2d 241 (C.A. 2, 1959), where the Commission sought to enjoin sales of unregistered securities, it was asserted that the Commission or its

9 / (continued)

judicial, or semi-judicial decision, and may properly carry a bias, it would seem that they should not be as authoritative"

Fishgold v. Sullivan Drydock & Repair Corp., 154 F. 2d 785, 789 (C.A. 2), affirmed, 328 U.S. 275 (1946). See also Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944).

^{10/} See also the remarks of Judge Medina, speaking for the majority, 224 F. 2d at 774. Cf. International Paper Co. v. Federal Power Commission, 438 F. 2d 1349, 1358 (C.A. 2, 1971). See also Sterling Drug, Inc. v. Federal Trade Commission, 450 F. 2d 698, 706 (C.A. D.C., 1971).

staff had concurred in the legality of the sale of certain unregistered securities. The court of appeals observed, however,

"that the Commission would not . . . be estopped even if it had acquiesced in the . . . transaction. It has often been said that 'the Commission may not waive the requirements of an act of Congress nor may the doctrine of estoppel be invoked against the Commission.' Securities and Exchange Commission v. Morgan, Lewis & Bockius, 3 Cir. 209 F. 2d 44, 49; Securities and Exchange Commission v. Torr, D.C. S.D. N.Y., 22 F. Supp. 602" 11/

It follows a fortiori that an investor, for whose protection the Act is designed, and who is not responsible for what the Commission or its staff may have said or done, may not be deprived of his statutory rights on a theory of Commission or staff acquiescence.

The defendants contend, however, that staff "approval" of accounting procedures and of a decision to include an earnings forecast is relevant to the establishment of the defense of "due diligence" (Memo pp. 5-6, 11); of course, it is also arguably consistent with having successfully misled the staff. But, in any event, the "due diligence" defense arises under Section 11 of the Securities Act, 15 U.S.C. 77k. Under Section 11(a), 15 U.S.C. 77k(a), a person who has purchased a security offered pursuant to a materially misleading registration statement has a cause of action against various persons who have had a role in the preparation of the registration statement. 12/ With the exception of the issuer of the

11/ In Gerstle, et al. v. Gamble-Skogmo, Inc., 298 F. Supp. 66 (E.D. N.Y., 1969), the Commission argued directly contrary to a position previously taken by a staff member at an informal conference. See Memorandum of the Securities and Exchange Commission, amicus curiae, at 7-8 and 19-30.

12/ See Sections 11(a)(1) through 11(a)(5), 15 U.S.C. 77k(a)(1) through 77k(a)(5).

securities, however, each may successfully defend against his personal liability if he can prove with respect to the portions of the registration statement for which he is responsible that

" . . . he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading" ^{13/}

An expert, such as an accountant, will be responsible in accordance with this standard for those portions of the registration statement purporting to be prepared or certified by him. Accountants certifying financial statements have been held liable for not conducting an examination in accordance with the standards recognized in their profession.

Escott v. BarChris Construction Corporation, 283 F. Supp. 643, 703

(S.D. N.Y., 1968). Non-experts must meet this standard only with respect to those portions of the registration statement for which no expert is

responsible. ^{14/} In Feit v. Leasco Data Processing Equip. Corp., 332 F.

^{13/} Section 11(b)(3)(A) and 11 (b)(3)(B)(i), 15 U.S.C. 77k(b)(3)(A) and 77k(b)(3)(B)(i). The "standard of reasonableness" under these provisions is defined in Section 11(c), 15 U.S.C. 77k(c), as "that required of a prudent man in the management of his own property."

^{14/} As regards portions of the registration statement for which an expert is responsible, a non-expert need only show that

" . . . he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading"

Securities Act, Section 11(b)(3)(C), 15 U.S.C. 77k(b)(3)(C).

Supp. 544 (E.D. N.Y., 1971), it was held with respect to directors and officers that "[t]he key to reasonable investigation . . . is independent verification of the registration statement by reference to the original written records." 332 F. Supp. at 576.

Thus, due diligence deals with the responsibility to ascertain the truth and completeness of the facts to be included in the registration statement. To that end, only the actions of the defendants themselves in investigating those facts can be considered; contrary to their assertion (Memo pp. 9, 11), their consultations with other persons, except to verify facts, are irrelevant.^{15/}

Defendants cite a number of cases in which courts appear to have inferred Commission approval from the fact that a registration statement has become effective or that proxy material has been mailed to shareholders and no enforcement action has been taken. Such inferences, we we have shown, are contrary to the provisions of Section 23 of the Securities Act and Section 26 of the Securities Exchange Act, supra, p. 5, and for that reason, we view the opinions that

^{15/} Defendants also argue (Memo p. 9) that the discussions with staff members are "highly relevant to the proof of scienter, still clearly required by the Second Circuit before 10b-5 liability is imposed." They rely solely upon Shemtob v. Shearson, Hammil & Co., 448 F. 2d 442, 445 (C.A. 2, 1971). But Shemtob does not suggest that scienter is a necessary ingredient for liability under Rule 10b-5; it merely lists a number of alternatives--among them scienter and "reckless disregard for the truth"--any of which would state a cause of action under Rule 10b-5, 448 F. 2d at 445.

reflect such inferences as erroneous.^{16/}

CONCLUSION

For the reasons set forth above, the Court should exclude from its consideration the purported evidence of Commission staff "approval" or acquiescence in these matters.

Respectfully submitted,

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^{16/} Defendants (Memo pp. 12-13) give prominence to the case of Armour & Co. v. General Host Corp., 296 F. Supp. 470 (S.D. N.Y., 1969), in which the court held that "the SEC's clearance of the registration statement may be accorded some weight," apparently because the plaintiff had first brought its complaints to the attention of the Commission's staff. On January 17, 1973, the Commission filed suit against General Host Corporation alleging violation of the securities laws with respect to the same registration statement. Securities and Exchange Commission v. General Host Corp., et al., 73 Civ. 275 (S.D. N.Y.).