

Securities and Exchange Commission Historical Society
Fireside Chat – Courts and the SEC
April 17, 2007

THERESA GABALDON: Good afternoon, and welcome back to the 2007 series of the Fireside Chats of the Securities and Exchange Commission Historical Society, broadcast on www.sechistorical.org. I am Theresa Gabaldon, Lyle T Alverson Professor of Law at The George Washington University School of Law and moderator for this year's chats. As our listeners may know, the SEC Historical Society preserves and shares the history of the U.S. Securities and Exchange Commission and of the securities industry through its virtual museum and archive at www.sechistorical.org. The museum's collection of over 2000 materials, not easily available through other online sources, is free and accessible worldwide at all times. The Society and the virtual museum are both separate and independent of the SEC and receive no federal funding. I would like to thank ASECA - The Association of SEC Alumni, Inc. and Pfizer Inc. for their generous sponsorship of this 2007 Fireside Chat season. Their support, along with gifts and grants from many other institutions and individuals, will help make possible the growth and outreach of the virtual museum this year.

Today's Fireside Chat looks at the impact and influence of the federal courts on the U.S. Securities and Exchange Commission. Joining me this afternoon are Paul Gonson, former Solicitor of the U.S. Securities and Exchange Commission, and also a founder of the SEC Historical Society, and Mark Kreitman, Assistant Director of the SEC's Division of Enforcement.

The remarks made today are solely those of the speakers and are not representative of the society. Our speakers cannot give legal or investment advice. Paul and Mark, welcome.

MARK KREITMAN: Thank you very much.

PAUL GONSON: Thank you. Glad to be here.

THERESA GABALDON: Would either you have any disclaimers that you care to add?

MARK KREITMAN: No, I think you have covered them.

THERESA GABALDON: Perhaps we can start today by talking about the SEC's independent litigation authority. It seems that we see the SEC in court much more than some of the other federal agencies. Paul, what accounts for that?

PAUL GONSON: The SEC has independent litigating authority; that is, it goes into courts with its own lawyers, both trial courts and appellate courts, rather than through lawyers in the Department of Justice or in the U.S. Attorney's offices. Mark has some interesting facts about how this all started many years ago.

MARK KREITMAN: The Second Circuit held in a case called *SEC v. Collier*, when the Commission was less than a year old, that the statute which seemed on its face to grant the SEC independent litigating authority, did in fact do that. The panel, which included both Learned Hand and Augustus Hand, reviewed the legislative history. In the

deliberations, the statutory language had been changed from language that originally authorized the Commission to refer matters to the Attorney General for litigation to language which specifically delegated to the Commission the authority to litigate on its own. The opinion quotes some interesting language by Robert Healy, who was then the Chief Counsel of the Federal Trade Commission. The Commission at the time was part of the Federal Trade Commission. Healy said, "My suggestion is where there is such a condition existing, namely the discovery of evidence of fraud, that Congress by the bill should say to the Attorney General, punish them, and to the Federal Trade Commission predecessor to the SEC, stop them." And he said, "If we," the then FTC, now SEC "get the information, why should we not use it and go after the fellow right then and there." And that opinion, which established independent litigating authority for the SEC has, as Paul has said, borne the test of time and is still the governing adjudication in the area.

THERESA GABALDON: It did sound like a stirring call to action.

PAUL GONSON: It's been very useful, both in my experience at the SEC and in Mark's, that the ability to go to court with your own lawyers means that the staff and the Commissioners are able to discuss how they want to do that, and exactly how they want to proceed and what tactics to take. Whereas I think, with respect to other agencies that litigate through the Department of Justice, while certainly there are longstanding relationships between agency lawyers and department lawyers, sometimes it is the case that the department may have its own policies or views, which may differ from the agency's views. So I think it's fair to say that in the 70 years or more since the *Collier* decision, which Mark has referred to, the SEC has become a formidable litigator in courts and some persons regard it as the premier law enforcement agency in the federal government.

THERESA GABALDON: Now, speaking of the Justice Department, could one of you tell us a bit about the criminal enforcement process? How does the SEC go about referring cases to the Justice Department and what role does it play there after?

MARK KREITMAN: By statute, the Commission has an obligation to refer to the Attorney General matters which it deems potentially worthy of criminal enforcement. There was a time, as Paul has told me, when there was a very formal process for these referrals. Nowadays it tends often to be rather informal. The staff will make contact with the local United States Attorney's office in the jurisdiction where the conduct has occurred or where the basic situs of the violation is located, advise that office what the investigation has found and enquire whether they may have an interest in potentially pursuing a criminal investigation. There's been a big change over the years, and even during my tenure at the Commission. It used to be the case that it was quite difficult to interest United States Attorney's offices, outside of the Southern District of New York as a possible exception, in pursuing securities fraud cases, although there was always some interest in pursuing some of these matters as mail and wire fraud cases. The view was that securities fraud cases were quite technical and posed problems which the criminal prosecutors might want to avoid. But that's changed quite dramatically, and I have actually had a number of cases in which there was competition among United States Attorney's offices for the right to consider, and in fact bring criminal enforcement cases in connection with matters that we had investigated.

THERESA GABALDON: What do you suppose might account for that change?

MARK KREITMAN: I think the Justice Department has taken a much greater interest in securities fraud, and I think that was spurred by the Presidential Commission on financial fraud, which included representatives of Justice and the SEC and other interested agencies. I think it became a priority for a great many United States Attorney's offices to bring securities fraud cases in their districts.

PAUL GONSON: Mark, is it still the case as it was in my day where the SEC would send a SEC lawyer to the U.S. Attorney to help the U.S. Attorney prosecute a criminal case?

MARK KREITMAN: That still is the case. Staff attorneys are nominated as special United States Attorneys, and take an active role in the prosecution of criminal matters that grow out of our investigations.

PAUL GONSON: In that sense, do they then report to the U.S. Attorney rather than to the Commission? Are they then subject to grand jury secrecy and Rule 6 (e) of the criminal rules, which prevent persons other than lawyers for the government in the criminal process to get their information?

MARK KREITMAN: Absolutely. And in fact, barring a 6(e) order from the court, they are prohibited from sharing with their colleagues at the Commission anything they learned that has been presented to a grand jury in the criminal context.

PAUL GONSON: So, is that a one-way street? The SEC gives information to the U.S. Attorney from his investigation but can't get it from the grand jury even though the SEC employee is there helping him.

MARK KREITMAN: It is a one-way street in that sense. There is the possibility for the staff in its investigation to uncover the same evidence that has been presented to a grand jury, but they can't get it from the criminal investigation, if in fact there has been a presentation to the grand jury. Outside of grand jury material, there is much greater sharing both ways. Of course, with respect to the procedures of parallel investigations, which have of course been approved by the Supreme Court, there are some restrictions.

THERESA GABALDON: Very interesting. On the rare occasions on which the SEC is sued, does it defend itself?

PAUL GONSON: Yes, it does. Just as it goes to court with its own lawyers when it is the plaintiff, it also goes to trial and appellate courts with its own lawyers when it is the defendant. Except, however, in the Supreme Court, the SEC must then go through the Solicitor General's Office. The SEC has had historically good relations with the Solicitor General, and that has not proved to be a problem. Defense lawsuits run the gamut. They could involve challenges to SEC rule making which, of course, has been very much in the press lately with cases in the DC Circuit. There are also Freedom of Information Act cases, Administrative Procedure Act cases, many appeals from SEC orders and administrative proceedings against firms and persons in the securities industry. These are quite a few examples of the defense work. All the defense work is handled by the General Counsel's Office in Washington, as is all of the appellate work, whereas the law enforcement work is handled both by the Division of Enforcement lawyers in Washington DC, and by regional office staffs.

MARK KREITMAN: Paul made reference to the excellent relationship between the Office of General Counsel at the SEC and the Solicitor General's office, and I think it's very widely believed that that results in significant part from Paul's role as Solicitor for many years at the Commission. As a matter of fact, in what is I think unprecedented in the administrative law, the Solicitor General on a number of occasions delegated to Paul the opportunity to argue SEC cases before the Supreme Court as a token of their respect and esteem for him.

THERESA GABALDON: I wouldn't doubt that for a moment. Mark, I think this one is probably up your alley, do you see the SEC making policy through its enforcement actions?

MARK KREITMAN: I think it's fair to say that that's accurate and the insider trading area is perhaps the best example. Section 10(b) and Rule 10 b-5 are the very general fraud prohibitions as is section 17(a) of the 1933 Act. There has been significant resistance at the Commission to particularizing them. Those statutes and rules prohibit, in very general terms, deception, scheme to fraud, manipulation and the like. The fear has been that greater attempts at particularization of the conduct that's prohibited would serve as a roadmap for those who would seek to evade prosecution. Securities fraud, it's been said and I think I heard this from Paul, is kaleidoscopic.

PAUL GONSON: I didn't invent that word; that comes from an old English case.

MARK KREITMAN: Kaleidoscopic in its variations. With a couple of exceptions, particularly 10b5-1, and 10b5-2, the Enforcement branch of the Commission has felt very strongly that prosecution can be more effective pursuant to general prohibitions of fraudulent conduct than pursuant to attempts to list every possible kind of fraud, the inclusion of which might be argued to be exclusive of others.

PAUL GONSON: I think that, with regard to the Commission making policy through litigation rather than through rule making, is different with regard to some of the more technical aspects of securities regulation. The Division of Corporation Finance, which processes offerings for stock and other securities and tender offers; Market Regulation, which regulates the stock market; and Investment Management, which regulates investment companies and investment advisors, have very detailed rules in contrast to the kind of general anti-fraud provisions that Mark has just spoken about. And indeed if you look at 17 CFR, I mean those rules are thicker than the Manhattan Yellow Pages. So they are very detailed.

THERESA GABALDON: My students have often complained about the weight of the statutory supplement in securities regulation.

MARK KREITMAN: Perhaps a good example of that is the Royal Dutch Shell case which discusses Rule 4,10, an unusually specific rule, in which the Commission has actually very particularly defined the methodology to be used for the determination of proved oil and gas reserves.

THERESA GABALDON: I think in this general area, probably it would appropriate to take a few moments to talk about what role the federal courts have played as far as the creation of SEC remedies is concerned.

MARK KREITMAN: The courts exercise plenary equitable jurisdiction, and I think have been active in exercising that jurisdiction in the securities area. Most of the remedies that are most commonly thought of as SEC remedies including the disgorgement, the appointment of specialists, be they consultants, or even receivers, are not provided for statutorily, but they are imposed and have been imposed for a long time pursuant to general plenary equitable power of the courts. There have been challenges. There was a case called Great West, which was a challenge to the authority of the Commission to seek disgorgement, but such challenges have not generally been successful.

PAUL GONSON: It will be interesting, if I might interject, to point out that while the federal system has abolished the distinction between law and equity, nonetheless the remedy that is statutorily provided for the SEC is a statutory injunction. The federal courts then consider that that action as one in equity. And then as the historic chancellor in equity, the federal judge then, as Mark said, is interested in providing complete relief even though parts of that relief may not be statutorily provided. So the examples that Mark gave like disgorgement or appointment of the receiver are examples. Another example might be the officer and director bar prior to the amendment of the statutes in 1990, the so-called Penny Stock statute, and then Sarbanes-Oxley, which gave the SEC specific authority to seek officer and director bars. The court said that there was an inherent authority in the court of equity to permit that. I guess we could go on and on, but these are examples of some of the remedies that have been fashioned by the courts to give complete relief.

MARK KREITMAN: Another important example is fair funds. Fair funds are provided for statutorily by Sarbanes-Oxley, but the courts have determined that penalties can be distributed to investors pursuant to the fair funds legislation so long as there is even a single dollar of disgorgement ordered against the defendant whose penalty is to be distributed. That is another example of judicial exercise of plenary power in the formation of remedies for the benefits of investors.

PAUL GONSON: It used to be that, prior to Sarbanes-Oxley, when the SEC obtained penalties in their law enforcement cases, they had to be given over to the U.S. treasury.

MARK KREITMAN: Absolutely right.

PAUL GONSON: They were not used at all to augment the SEC's budget, were they?

MARK KREITMAN: No, they went to the general fund, unfortunately.

PAUL GONSON: Today, they can be given to investors. I read just recently that the SEC now has distributed more than \$1 billion back to investors.

MARK KREITMAN: There is a very substantial backlog of money that will, hopefully in short order, be distributed to investors as well.

THERESA GABALDON: That's impressive. Although I suppose it's a little regrettable to hear that none of it's paid out in bonuses to the staff.

MARK KREITMAN: Well, we are not at the Commission for the money.

PAUL GONSON: Or commissions to the private lawyer.

THERESA GABALDON: In which courts does the most securities litigation involving the SEC take place?

MARK KREITMAN: Most of it is in the jurisdictions with big cities - the Southern District of New York; the Northern District of Illinois which is in Chicago; Los Angeles, which is the Southern District of California; the District of Columbia; Atlanta, and increasingly Miami. These are the districts in which there is both a substantial body of securities law, judicial precedent and judges who have a greater familiarity with the law and doctrine that they will call upon to inform their decisions of particular cases.

THERESA GABALDON: Are there some courts in which the SEC actually prefers to litigate?

MARK KREITMAN: I think the Southern District is generally considered to be the SEC's forum of choice. It's where Wall Street is and where the greatest volume of securities litigation occurs. Failure to file cases are generally heard in the District of Columbia and challenges to the Commission's actions generally are heard in the District of Columbia.

THERESA GABALDON: Paul, how about private litigants? Are some circuits viewed as more plaintiff friendly or less plaintiff friendly?

PAUL GONSON: The Southern District of New York draws a lot of securities class actions, as do the other large cities that Mark has just mentioned. With regard to circuits, the Second Circuit has generally been hospitable to private lawsuits. The Ninth Circuit has been hospitable as well. The Fourth Circuit has been inhospitable to them, a very conservative circuit. So I think that given the venue requirements of the securities laws, that is where you can bring your cases, if lawyers are able to avoid the Fourth Circuit, they generally do that. And I think it's probably too for the SEC, Mark, isn't it? The Fourth Circuit has not been too good for the SEC either.

MARK KREITMAN: We've had some adverse decisions in the Fourth Circuit, that's certainly true. Interestingly, with respect to private litigation, there have been some inconsistencies. For example, in the recent Tellabs case, which was argued before the Supreme Court, dealing with the requirement for pleading scienter in private actions. As one might have expected, the Seventh Circuit had the most favorable rule to private plaintiffs but the Sixth Circuit and the Ninth Circuit had adopted less favorable rules from the point of view of private plaintiffs requiring a stronger showing of scienter than the Seventh Circuit had required.

PAUL GONSON: The conflict in the circuits, I guess, prompted the Supreme Court to take that case.

MARK KREITMAN: People had commented upon the fact that it was the Seventh Circuit case that went up, leading some to believe that the court might have been considering reviewing and modifying that rule, although I've heard from people who heard the argument that it was very hard to read the court.

PAUL GONSON: It is always hard to read the court. You can walk out of the court, thinking that you have won the case or lost the case, and then be surprised when the decision comes down. One thing I think also that might be worth mentioning, you are

talking about the pleading requirements of the Private Securities Litigation Reform Act, in which the SEC filed an amicus curiae brief at the Supreme Court in the Tellabs case. With regard to your question, as to where private plaintiffs might like to file, after the PSLRA, as we call it, was enacted in 1995, which imposes very strict rules for securities law class actions in federal court, plaintiffs started bringing national class actions in the state courts, certain state courts which were hospitable to them. The concept of a national class action in a state court is sort of mind-boggling, but there are states that do permit that. A few years later, Congress plugged that loophole by no longer permitting large class actions alleging securities fraud to be brought in state court. And so today, they're all back in federal court.

MARK KREITMAN: And with respect to the Commission's amicus brief in the Tellabs case, it surprised some observers because Commission amicus briefs are generally viewed as pro investor, and therefore, pro private plaintiff investors. In that case, the Commission filed a brief supporting the application of the more stringent standard for pleading in private class actions.

PAUL GONSON: Didn't surprise me at all. And the reason why it didn't surprise me is that SEC Chairman Cox was one of the principal authors of the PSLRA, when he was in Congress in 1994, and of course was interested in stricter pleading standards in order to weed out class actions that did not have merit. So I think it might be understandable that he would be interested in continuing that now that he is at the SEC.

THERESA GABALDON: Speaking of amicus briefs, it does seem that the SEC is quite active in filing amicus briefs in private litigation. In that regard we have a question from a listener relating to this and directed to Paul. Michael Halloran. SEC Deputy Chief of Staff and Counselor to Chairman Cox, asks when the SEC is deciding whether to come into a private civil cases as amicus, is it fair to say that it does so solely on the basis of the law, the legal principle to be established or protected, and that who the parties are is not relevant?

PAUL GONSON: Absolutely. The SEC has been very interested in amicus briefs. It has a very active program in filing these friend-of-the-court briefs. Why it files, in what cases and what positions it takes, are always very interesting speculations. I think the short answer is that the SEC's interest is protecting investors. And consequently, if there is an issue involved, which they think is of merit to express their views they generally do. And in these cases, the SEC usually will focus on an issue, but then say that it expresses no view on how the case should be decided, or what the outcome of the case should be. The parties are really irrelevant to that; it's really the issue. The SEC of course is interested in the precedential value of these decisions. So it usually goes into appeals courts or the Supreme Court, where the precedent effect would be much larger than in a district court. It's interestingly we talked about the Tellabs case in the Supreme Court and the pleading requirements of PSLRA. Some of the lawyers who wrote that brief for the SEC were lawyers who, when I there some ten years ago or so, were writing briefs in district courts on that issue. Almost never did those issues get appealed to appeals courts. So, as the law was being developed shortly after the statute was enacted, it was important to the SEC that it gets its views to the courts where in fact the decisions were being made.

MARK KREITMAN: Another interesting aspect of the amicus program, which of course Paul is much more qualified to speak about than I am, is the fact the Commission

sometimes has filed amicus curiae briefs in cases which are not on their face securities cases, but in which for one reason or another, the Commission has felt as though its programmatic interests required it to express a view.

PAUL GONSON: We call that the “Greater SEC Metropolitan Area” of litigation.

THERESA GABALDON: Very descriptive. How does the Commission interact with the Solicitor’s General Office on these matters?

PAUL GONSON: As I mentioned before, the Commission has very good relations with the Solicitor General. And the way it works in practice is that sometimes the Supreme Court will issue an order asking the Solicitor General to file a brief expressing the views of the United States as to whether a review should be granted in a particular case. And if that case is a securities case or a case in the neighborhood of a securities case, the Solicitor General will ask the SEC to draft that brief. Lawyers in the General Counsel’s Office will draft the brief, send it to the Solicitor General and usually there will be conferences. The Solicitor General of course has the last word, and he speaks for the government. On merits briefs, as distinguished from briefs in connection with petition for cert, the SEC sometimes itself will initiate the request of the Solicitor General that the SEC file a brief in the Supreme Court expressing its views and the procedures are similar; that is, there will be some negotiation as to the position to be asserted. Generally, the Solicitor General will defer to the SEC with regard to the position and the Solicitor General’s staff will do some editing of the brief, and there will be drafts that will go back and forth. We always are very thankful for short deadlines, because we know the brief will have to be filed by a certain day; otherwise these discussions could go on for months.

THERESA GABALDON: The focus of today’s program is on the courts in the SEC, but I think that we can’t ignore the fact that more and more private disputes are being resolved by arbitration rather than by litigation. I would be very interested in hearing your thoughts of why that’s taking place.

PAUL GONSON: Arbitration is a fascinating subject because the SEC had one position for many years and changed its position with regard to securities arbitration, that is, arbitration of claims that customers have against their stockbrokers for the most part. It is also an interesting example of how the SEC makes policy through its amicus participation and private actions. Generally, the SEC supports securities industry arbitration, which is administered mostly by the NASD and the stock exchanges, and it has power to review and even direct the NASD and the stock exchanges as to what their rules should be. But it has no power to review any particular arbitration case. When a customer opens an account at a stockbroker, generally the customer is asked to sign an agreement which usually includes the provision that the customer agrees to arbitrate any dispute with the stockbroker. For many years, the SEC took the position that these pre-dispute arbitration clauses were not enforceable by the broker, because of the provision in the securities statutes that says that an investor cannot be forced to waive the protection of the securities laws. Many investors did in fact choose to sue their brokers for fraud in court under 10b-5, notwithstanding these pre-dispute arbitration clauses. This was supported by a 1953 decision of the Supreme Court in a case called *Wilko v. Swan*. More than 30 years later, in 1987, the Supreme Court handed down a decision, a five to four decision in a case called *Shearson v. McMahon*, upholding the enforcement

of the pre-dispute arbitration clause, effectively reversing this more than 30 year old precedent in the *Wilko* case.

And what's dramatic, at least to me, was that the SEC changed its position from the one that I just mentioned and filed an amicus brief supporting arbitration. The SEC gave two reasons. First, the traditional hostility against arbitration evident in the *Wilko* case some 30 years earlier had gradually dissipated. The court had sustained arbitration in anti-trust cases, international securities disputes and so on. And secondly, and I think more importantly, the 1975 Act amendments gave to the SEC power to oversee the fairness of security industry arbitration. And there is a poignant note and a very recent epilogue to this story about arbitration. And the poignant note relates to the Second Circuit decision that was reversed by the Supreme Court in *Shearson v. McMahon*. That decision was written by for the Second Circuit by Judge William Timbers. The settled law in the Second Circuit of course was the *Wilko* decision that said you couldn't enforce these arbitration agreements. Judge Timbers writes in his opinion for the Second Circuit, and I quote, "Despite the settled law of this circuit that claims under 10(b) and Rule 10b-5 are not arbitrable, *Shearson*, speculating as to what the Supreme Court may do with our settled law, invites us to overrule our own precedents. We decline the invitation." At the very end of the opinion, Judge Timbers, again writing for the court, says, "It would have been helpful if the Securities and Exchange Commission had volunteered an amicus brief to inform us of its views. Without any request, the Commission rendered substantial help with respect to the corresponding questions in the *Wilko* case." We were puzzled by that because the court had never asked the SEC for its views. The poignancy is that Judge Timbers had been General Counsel of the SEC in the 1950s when the *Wilko* case was going through the courts, and the amicus briefs that he refers to were briefs that he wrote and filed in the Second Circuit and in the Supreme Court. And here was the SEC now reversing him in the Supreme Court.

The epilogue, which I would like to point out, is an article on the front page of yesterday's Wall Street Journal that has a headline, "SEC Explores Opening Door to Arbitration." The first sentence says, "The Securities and Exchange Commission is exploring a new policy that could permit companies to resolve complaints by aggrieved shareholders through arbitration, limiting shareholders ability to sue in court. This initiative is at the discussion stage and may not lead to any changes." And what this means is that these big securities class actions may in fact be preempted by arbitration clauses, and the article goes on to say that this idea is likely to "spark fierce opposition from both investor rights groups and trial lawyers." I think there will be a second phase of the big arbitration dispute coming up in the future.

MARK KREITMAN: Arbitration is generally regarded as a more efficient method of adjudication. Statistics show that, up until a few years ago, investors in NASD arbitrations prevailed about 50% of the time. I was informed last night by a student of mine, who is doing a paper on the matter, that in the past two years that number has declined to below 40%. There is kind of an interesting irony in the kinds of decisions that arbitrators tend to render in these matters. Although most of the arbitrations would seem to be binary in nature - either the investor was right, and was entitled to all of his money, or the brokerage firm was right, and the investor is entitled to none - a great many opinions kind of split the baby. But since the arbitrators are not required to explain how they arrive at those results, it's something of a mystery.

PAUL GONSON: As we all know, appeals from arbitration awards are very limited in scope and arbitrators seldom write opinions, which makes it very murky as to just how they arrived at their decision.

MARK KREITMAN: One of the famous or notorious recent decisions was one in which three Merrill Lynch brokers were fired by the firm and sanctioned by the Commission, but then reinstated with very substantial awards by an arbitrator. And, of course, the court, as Paul mentioned, declined to intervene.

THERESA GABALDON: It is interesting to think that the role of courts does seem to be declining as the importance of arbitration is increasing. It was also interesting to hear you say that the SEC seems to have changed its position and that that was something that the courts regarded as important on the issue. What sort of deference do the federal courts generally give the SEC's position in litigation?

PAUL GONSON: Generally speaking, it depends really on the nature of the case. If the case has to do with an interpretation by the SEC of one of its own rules, then the courts generally give quite a lot of deference. As I think most of our listeners will be aware, there is a general administrative law principle that in construing statutes, if the statute is crystal clear on its face, of course, then that is the end of it; the court will construe it upon its plain meaning. But if the statute is subject to several different reasonable interpretations, the court then will generally give deference to the SEC's views even if, as an original matter, the court might have come out the other way. One example was the construction of SEC Rule 10b-10 under the Securities Exchange Act; that's the confirmation rule dealing with what requirements must be met when a stockbroker confirms a trade to a customer. There, the Second Circuit gave virtually 100% deference to the SEC, even going so far as to say that if it were deciding this as an original matter, it would have come out the other way. This kind of deference, sometimes called Chevron deference, named for the famous administrative law case in the Supreme Court, is not unique to the SEC but is part of a general federal government administrative law.

But on the opposite of the scale, as we mentioned about the amicus program, the SEC will go into courts, often the Supreme Court, and express views in private actions, perhaps even whether there should be an implied right of action from statute. And in that case, the court will give the SEC no deference whatsoever because the SEC does not administer private actions. The SEC's views may be persuasive, perhaps for policy reasons. but they are not entitled to deference.

Finally, I might note that in appeals from SEC orders and administrative proceedings against broker dealers and investment advisors, there are some rules of deference that are built into the judicial review statute itself, which is Section 25(a) of the Securities Exchange Act. For example, that statute says that a finding of fact by the SEC is binding on the court of appeals if supported by substantial evidence in the record.

MARK KREITMAN: In the Financial Planning Association case that was argued just last month before the D.C. Circuit, this very issue of deference was perhaps the determinant question. The D.C. Circuit struck down as in excess of the Commission's authority a rule interpreting the Investment Advisors Act that exempted brokers with fee based accounts from registering as investment advisors as long as the advice they were providing was solely incidental to their trading activity. Two of the judges - Judge

Kavanaugh and Judge Rogers - really gave very little if any deference to the Commission, but the third - Judge Garland - was prepared to give substantial deference. But the language of the opinion really speaks in terms of ambiguity. The majority opinion felt that the rule had no ambiguity and therefore could be interpreted on its face without recourse to the Commission's interpretation. Judge Garland felt that it was ambiguous and therefore recourse to the Commission's interpretation was appropriate. I guess it's a little problematic to think about a case, in which there is a dispute with respect to the ambiguity of the statute and some judges say it's absolutely clear and another says, no, it's not clear. That itself might in the minds of some observers reflect the ambiguity.

PAUL GONSON: Mark and I were talking today about a case - not an SEC case - many years ago, to the Supreme Court decided by a Justice who I will not identify, where the majority opinion gave no deference to an agency's construction because of the majority opinion said the statute was clear on its face. There were three or four separate opinions by the justices, each of which said the statute is clear on its face, but differed as to what it meant. So the only unanimous part was that the statute was clear on its face.

THERESA GABALDON: Everyone has a different dictionary, I guess. When you are thinking about things that are ambiguous, certainly the definition of security itself comes to mind. It is my impression that a great deal of the definition of this has taken place under the direction of the federal courts, that is, the SEC has never adopted any kind of rule with respect to the interpretation of some fuzzier terms.

PAUL GONSON: This is very true. As you know, the word security is defined in both the 1933 and 1934 Acts and this list includes specific kinds of instruments, for example, stocks and notes, and also includes general categories such as investment contracts and instruments commonly known as securities. It's also important to note that the definition is jurisdictional. That is, if something is found not to be a security, then the SEC has no jurisdiction. So it becomes vital to SEC enforcement that in cases that it brings the instrument of transaction in question is found to be a security. I was interested in going back over the years into these Supreme Court decisions that define securities and the first five cases that went to the Supreme Court in the earlier years, this is from 1943 to 1967. In those five cases, the courts of appeals all ruled that the transactions were not securities. In each of those five cases, the Supreme Court reversed and said, yes they are. This reflected the early narrow construction that the lower courts were putting on the securities laws and the broad construction that the Supreme Court was putting on something that we used to call the expansion phase of Supreme Court cases in the earlier years. And then in the next three cases, involving the definition of security, which were from the mid-'70s to the early '80s, the courts of appeals, now taking the cue or direction from these five very liberal cases, said yes, they were securities, and then each of those cases was reversed by the Supreme Court and said no they are not. And this is called the restrictive phase, where the pendulum swings back. And then from 1985 to 1990, there was a return to the expansive approach where again the courts of appeals having taken their cue said no, they weren't and the Supreme Court said, yes, they are.

One case I think that merits particular mention because it's very influential, and in many cases that came after that, is the famous *Howey* case in 1946. In that case, the company was selling citrus groves in Florida, and offered a management contract to cultivate and harvest and market the fruit. Most purchasers were non-residents of

Florida who lacked the skill to cultivate and market these citrus products and most of them elected to take these management contracts. The lower court viewed this transaction as an ordinary real estate sale plus a separate management contract and said it was not a security. The Supreme Court reversed, held it was a security in the form of an investment contract, and the court articulated the test which has become very famous. And that is an investment contract "is an investment of money in a common enterprise with profits to come solely from the efforts of others." "Solely," meant and it was interpreted by some courts to mean that if the investors did any work at all, then it wasn't a security because it wasn't solely from the efforts of others.

In 1975, the Supreme Court relaxed the "solely" requirement and said, "reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." This was the *United Housing Foundation v. Foreman* case. And this relaxing of "solely" then allowed investors to use some of their efforts and still meet investment contract tests. One example is the pyramid promotion schemes where investors bring other investors into the scheme. Those have been held to be securities in the form of an investment contract. Another example are limited partnerships with limited partners who it may engage in some minor activities, but they are otherwise essentially passive investors and the general partner is making the important decisions. These two have often been held to be investment contracts.

MARK KREITMAN: The *Howey* test as modified, as Paul has indicated, is still good law; the Supreme Court relied on it in the *Edwards* case in 2004 and just this month, the Eleventh Circuit applied the *Howey* standard in a case called *SEC v. Merchant Capital* to sustain a Commission decision that certain registered limited liability partnerships marketed by a small Tennessee company were investment contracts, and therefore securities subject to jurisdiction, incidentally reversing a 111 page decision by the Northern District of Georgia to the elation of Bill Hicks and Alex Rue in our Atlanta office.

PAUL GONSON: So the poor judge had to write all that for vain. I might note that under this investment contract test, some of the following are securities: whiskey warehouse receipts are held to be securities; and as I mentioned pyramid promotion schemes and limited partnerships and even vacation condos, where you go to a vacation place, buy a condo and then put the condo in a rental pool run by the promoter and you get a share of the rents; that is being held also as a security. The SEC has put out a release to define the circumstances under which they will or won't be securities.

THERESA GABALDON: One can certainly see why the SEC might be content to leave this expansive construction business to the courts, in fear that adopting a rule on this subject might be unduly narrowing, just as you mentioned earlier, with respect to possibility of insider trading, . Mark, talking again about insider trading, you mentioned Section 10(b), Rule 10b-5, Section 17 of the 33 Act, all are very vague and most law really has been left to the courts. Would you say that the law with respect to insider trading is becoming more restrictive, less restrictive or just more interesting?

MARK KREITMAN: I am not sure if it's becoming either more or less restrictive. It has changed in two significant respective ways, as a result of statutory interpretation, which as we've all said is unusual. Rules 10b-5(1) and (2) addressed two issues which were left ambiguous by adjudications. In the *Adler* case, which incidentally Paul and I worked on together, the Eleventh Circuit held that it was insufficient to show that trading while in possession of material non-public information to establish a violation of 10(b) and 10b-5,

although that gave rise to a strong inference that the information had been used somewhat at variance with an earlier criminal case called *Teischer*. *Teischer* had held that since the mind can't be bifurcated, possession of information necessarily implies its use and that it's an impossible proof burden to show use of information, which is actually in a defendant or respondent's mind. In Rule 10b-5 (1), the statutory amendments said that trading in possession of material, non-public information actually constitutes trading in reliance upon that information with certain affirmative defenses which can be put forward by defendants. And in the other ambiguous area, made ambiguous by the *Chestman* case and addressed in *SEC v. Yun*, a Florida case, the question of inter-familial tips had come to the fore and there was a statutory amendment, again a 10b-5 rule amendment, which defined specific relationships which would be held to constitute relations of trust and confidence, such that trading upon information communicated by people in those relationships could be held per se to be illegal tips.

PAUL GONSON: But isn't it interesting that the SEC embroiders, if I can put it that way, some very specific rules with regard to insider trading, but the guts of insider trading - is it insider trading or not? - is not the subject of any rule or any statute; it's not defined anywhere. You even have the odd circumstances where Congress has passed certain statutes, such as the Insider Trading Sanctions Act, where Congress says that a court can impose up to three times the profit gained or loss avoided as a penalty, it still doesn't define the offense. So we have an undefined offense with all kinds of embroidery on it.

MARK KREITMAN: And it is an offense that at least some Commissioners have referred to as the capital crime of securities fraud. That heightens the irony.

THERESA GABALDON: I think we have got a couple of minutes more perhaps for one more question. One thing that I am quite interested in is the role of the courts in moderating inter-agency jurisdictional disputes. It's my perception that every now and then the SEC and the banking regulators might be making the claim to regulate, as for instance some of that seem to be going on in the *Marine Bank* case, which was a definition with security case. And certainly there have been jurisdictional disputes between the FDIC and the SEC?

PAUL GONSON: In the *Marine Bank* case, to which you refer, the Supreme Court held that a CD issued by a federally regulated bank and insured by the FDIC was not a security. In the lower courts, the courts of appeals, the SEC and the FDIC had taken opposite positions on that. One of these cases, the *Marine Bank* case, came to the Supreme Court. The Solicitor General then invited the general counsels of the SEC and the three banking regulators to a suite in his office, locked the door, and said you guys aren't coming out until you agree on a common position that you'll all sign in the Supreme Court. That worked fine, and the parties all agreed to say that the CD was not a security, which is what the court held. But all the banking regulators and the SEC dropped numerous footnotes in that common brief to hold back and preserve the positions that they had been concerned about and litigating with each other in the court of appeals, and those footnotes proved to be very helpful. Without going into details as to what they were, they actually did help the SEC in its program.

MARK KREITMAN: And of course there is something of a difference in philosophy between the SEC which is after all a disclosure agency and puts a high premium on transparency; and the banking agencies, whose greatest fear is the possibility of a run

on the bank and are less concerned with disclosure to banking depositors than the SEC is concerned with disclosure to investors for the protection of investors.

THERESA GABALDON: Paul and Mark, thank you for this extremely interesting discussion of how the federal courts have made their influence felt on the work of the SEC over the years.

I would encourage all listeners, if you want to learn more about some of the cases mentioned, to use the master search function in the virtual museum and archive to find the materials of interest to you. I would like to thank you again ASECA -The Association of SEC Alumni Inc. and Pfizer Inc. for sponsoring today's Fireside Chat. This Fireside Chat is now archived in audio format in the virtual museum so you can listen again to the discussion at any time. A transcript of the discussion as well as the audio in MP3 format will be accessioned in the Online Programs section in the coming months.

Our next Fireside Chat will focus on the capital crime, one of the most persistent frauds to have come under federal court review, insider trading. For those listeners who have visited the Fair to All People permanent gallery in the virtual museum, you are well aware that insider trading did not begin in the 1980s. Please plan to join me on May 22nd at 3:00 p.m. Eastern Daylight Time. Ralph Ferrara and Donna Nagy will be with me to add their perspectives to this most probably never-ending saga.

Thank you again for being with us today.