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Sec Enforcement Techniques: Expanding And Exotic Forms Of Ancillary Relief

James C. Treadway, Jr.

SEC ENFORCEMENT TECHNIQUES: EXPANDING AND EXOTIC FORMS OF ANCILLARY RELIEF

JAMES C. TREADWAY, JR.*

The enforcement process of the Securities and Exchange Commission has a widespread impact upon the corporate and financial world. It is generally recognized that the Commission has extensive regulatory powers over certain members of the financial community, such as broker-dealers, securities exchanges and registered investment companies. However, through its enforcement procedures, the SEC has begun to exert increasing control over ordinary commercial and industrial companies, accounting firms, and even law firms. This new and expanded control over such entities is not confined to transactions universally accepted as subject to the jurisdiction of the SEC, such as raising funds by selling stock to the public. The immediate past has seen the Commission use enforcement cases as a means of exacting substantial concessions from alleged violators of the federal securities laws, often resulting in direct SEC involvement in the internal affairs of the alleged violator.

In recent enforcement cases, the SEC has obtained the appointments of a receiver displacing incumbent management[1] and of special receivers or masters to make public disclosure and reports of corporate transactions and affairs.[2] The Commission has also obtained substantial changes in the make-up of a board of directors which effectively deprived the alleged violators of their dominant control of the corporation[3] and similar restructurings of executive committees.[4] Other SEC involvement in internal corporate affairs includes "bargaining" for concessions pursuant to which management agrees to retain special counsel to advise it with respect to its obligations under

*Member of the firm of Dickstein, Shapiro & Morin, Washington, D.C. A.B. (1964), University of Georgia; L.L.B. (1967), Washington & Lee University.

[1]*E.g.*, SEC v. U.S. Tank Car Corp., SEC Litigation Release Nos. 6512 (Sept. 11, 1974), 6520 (Sept. 17, 1974) and 6573 (Nov. 4, 1974), SEC v. Arata, SEC Litigation Release No. 6180 (Dec. 27, 1973). The SEC attempted but failed to obtain similar relief in SEC v. Brigadoon Scotch Distrib., Ltd., CCH FED. SEC. L. REP. ¶ 94,980 (S.D.N.Y. Feb. 11, 1975), and SEC v. Clinton Oil Co., Civil Action No. W-5020 (D. Kan. Jan. 15, 1973).

[2]SEC v. Koenig, 469 F.2d 198 (2d Cir. 1972).

[3]SEC v. Mattel, Inc., SEC Litigation Release Nos. 6531 (Oct. 2, 1974) and 6467 (Aug. 8, 1974).

[4]SEC v. Mattel, Inc., SEC Litigation Release No. 6531 (Oct. 2, 1974); SEC v. Great Coastal Gas Corp., SEC Litigation Release No. 6054 (Sept. 12, 1973).

the federal securities laws,[5] and the institution of internal corporate procedures and controls to prevent future violations of the securities laws.[6]

Industrial corporations and their managements have not been the only ones to fall subject to such unusual sanctions in the context of enforcement cases. Under pressure from the SEC, a major accounting firm has agreed to submit to a review of its internal procedures by fellow accountants,[7] another accounting firm has agreed to send one of its partners to a refresher course,[8] and a law firm has agreed to adopt certain internal controls and to embark upon a continuing education program for certain of its members.[9]

All of these developments have occurred in the context of enforcement cases brought by the SEC under the Securities Act of 1933[10] and the Securities Exchange Act of 1934,[11] both of which are denominated as disclosure laws by their preambles. In addition, these acts are quite specific in granting the SEC its general powers to take action against violators, primarily the power to seek injunctions against violations. Section 20(b) of the 1933 Act[12] and § 21(e) of the 1934 Act[13] contain virtually identical language, which provides in pertinent part:

> Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation . . . , it may in its discretion, bring an action . . . to *enjoin* such acts or practices . . . .[13.1]

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[5] SEC v. Great Coastal Gas Corp., SEC Litigation Release No. 6054 (Sept. 12, 1973).

[6] SEC v. Canadian Javelin, Ltd., Securities Exchange Act Release No. 11172 (Jan. 9, 1975); SEC v. Allegheny Beverage Corp., SEC Litigation Release No. 6670 (Jan. 8, 1975); SEC v. Mattel, Inc., SEC Litigation Release Nos. 6531 (Oct. 2, 1974) and 6467 (Aug. 8, 1974); SEC v. Sunshine Mining Co., SEC Litigation Release No. 6544 (Oct. 11, 1974).

[7] *In re* Laventhol, Krekstein, Horwath & Horwath, Securities Exchange Act Release No. 10172 (May 23, 1973). *See also In re* Touche Ross & Co., Securities Act Release No. 5459 (Feb. 25, 1974).

[8] *In re* Benjamin Botwinick & Co., Adm. Proc. File No. 3-3518 (Jan. 15, 1975).

[9] *In re* Jo M. Ferguson, Securities Act Release No. 5523 (Aug. 21, 1974). *See also* SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973). *Cf.* SEC v. National Student Marketing Corp., 360 F. Supp. 284 (D.D.C. 1973).

[10] 15 U.S.C. § 77a, *et. seq.* (1970).

[11] 15 U.S.C. § 78a, *et. seq.* (1970).

[12] 15 U.S.C. § 77t(b) (1970).

[13] 15 U.S.C. § 78u(e) (1970).

[13.1] Emphasis added.

Despite this seemingly uncomplicated and straightforward language, in enforcement cases the SEC has increasingly obtained the forms of relief enumerated above, in addition to the statutory injunction against future violations. Such exotic relief is generally referred to as ancillary relief, and there is ample precedent for ancillary relief in injunctive proceedings, dating back to some of the earliest cases decided under these acts.[14] When decreed by a federal court, such relief has been granted on the theory that the court has broad discretion in fashioning remedies for securities law violations since it sits as a traditional court of equity.

This article does not purport to examine the general equity power of the federal courts; rather, it focuses upon recent enforcement cases which involve exotic and novel forms of ancillary relief with potentially far-reaching consequences for generally unregulated entities. In so doing, some conclusions are drawn as to the basis upon which the SEC determines that it will seek ancillary relief, whether the forms of ancillary relief in the cases are consistent with the disclosure philosophy of the 1933 and 1934 Acts, and whether as a policy matter the SEC should be so involved in the internal affairs of corporations, accounting firms, and law firms.

It is important to remember that virtually all of the enforcement cases discussed herein were settled by mutual consent, generally without any admission or denial of violations,[15] and were not litigated on the merits. As a result, the decrees emanating from them are

[14] *E.g.*, Deckert v. Independence Shares Corp., 311 U.S. 282 (1940); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

[15] As a procedural matter, the method of settling cases in this fashion involves the execution of a "Stipulation and Consent to Final Judgment of Permanent Injunction" by the SEC and the defendant. This is then presented to the court, which enters the agreed-upon injunction based upon the Stipulation and Consent. The language which is critical in making it clear that there is no finding of a violation of law generally reads as follows:

> This Stipulation and Consent is entered into solely for the purpose of settlement of this action, without trial or argument of any issue of fact or law. Neither this Stipulation and Consent, nor the entry of judgment herein in accordance with the Final Judgment of Permanent Injunction in the form annexed hereto, shall constitute any evidence or any admission or any adjudication with respect to any allegation of the Commission's complaint or any fact or conclusion of law with respect to any matter alleged in or arising out of the Commission's complaint, or of any wrong-doing or misconduct on the part of defendant XYZ or any of its officers, agents, servants, employees, successors, assigns, or any person or persons acting in concert or participation with it.

without broad judicial approval. Nevertheless, it is important to attempt to assess the potential consequences of the trend represented by these decrees.

It must be emphasized, however, that the discussion of these cases is in no way intended as any conclusion or implication that violations of the law in fact occurred or that any defendant or person associated with any defendant was engaged in any illegal, improper, or unethical activity.

I. *Limited Receiver for Disclosure Purposes*

One of the more important recent cases dealing with ancillary relief in SEC enforcement cases, in part because it is one of the few cases litigated and decided on the merits, is *SEC v. Koenig.*[16] In *Koenig*, the SEC commenced two enforcement actions against a publicly-held corporation and its president within a relatively short period of time. Both actions were based principally upon alleged violations of § 10(b)[17] of the 1934 Act and Rule 10b-5,[18] generally arising out of allegedly misleading or inaccurate press releases and failures to make public disclosure of the true state of various corporate affairs and transactions.

In the first case, the SEC sought the standard injunction against future violations of the securities laws. This case was settled by consent without any admission of violation by the defendants. In the second case, however, the SEC also sought the appointment of a "limited receiver" with the power to investigate the affairs of the corporation and to make timely and accurate reports of the state of its affairs to the SEC, to its stockholders and to the general public. Despite the defendants' contentions to the contrary, the Second Circuit ruled that courts could appoint such limited receivers and that such relief was appropriate in light of the nature of the alleged courses of conduct of the defendants.

In so ruling, the Second Circuit affirmed the district court[19] which had ruled in favor of the limited receiver sought by the SEC. The district court had given cogent and explicit reasons for its decision. The court emphasized that the defendants had engaged in a "complex set of secret securities transactions"[20] which had the effect of leaving the court in the position of being unable to determine the

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[16] 469 F.2d 198 (2d Cir. 1972).
[17] 15 U.S.C. § 78j(b) (1970).
[18] 17 C.F.R. § 240.10b-5 (1974).
[19] [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,536 (S.D.N.Y. 1972).
[20] *Id.* at 92,561.

nature and extent of the injury to stockholders. The court therefore considered the limited receiver "necessary to preserve the status quo while an accurate picture of what transpired is obtained."[21] It then proceeded to enumerate the sins of the defendants: "misleading and late reports to the SEC," "incomplete press reports to the public," the secret transfer of "voting control of valuable European subsidiaries" to the individual defendants, and the frustration of "all attempts of dissident shareholders to change the present management."[22] Having made these findings, the court formulated the following decree and ancillary relief:

> In view of these past activities, the Court concludes that it cannot rely on the defendants to implement the directions of the Court. . . . A receiver therefore will be appointed and will be directed to (1) investigate the recapitalization of the European subsidiaries of ECO; (2) make full, complete and accurate public disclosure of all material events and facts concerning the defendants, their officers, agent, servants, employees, directors, subsidiaries and affiliates; (3) make timely and accurate filing of reports with the SEC in conformity with Section 13(a) of the Securities Exchange Act and the Rules promulgated thereunder and to make those amended filings necessary to correct those reports presently filed; (4) issue a report to ECO stockholders for the years 1970 and 1971; (5) hold a 1972 annual ECO stockholders' meeting and (6) make ECO's books and records and stockholder list available to any ECO stockholder who is legally entitled to access to these documents.[23]

The receiver appointed by the court was former New York Mayor Robert Wagner, who conducted his investigation and prepared his report much in the capacity of an "independent legal auditor." Thereafter, he distributed a thirty-five page report which detailed various transactions which the SEC had alleged to involve violations of the securities laws. The report concluded that certain explanations of officers and directors as to why the transactions occurred were "illogical and therefore incredible,"[24] and drew conclusions as to whether certain actions taken by incumbent management were for

[21] *Id.*
[22] *Id.*
[23] *Id.* (footnotes omitted).
[24] Report submitted by Robert F. Wagner, Receiver, Pursuant to Order of United States District Court, Southern District Of New York, 1973, p. 5.

the benefit of stockholders or whether, to the contrary, they lacked any legitimate corporate purpose. The report was highly critical of management, concluded that management had released false financial information to the public,and generally took a dim view of virtually all the corporate actions attacked by the SEC in its complaint.

As previously noted, part of the significance of this case is that it is one of the few cases involving such extraordinary relief which was litigated rather than settled by consent. Another important aspect is that the ancillary relief was limited to the concept of disclosure, the basic philosophy of the 1933 and 1934 Acts. The court specifically referred to the receiver as a "limited receiver," and his powers were confined to conducting an investigation and making public disclosure of the results of his investigation.

In light of the egregious nature of the violations alleged and found by the court, this case should be considered for comparison purposes when evaluating subsequent enforcement actions brought by the SEC in which the relief sought is much broader, even though the alleged violations appear no more extreme. Such a comparison prompts one to speculate whether the *Koenig*[25] decision was the beginning of a now pronounced trend, as a range of later enforcement actions seem to indicate. Of course, one can only speculate as to the thought processes of the SEC, but subsequent cases seem to indicate that this may be so.

II. *The Outright Receiver — A Bargaining Tool and an End In Itself*

In some instances the SEC apparently has concluded that the type or extent of alleged violations of the securities laws are such that ancillary relief which goes well beyond disclosure is warranted. A significant example of such a case is *SEC v. Clinton Oil Co.*,[26] which a former SEC Commissioner has cited as an example of "more comprehensive and effective relief" in the enforcement area.[27]

Clinton Oil was one of the glamour companies of the 1960's and the early 1970's, attracting widespread investor interest. The company was engaged in oil and gas exploration, principally financed by the public sale of limited partnership interests in oil and gas drilling funds.[28] The common stock of the company was also publicly traded.

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[25] 469 F.2d 198 (2d Cir. 1972).

[26] Civil Action No. W-5020 (D. Kan. Jan. 15, 1973).

[27] Speech of Former SEC Commissioner Hugh Owens before the North American Securities Administrators, September 1973.

[28] The interests in these limited partnerships were the subject of registration statements filed under the Securities Act of 1933.

Clinton Oil reached its zenith when it sold its 1969 drilling program to the public for $100,000,000, the largest oil and gas program ever sold. Yet, according to the SEC's complaint, all was not well with Clinton Oil, and had not been well for many years. Among other things, contrary to Clinton's announcement, the spectacular 1969 program was not fully sold to the public. Instead, approximately $30,000,000 of the sales were on credit, meaning that Clinton Oil had received no cash for these sales. Furthermore, for a substantial period of time Clinton and its insiders had received interests in various drilling programs on credit, subsequently exchanging those interests for stock in the company, and finally selling the stock to pay the indebtedness. In addition, sales of Clinton common stock by insiders were carefully orchestrated to avoid depressing the market price of the common stock, and the company was also making loans to insiders to buy Clinton stock in the open-market to bolster the price of the stock. None of this was disclosed to the SEC or to public investors.

To remedy this situation, the SEC's complaint included a prayer for:

> An order appointing a receiver to take control of all of the business of defendant Clinton Oil Company and authorizing, empowering and directing such receiver to take charge thereof to conduct the same until order of the court; and to require said receiver to obtain an accounting of all disbursements by Clinton Oil Company to each defendant named herein for the period January 26, 1966, to the effective date of said receivership.[29]

While the goal of the SEC in this case may have been admirable — and certainly the alleged fraud was massive and blatant — it should be noted that the relief requested went well beyond the concept of disclosure. Indeed, one of the SEC's other prayers was for an order that Clinton Oil amend all previously filed reports with the SEC to correct alleged disclosure deficiencies.[30] Thus, supplementing the relief relating to disclosure, the additional relief sought by the SEC would have had the effect of ousting incumbent management and transferring total control over the company to a court-appointed receiver.

Although the receiver the SEC sought was not appointed, *Clinton*

[29]SEC Complaint at 45, SEC v. Clinton Oil Co., Civil Action No. W-5020 (D. Kan. Jan. 15, 1973).

[30]*Id.* at 43.

Oil was settled by a consent decree which indirectly involved the same result. The defendants consented to a court-supervised change in management in which the principal perpetrators of the alleged scheme were removed and new, independent management was brought in to try to maintain Clinton Oil as a viable corporation.

Consequently, even though the SEC did not obtain the appointment of a receiver, the mere existence of the prayer for appointment proved a powerful bargaining tool. The only way incumbent management could have avoided the appointment of a receiver and remained in control of the company was by a long trial which in all probability would have involved at least one appeal. The expense would have been enormous, the pressure incalculable, and the exposure in companion private civil actions staggering if the case had been lost. Accordingly, the defendants apparently concluded that discretion was the better part of valor and yielded to a settlement which involved no admission of violation.

The progression from *Koenig* to *Clinton Oil* is worth remembering. In *Koenig,* which was decided approximately 18 months before *Clinton Oil,* the SEC's prayers for relief were tied strictly to disclosure. In *Clinton Oil,* the relief originally sought covered the whole gamut of disclosure and also sought to effect a change in management. Thus, within a relatively short period of time, the SEC progressed to the point of evaluating the fitness of a corporation's management and, upon concluding that it was unfit to run a public company, seeking its ouster. The progeny of *Koenig* and *Clinton Oil* serve to demonstrate how rapidly this trend has accelerated.

SEC v. U.S. Tank Car Corp.[31] is a recent case which illustrates this trend. The defendants in *U.S. Tank Car* allegedly sold various unregistered securities in the form of interests in railroad tank cars and an accompanying management program for the cars. According to the SEC's complaint, in excess of $9 million in proceeds which were received from various investors from August 31, 1973, until June 30, 1974, were not used to purchase tank cars. Of this amount, only $878,300 was paid to tank car manufacturers. The defendants allegedly diverted the balance of the proceeds to their personal use, while providing fraudulent certificates of ownership to investors. The SEC sought the standard preliminary and permanent injunctions, as well as appointment of a receiver. After a hearing, the Court entered a temporary restraining order and appointed an attorney as a receiver

[31] SEC Litigation Release Nos. 6512 (Sept. 11, 1974), 6520 (Sept. 17, 1974), and 6573 (Nov. 4, 1974).

of the corporation.[32]

In assessing the apparent reasons for the prayer for a receiver in light of *Koenig* and *Clinton Oil,* it should be noted that *U.S. Tank Car* involved alleged fraud in the form of outright theft of investors' funds. In light of such blatant violations, the SEC obviously felt that the traditional injunction or remedies confined to disclosure were insufficient under the circumstances. Apparently, in this case the SEC viewed diversion or theft of investors' funds as grounds for seeking extraordinary forms of relief, including a receiver. From a purely visceral level of justice and equity, it is easy to applaud the SEC's efforts in a case such as *U.S. Tank Car.* If the SEC's allegations in such cases turn out to be true, massive and blatant violations of the securities laws will have occurred and defendants will have demonstrated a patent unwillingness to comply with the law. In *U.S. Tank Car,* it appears that the egregious nature of the violations, *coupled with the element of diversion of investors' funds,* prompted the SEC to seek the extraordinary relief involved.

SEC v. Brigadoon Scotch Ltd.[33] is an example of another case wherein diversion or potential diversion of investors' funds was involved and the SEC sought broad ancillary relief, including the appointment of a receiver. The SEC alleged that the various Brigadoon defendants were offering for public sale without compliance with the registration requirements of the 1933 Act certain unregistered securities, namely investment contracts in the form of interests in scotch whiskey and in rare coin portfolios.[34] The SEC also alleged various violations of the anti-fraud provisions of the securities laws.[35] In addition to the usual injunctive relief, the SEC sought the disgorgement by all defendants of all proceeds received in connection with their sales of unregistered securities and the appointment of a receiver of the assets and property of the defendants to, among other things, assist investors in obtaining the return of their investments and to distribute to investors the proceeds disgorged by the defendants. The SEC also sought an order freezing the assets of the defendants pending the disposition of its request for this ancillary relief, as well as an order staying and restraining all creditors of the defendants.

On February 11, 1975, a hearing was held before the court on the SEC's motion for a preliminary injunction.[36] The court first ruled that

[32]SEC Litigation Release No. 6520 (Sept. 17, 1974).

[33]SEC Litigation Release No. 6640 (Dec. 12, 1974).

[34]Securities Act of 1933 § 5, 15 U.S.C. § 77e (1970).

[35]Securities Act of 1933 § 17(e), 15 U.S.C. § 77q(a) (1970); Securities Exchange Act of 1934 § 10(b), 15 U.S.C. 78j(b) (1970).

[36]SEC v. Brigadoon Scotch Distrib., Inc., CCH FED. SEC. L. REP. ¶ 94,980

the rare coin portfolios which were offered and sold by Brigadoon involved a "security" within the meaning of § 2(1) of the 1933 Act. Having made that determination, the court granted the Commission's motion for a preliminary injunction. However, the court did not see fit to grant the application for ancillary relief:

> The application for the appointment of a receiver is denied. No showing has been made that such a drastic remedy is necessary for the protection of the public. Indeed, it appears that the expense which a receivership would involve would not only impose an undue burden on the defendants but could jeopardize the interests of the public as well.[37]

The foregoing is the only explanation given by the court as a basis for its decision not to grant the SEC's prayers for ancillary relief.

Notwithstanding the court's ruling, some valuable insight into the SEC's philosophy can be drawn from the prayers for relief when viewed against a background of the alleged violations. Prayers for receivers, disgorgement and the freezing of assets are forms of relief designed principally to assure that investors' funds are preserved intact and not wrongly diverted. In these respects, *Brigadoon* bears a distinct similarity to *U.S. Tank Car,* although in *Brigadoon* actual diversion of investors' funds was not alleged. According to the SEC, the ancillary relief requested would have enabled all interested parties to obtain a judicial determination of their respective rights.

Since the SEC is admittedly attempting to protect the interests of *all parties*, even creditors, the *Brigadoon* approach to enforcement cases deserves substantial reflection. While the goal of protecting all interests may be admirable from a social policy standpoint, the fact remains that the relief the SEC sought but was denied is quite far-reaching and that protecting non-security holders lies outside the Congressional mandate given the SEC by the '33 and '34 acts. Unfortunately, the court did not focus extensively on the ancillary relief question and therefore little insight into judicial attitudes on the issue can be gleaned from this case.

III. *Ponzi and Pyramid Schemes*

Thus far, the cases examined have allegedly involved instances of egregious violations, and in many cases the misappropriation of investors' funds, indicating that blatant violations coupled with di-

(S.D.N.Y. Feb. 11, 1975).

[37] *Id.* at 97,388.

version of funds appear to be the basis for the SEC's actions. This conclusion is supported by actions in another area in which the SEC has begun to seek broad ancillary relief, usually a receiver. These cases involve pyramid schemes and the so-called "Ponzi" schemes.[38]

A pyramid scheme[39] essentially involves a process whereby individuals invest a sum of money and in return obtain the right to receive compensation based upon the number of other individuals they can recruit to participate in the scheme. Individuals brought into the scheme are recruited on the same basis and a pyramid effect occurs. Ultimately, arithmetic controls and those at the bottom of the pyramid suffer losses since they are left with no one to recruit. Generally, pyramid schemes are tied to the sale of a product which is to be resold down the pyramid. Cosmetics, cookware, and franchises or dealerships provide recent examples. Regardless of the product involved, the viability of such schemes depends upon the enrollment of a geometrically increasing number of participants and collapse is inevitable.

Some schemes of recent vintage have involved substantial sums of money, running into hundreds of millions of dollars.[40] In light of the magnitude of the sums involved, and having generally convinced the courts that interests in such schemes fall within the statutory definition of a "security,"[41] the SEC has begun to act vigorously, routinely seeking to close down such operations by obtaining the appointment of a receiver.

Examples of such enforcement actions cover a variety of cases, many relatively unpublicized, which generally are settled by consent. One such example is *SEC v. Arata.*[42] In *Arata*, the defendant com-

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[38]Named for Charles Ponzi, a Boston swindler who devised the original scheme in the early 1900's. His scheme involved postal money orders, which he represented he was purchasing with the investors' funds. Instead, funds from new investors were used to repay old investors and additional investors were constantly recruited.

[39]Legislation was introduced by Senator Mondale in the 93rd Congress which would have outlawed pyramid schemes without regard to whether such schemes involve the sale of unregistered securities. Other than a hearing, no action was taken on the bill. (S. 1939, introduced June 4, 1973; hearing on July 10, 1974).

[40]Former SEC Commissioner Hugh Owens has estimated that pyramid schemes resulted in investors' losses exceeding $1 billion. (Speech before North American Securities Administrators, September 1973).

[41]The SEC has generally argued that the interest purchased by the investor is either a "certificate of interest or participation in a profit-sharing agreement" or an "investment contract," both of which are included in the definition of "security" in § 2(3) of the Securities Act, 15 U.S.C. § 77b(3) (1970). A series of recent cases has supported the SEC's views. *See, e.g.,* SEC v. Glenn Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973).

[42]SEC Litigation Release No. 6180 (Dec. 27, 1973).

pany received public funds which purportedly were being used to speculate in the commodities market. Public investors were to share in the profits of the speculation, which were to come from the commodities trading skills of the principals of the defendant. The issuer allegedly provided investors with false reports of huge profits, which enabled the defendant to obtain additional public funds. According to the SEC's complaint, the defendants' commodity speculations were highly unsuccessful and most of the sums paid to investors as their share of profits in fact came from money obtained from new investors. In short, the operation actually represented a classic Ponzi scheme. It required the constant infusion of new funds from new participants. The "new" participants in turn were repaid with funds obtained from subsequent, newer participants.

In its complaint, the SEC requested the appointment of a receiver in addition to the usual injunctions. The defendants consented to the requested relief without admitting or denying any violations. The *Arata* case is one wherein it is relatively easy to divine the reasons behind the SEC's prayers for relief. The existence of the Ponzi scheme and the diversion of assets clearly were the reasons which led the SEC to conclude that a receiver to freeze the situation and to allocate funds among the defrauded parties was the only effective way to remedy the violations.

In December of 1974, a new medium was legalized for public investment — gold. For a time prior to legalization, anticipation of this change and the concomitant steadily increasing price of gold on the international market led many promoters to devise plans which capitalized on gold and silver fever. In most instances, the public investors who put money into these ventures did so on a highly leveraged basis, planning to reap vast profits as the price of precious metals spiralled higher and higher.

These ventures did not escape the attention of the SEC. In December 1974, the SEC filed an action against the Pacific Coast Coin Exchange,[43] the nation's largest seller of margin contracts in gold and silver coins. The SEC alleged fraud in connection with the sale of coin contracts, charging that the defendants had sold $1 billion of these contracts to approximately 25,000 people since 1970. The SEC's complaint alleged that the sales were in violation of the registration requirements of the 1933 Act[44] and the various anti-fraud provisions of both the 1933 and 1934 Acts.[45] The critical substantive issue was

[43]SEC v. Monex Int'l, Ltd., SEC Litigation Release No. 6638 (Dec. 12, 1974).

[44]Securities Act of 1933 § 5, 15 U.S.C. § 77e (1970).

[45]Securities Act of 1933 § 17(a), 15 U.S.C. 77 (e) (1970); Securities Exchange Act

whether the sale of the margin contracts involved the sale of a "security."[46] In addition to the prayer for the usual injunctions, the SEC requested that a receiver be appointed to take control of the defendant company and its assets.

In its complaint, the SEC alleged that the $1 billion in sales generated by the Exchange resulted from a "nationwide, polished, hard sell, fraudulent promotional and marketing campaign . . . ."[47] The Commission charged that the operation was replete with fraudulent misrepresentations and material omissions, that the defendants levied exorbitant charges for services never performed, that the defendants arbitrarily fixed silver prices to maximize the Exchange's profits at the expense of investors, and that the defendants employed scare tactics to pressure investors into unwisely large margined investments in coin contracts. The SEC further charged that the defendants failed to disclose to the investors that they were using their funds to acquire a jet airplane, a cattle operation and a gold mine, and that substantial personal loans were made to Exchange officers and their associates from investors' funds. The SEC also alleged that about 75% of the customers' positions were covered by hedging in the futures market in silver bullion and not by silver coins stored in depositories as the defendants had represented, and that the Exchange did not own any depositories, although a list of depositories appear in the Exchange's advertisements.

The SEC's complaint stopped short of alleging the existence of a Ponzi scheme, but a between-the-lines reading of the allegations indicates that a Ponzi probably existed. A continually expanding base of investors was involved, funds were diverted, and whatever "profits" were returned to investors apparently came from new investors' infusions of cash.

The Ponzi scheme element was clearly present in similar cases brought by the SEC, such as *SEC v. Western Pacific Gold & Silver Exchange Corp.*[48] In this case, the SEC charged that the defendants sold unregistered securities[49] in the form of investment interests in gold coin and silver, which were represented by written agreements.

of 1934 § 10(b), 15 U.S.C. § 78j (1970).

[46]The SEC's theory appears to be that the commingling of investors' funds and reliance by the investor upon the Exchange in anticipation of a profit were sufficient to create a security in the form of an "investment contract." *See, e.g.*, SEC v. W.J. Howey Co., 328 U.S. 293 (1946); SEC v. Koscot Interplanetary, Inc., 365 F. Supp. 588 (N.D. Ga. 1973) for an analysis of the concept of an investment contract.

[47]SEC Litigation Release No. 6638.

[48]SEC Litigation Release No. 6616 (Dec. 3, 1974).

[49]In violation of § 5 of the Securities Act, 15 U.S.C. § 77e (1970).

In addition, the Commission alleged violations of the anti-fraud provisions of the 1933 and 1934 Acts[50] by virtue of material misrepresentation and omissions in connection with the sale of these interests. Specifically, the SEC charged that the defendant corporation was insolvent, that the investors' funds were not used to acquire silver and gold coins but were converted to the defendants' use, and that the method of operation of the defendants involved repaying existing investors by raising money from other investors. In summary, the SEC alleged that the operation was both a Ponzi scheme and outright thievery.

The Commission sought the standard injunction against future violations of the registration and anti-fraud provisions. It also requested ancillary relief in the form of:

> [A]n order restraining and enjoining the defendants from altering, destroying, concealing, disposing, dissipating, or removing any books, records, documents, correspondence, funds, or assets . . . , an order appointing a receiver of all assets and property of the defendants . . . , an order requiring the defendants to provide the court with an accounting . . . , and an order requiring the defendants to disgorge any and all funds or silver which they have received . . . .[51]

On January 30, 1975, the court entered a preliminary injunction order against the defendant, which prohibited violation of the registration and anti-fraud provisions of the '33 and '34 Acts. The order further granted the ancillary relief requested by the SEC, including the appointment of a receiver. In addition, the court determined that the interests sold by the defendants involved "securities" within the statutory definition of that term.[52]

In a series of similar cases involving gold and silver investments, the SEC has also sought extreme ancillary relief.[53] As with *Western Pacific,* these cases all involved elements of a Ponzi scheme, diversion or conversion of assets, and alleged misrepresentations.

A final case for consideration involves a pyramid scheme. In *SEC*

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[50]Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1970); Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 77j (1970).

[51]SEC Litigation Release No. 6616 (Dec. 3, 1974).

[52]SEC Litigation Release No. 6726, Civil Action No. LV-74-188 RDF (D.C. Nev. Feb. 11, 1975).

[53]SEC v. Silver Mint Mortgage Co., Ltd., SEC Litigation Release No. 6585 (Nov. 14, 1974); SEC v. Constitution Mint, Inc., SEC Litigation Release No. 6586 (Nov. 14, 1974); SEC v. Continental Silver Corp. of Nevada, SEC Litigation Release No. 6604 (Nov. 14, 1974).

v. Futuristic Foods, Inc.,[54] the Commission alleged that defendants were "operating a pyramid promotional scheme whereby persons who invest substantial sums of money to purchase interests or participations in Futuristic Foods, Inc., will then attempt to locate other prospective investors for the defendants to recruit."[55] Charging violations of the registration provisions of the 1933 Act and of the anti-fraud provisions of the 1933 and 1934 Acts, the Commission requested the standard injunctions along with the following ancillary relief:

> [T]he appointment of a receiver to marshall and collect all the assets of Futuristic Foods, Inc. in order to prevent waste and dissipation of corporate assets; that an accounting be performed; and that rescission offers be made to all persons who invested in the Futuristic Foods, Inc. promotional scheme. The Securities and Exchange Commission has alleged that monies of approximately $1,000,000 have been obtained by the defendants illegally since January, 1973, to date.[56]

The common thread which emerges from the Commission's requests for relief in these cases is that the SEC has not hesitated to use its enforcement powers in attempting to obtain far more than the statutory injunctions against Ponzi and pyramid schemes. Companies have been closed down and the SEC has assumed virtually total control over the operations of some defendant corporations. Thus, the Ponzi and pyramid schemes emerge as the types of violations which the SEC will uniformly seek to remedy by broad forms of ancillary relief, generally including a receiver. The Commission's rationale appears to be that the continued operation of such schemes will by their very nature result in more violations as later levels of participants are brought into the operations. This factor, plus the absence of any economic substance to the schemes, emerges as the basis for the SEC's apparent conclusion that relief confined to disclosure is inadequate.

IV. *Internal Corporate Procedures As a Form of Ancillary Relief*

Ponzi and pyramid schemes are sensational merely by virtue of their blatant nature and the sometimes staggering sums of money involved. Consequently, such operations and the resulting SEC enforcement cases seem to lack any logical relationship to the tradi-

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[54] SEC Litigation Release No. 6506 (Sept. 5, 1974).
[55] *Id.*
[56] *Id.*

tional corporate enterprise. Yet, there is a distinct connection in light of the recent remedies sought by the Commission in both areas.

Recent cases against traditional corporations have involved the appointment of special auditors or masters to investigate the affairs of the allegedly offending company and to make public reports of the results of the investigation. They have also resulted in the appointment of special counsel to do the same, the addition of new outside directors, and orders that the offending corporation adopt certain internal controls or procedures to prevent future violations. In each instance, the result is the imposition of a quasi-governmental layer of authority which deprives incumbent management of its absolute control over the internal affairs of the corporation, although perhaps not totally displacing incumbent management with a court-appointed receiver as has frequently occurred in the Ponzi cases. Yet, the logic behind the relief sought in the Ponzi cases and some of those discussed below is essentially the same; *i.e.*, that mere injunctions against future violations are inadequate and that existing management must be replaced or restructured to prevent recurrences of the alleged violations.

One of the more informative cases involving internal corporate restructuring as the result of an enforcement action is *SEC v. Mattel, Inc.*,[57] which was settled in October, 1974. The case actually involved an original consent order and a subsequent amendment to the original decree. The original consent decree settled an SEC case alleging that Mattel, a financially troubled toy maker, misrepresented a projected fiscal 1973 profit when it had reason to know that it would have a $32 million loss for 1973. In addition to the standard anti-fraud injunctions, the original order required Mattel to name two unaffiliated directors and to establish two committees, a Financial Controls and Audit Committee and a Litigation and Claims Committee. The first committee was to institute internal procedures to assure that recurrences of the defective financial reporting violations did not occur. The second committee was to investigate whether and upon what basis Mattel might have claims against its present or past officers and directors arising out of violations by them of the federal securities laws.

The amended order was entered as the result of additional information subsequently disclosed by Mattel to the SEC. This information indicated that Mattel may have overstated its 1971 pre-tax in-

[57] SEC Litigation Release No. 6531 (Oct. 2, 1974); SEC Litigation Release No. 6467 (Aug. 8, 1974).

come by as much as $10.5 million, as well as overstating its revenues for.its second and third quarters of fiscal 1972 by $6.8 million. Under the amended decree, Mattel was required to take the following further action:

> (i) appoint and maintain a Board of Directors, a majority of which should be unaffiliated with Mattel, satisfactory to the Commission and approved by the Court,
> (ii) maintain a majority of the new unaffiliated directors on its Executive Committee;
> (iii) amend its filings with the Commission . . . ;
> (iv) a majority of the new unaffiliated directors to appoint a Special Counsel, satisfactory to the Commission and approved by the Court, to investigate matters raised in the Commission's complaint . . . ; to file a report with the Court of his findings and recommendations, and as approved by the new directors, institute actions on behalf of the Company against past or present officers, directors, and others; and,
> (v) the Special Counsel to retain a Special Auditor satisfactory to the Commission, the Court and Mattel, to audit the 1971 and 1972 financial statements and other statements as requested, and to file within four months a report of his findings with the Court and the Commission.[58]

In addition, Mattel publicly announced that during its negotiations with the SEC relating to the settlement it had agreed to eliminate the position of chairman, which was held jointly by the company's cofounders, who would, however, continue as directors.

Although Mattel neither admitted or denied the accuracy of any of the substantive allegations of the SEC's complaint nor the accuracy of the information which gave rise to the amended decree, to those who have not followed recent developments the scope of the relief agreed to is startling. As a result of the new unaffiliated directors who are required to determine whether to sue former management and to publicize the grounds for the suit, the Special Counsel who must make an investigation and file a public report, and the Special Auditor who is to conduct a special audit, effective control over the corporation was removed from incumbent management. While an outright receiver was not sought, the relief obtained is just as comprehensive from a practical standpoint.

Some foreshadowing of the *Mattel* decree can be found in *SEC v.*

[58]SEC Litigation Release No. 6531 (Oct. 2, 1974).

Great Coastal Gas Corp.[59] As with *Clinton Oil,* a former SEC Commissioner publicly praised *Great Coastal* as representing a great step forward in the SEC's enforcement process and as an example of structuring new and effective decrees to fit the violations.[60]

Great Coastal was based on a series of alleged violations of the anti-fraud provisions[61] and reporting requirements[62] of the 1934 Act. Generally, the alleged misrepresentations and omissions related to discussions concerning Great Coastal's gas reserves and the ability to deliver production to consumers. As part of the consent decree, a major change in the management of Great Coastal occurred. The number of directors was increased from ten to thirteen, with six new independent directors satisfactory to the SEC to be designated by the court and elected by the directors. In addition, a new Executive Committee comprised of three people, two of whom were to be designated by the court and approved by the Commission, was to be elected. At the company's expense, the Executive Committee was to "retain independent legal counsel to advise them regarding their functions as directors or as members of the Executive Committee, or as to any other related matters which may arise."[63] The settlement of the case also involved the appointment of an independent audit committee consisting of three members, the majority of whom were to be new, unaffiliated members of the board.

In assessing the significance of this decree, two major factors quickly emerge. First, the appointment of the new independent directors, executive committee, and audit committee deprived incumbent management, alleged to be the principal wrongdoers, of their dominant control over Great Coastal. Thus, these former insiders were forced to deal with disinterested directors[64] and to persuade them that particular actions were wise and legal before committing the corporation to a course of action or consummating a particular transaction.

The second significant factor emerging from *Great Coastal* is the requirement that the Executive Committee retain independent counsel. This is a novel aspect of the decree and appears to be intended to ensure through outside legal advice that the independent directors will be an effective influence. Generally, corporate counsel advises

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[59]SEC Litigation Release No. 6054 (Sept. 12, 1973).

[60]Speech of former SEC Commissioner Hugh Owens before the North American Securities Administrators, September 1973.

[61]Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (1970).

[62]Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m (1970).

[63]SEC Litigation Release No. 6054 (Sept. 12, 1973).

[64]To insure that the new directors are in fact disinterested, the decree provided that they must be persons acceptable to the SEC.

directors as a group. In an industrial and commercial corporation it is unusual for committees of directors to have different counsel. Corporations generally have a long-standing relationship with counsel, and a court-ordered intrusion by new, outside counsel is a significant deviation from the norm. The significance of this portion of the decree can readily be imagined by picturing the disruption, confusion and disagreement in the board room when one counsel in good faith recommends one course of action and the second counsel in good faith disagrees.

The message which can be gleaned from *Great Coastal* is that the SEC will go to great lengths to fashion decrees which will restructure management or relieve management of its absolute control over sensitive corporate operations if such relief is necessary because of incumbent management's apparent insensitivity to its obligations under the securities laws.

Another noteworthy case involving the adoption of tailored internal procedures and controls to prevent the repetition of particular violations is *SEC v. General Host, Inc.*[65] In *General Host,* the SEC charged a number of violations of the 1933 Act,[66] the 1934 Act[67] and the Investment Company Act of 1940[68] in connection with General Host's takeover of both Armour & Company and Lil' General Stores, Inc. Violations were also alleged in connection with the two takeovers as a result of transactions involving the Goldfield Corporation. The case was settled by consent, including the entry of the usual injunctions against future violations.

In addition, General Host was ordered by the court to adopt certain internal procedures designed to preclude the future possibility of violations of the nature alleged in the complaint. These procedures were "to be employed in connection with any plan or attempt to acquire control of any corporation . . . by means of a tender offer, exchange offer, merger, consolidation or other business combination in connection with any plan or attempt to acquire control of such corporation."[69] The decree provided, however, that the procedures were applicable only when the corporation sought to be acquired was subject to the reporting requirements of the 1934 Act or has previously made a public offering of its securities.

The procedures General Host was required to adopt included the

[65]SEC Litigation Release No. 6164 (Dec. 13, 1973).
[66]15 U.S.C. § 77a, *et seq.* (1970).
[67]15 U.S.C. § 78a, *et seq.* (1970).
[68]15 U.S.C. § 80a-1, *et seq.* (1970).
[69]SEC Litigation Release No. 6164 (Dec. 13, 1973).

appointment of "an acquisition supervisor" with the authority to supervise all acquisitions, the convening of meetings of officers and directors to advise them of the terms of the consent decree and of applicable federal securities laws, and the periodic convening of meetings to review the progress of any acquisition attempts which are being made. Minutes were ordered to be kept of such meetings, including reports of financing, tenders of shares, and of contacts with outside individuals, underwriters, dealer-managers or other agents. The prescribed procedures also required that provisions be adopted to assure that press releases were accurate. Furthermore, the decree prohibited certain contacts outside General Host.

Another case involving the effective imposition by the Commission of internal controls is *SEC v. Sunshine Mining Co.*[70] In this case, the SEC alleged material defects in the proxy material of Sunshine Mining for three years, in that the proxy material failed to disclose the existence of certain "personal arrangements and agreements" which enabled the Chief Executive Officer of Sunshine and others to acquire control of a second company. Further alleged defects in the proxy material involved failure to disclose various corporate bank deposits which enabled Sunshine directors to obtain loans at the same banks. The SEC's basic allegation was that Sunshine's proxy material was defective by failing to disclose the indirect benefits conferred upon the directors as a result of such transactions.

To settle this case, Sunshine and the other defendants first consented to an injunction against future violations of the proxy provisions of the 1934 Act.[71] In addition, the court ordered Sunshine to institute and comply with internal procedures satisfactory to the SEC. These procedures provided for investigations by a committee of Sunshine's directors to determine whether Sunshine's cash deposits and investments in certificates of deposit and comparable money market instruments issued by banks were made for valid business purposes and whether they conferred any material direct or indirect economic benefit on any director, nominee for director, or executive officer of Sunshine. Sunshine was also ordered to communicate to shareholders the material facts alleged in the Commission's complaint, the substance of the SEC's allegations, and the substance of the terms and provisions of the consent judgment. Such information was required to be given to all stockholders of record prior to the next meeting of Sunshine stockholders for the election of directors.

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[70]SEC Litigation Release No. 6544 (Oct. 11, 1974).

[71]Securities Exchange Act of 1934 § 14, 15 U.S.C. § 78n (1970).

As with *General Host, Great Coastal* and *Mattel*, the *Sunshine Mining* decree was tailored to deal with specific transactions and alleged violations. As a general matter, the *Sunshine Mining* decree is essentially a disclosure decree[72] in that it compels dissemination of information to stockholders. The aspect of the decree that is not related to disclosure, at least potentially, is the appointment of the investigating committee. Looking to the future, what will occur if the committee determines that the transactions were improper? Will the company be compelled to sue the officers and directors involved to avoid being sued itself by irate shareholders? Unfortunately, the decree is silent on this significant point.

It should also be noted that under the decree the company is binding itself to disclose in its forthcoming proxy material certain information, *i.e.*, the details of the criticized transactions. Failure to make such disclosures could involve a violation of the terms of the decree and thus be grounds for a contempt citation.[73] A contempt citation could result even if the transactions were immaterial[74] and nondisclosure otherwise was proper under the proxy rules. In light of these two factors, it would be a mistake to assume that *Sunshine Mining* represents any retreat by the SEC.

SEC v. Canadian Javelin, Ltd.,[75] is another recent case settled by consent which resulted in the creation of various internal controls. *Canadian Javelin* was a lengthy and hotly contested proceeding which began in November, 1973, when the SEC filed a civil injunctive action, generally alleging violations of the registration provisions of the 1933 Act, the making of false and misleading statements, and the filing of false and inaccurate documents with the Commission. More

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[72]As was the decree in the first case analyzed in this article, SEC v. Koenig, 469 F.2d 198 (2d Cir. 1972).

[73]Contempt citations may be issued by federal district courts under their traditional contempt powers upon application by the SEC for such citations.

[74]Schedule 14A (the format for proxy statements) promulgated by the SEC under § 14 of the Securities Exchange Act, 15 U.S.C. § 78n (1970), provides that transactions between an issuer and members of its management are not material and therefore not required to be disclosed if the amount involved does not exceed $40,000. 17 C.F.R. § 240.14a-101 (1974). Another test of "materiality" under the Securities Exchange Act is found in Form 10-K promulgated by the SEC pursuant to § 13 of the Securities Exchange Act, 15 U.S.C. § 78m (1970). In that form litigation is not deemed material and therefore is not required to be disclosed, if the claim for damages does not exceed 10% of the current assets of the company. The general definition of materiality under the Securities Exchange Act, however, is found in Rule 12b-2, which limits materiality "to those matters as to which an average prudent investor ought reasonably to be informed . . . ." 17 C.F.R. § 240.12b-2 (1974).

[75]SEC Exchange Act Release No. 11172 (Jan. 9, 1975).

specifically, the SEC alleged that the defendants issued numerous false and misleading press releases and other statements concerning the company's copper project in Panama and another prior corporate project in Newfoundland. In addition to the usual injunctions against future violations of the securities laws, the SEC sought a special receiver and other ancillary relief.

In July, 1974, the defendants consented to the entry of permanent injunctions against violations of the anti-fraud, reporting, and registration provisions of the securities laws.[76] The judgment entered by the court also required the board of directors of the company to consist of at least 40% outside independent directors[77] satisfactory to the SEC. The company was further ordered to establish a standing compliance committee, a majority of which was to consist of independent outside directors. This committee was to screen and pass upon all information the company disseminated to the public. In addition, the company was required to designate a public information officer responsible for dissemination of all such information and to name a special outside counsel satisfactory to the Commission. Finally, the court ordered the filing with the SEC of all necessary reports and all amendments and supplements thereto as may be required to satisfy the disclosure obligations under the federal securities laws.

In its most basic terms, *Canadian Javelin* is a touting case involving over-aggressive public relations activities, to the extent that they became allegedly deceptive. The relief decreed was structured to deal with the public relations excesses which led to the violations alleged in the SEC's complaint and in that respect represents another tailored decree. Nevertheless, while the *Canadian Javelin* decree essentially focuses upon disclosure, it would again be a mistake to assume that *Canadian Javelin* represents any retreat by the SEC in the enforcement area. The only alleged violations related to disclosure deficiencies, yet a restructuring of the board of directors was obtained. This relief apparently was viewed by the SEC as an adjunct to proper disclosure procedures by placing independent directors in a position to influence disclosure policies. It is noteworthy that the elements of

[76] Securities Act of 1933 § 5, 15 U.S.C. § 77e (1970); Securities Exchange Act of 1934 10(b), 15 U.S.C. 78j(b) (1970); Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m (1970).

[77] The Securities Exchange Act contains no provision which prescribes the required composition of the Board of Directors of a public company. In contrast, § 10(a) of the Investment Company Act requires at least 40% of the directors of a registered investment company to be independent. 15 U.S.C. § 80a-10 (1970). This appears to be the genesis of the independent director requirement of *Canadian Javelin*.

diversion of assets or improper use of funds were not alleged, so that there was no basis whatsoever for seeking a receiver or similar relief.

Sham transactions, diversion of funds, willful falsification of financial statements and results of operations, as well as a series of false filings with the SEC provide the factual background for another case, the settlement of which involved some rather exotic relief. In the complaint filed in *SEC v. Allegheny Beverage Corp.*,[78] the Commission alleged violations of the anti-fraud, registration, reporting, and proxy provisions of the federal securities laws.

The SEC charged that the three corporate and four individual defendants engaged in a sham public debenture offering, "the terms of which required that unless at least $10 million was raised, all monies received were to be returned to investors and the offering discontinued."[79] The Commission alleged that the offering raised only $500,000, but that the defendants created the appearance of having raised $10 million by several sham transactions and thus retained the $500,000. The SEC further contended that the defendants issued misleading press releases and an annual report to stockholders which materially overstated income from the sale of vending machines. The overstatement of revenues and income involved sales of vending machines to new companies in shaky financial condition, for which either no down-payments or very small down-payments were required. Such sales produced $16.7 million in revenues and $3.1 million in income out of the year's total income of $6.9 million. Since the collectibility of the notes arising from many sales was doubtful due to the precarious financial condition of the machine purchasers, the Commission argued that revenue and income should not have been recognized from the receipt of the notes. The SEC further alleged the personal use of $540,000 of corporate funds by the president of the three corporations.

In addition to the usual injunctions against violations of the securities laws, the court's decree included an order for broad ancillary relief directing that:

> 1 The president of the companies pay $70,000 to ABC, reflecting gains from his use of corporate funds and his insider trading, $25,000 of which is to be set aside for compensation for losses to individual purchasers of ABC stock alleged to have been sold by the president and other officers in violation of the anti-fraud provisions of the Federal securities laws;

[78]SEC Litigation Release No. 6670 (Jan. 8, 1975).
[79]*Id.*

2 A special agent be appointed to confirm the return to ABC by the president of $540,000 of corporate funds alleged by the SEC to have been personally used by the president;
3 ABC establish an independent audit committee, composed of unaffiliated persons acceptable to the SEC and ABC and approved by the Court, to select independent certified public accountants to conduct ABC's annual audits; to approve or disapprove ABC's management decision to change such accountants; to determine the position and policy of ABC in any dispute or disagreement between ABC's management and the independent accountants; and to formulate the position of ABC's management, including the president, in any request by the accountants for any documents or information requested of the president by the accountants;
4 The president make available to ABC's accountants, if needed, in the audit of ABC, any personal documents or other materials requested by the accountants;
5 The three companies and the president file with the SEC reports containing a full and accurate description of any future transaction, direct or indirect, between ABC and its president; and
6 ABC file with the SEC amended annual and periodic reports in accordance with the allegations of the complaint.[80]

Following the trend of the previously discussed cases, *Allegheny Beverage* is yet another indication of the uniquely tailored forms of relief the SEC may obtain as the price of settling an enforcement case by consent.

A slightly different but nonetheless novel approach was incorporated in the consent decree in *SEC v. Union Planters Corp.*[81] In this case, a bank holding company, its principal bank, a broker-dealer, and various individuals allegedly engaged in a fraudulent scheme in violation of § 10(b) and Rule 10b-5 of the 1934 Act. The alleged scheme principally related to improper valuations and sales of securities in the bank's investment and trading accounts.

Specifically, the SEC's complaint charged that securities which had declined in value since their original purchase were transferred from the Bank's securities trading account to its securities investment account. Since the bank valued securities in the investment account at original cost, no downward valuation or write-down oc-

[80] *Id.*
[81] CCH FED. SEC. L. REP. ¶ 95,003 (W.D.Tenn. Feb. 7, 1975).

curred. The SEC further alleged that the various defendants created an arrangement whereby the Bank from time to time would sell certain securities to the broker-dealer at prices in excess of the market value of the securities. Such transactions enabled the Bank either to conceal losses which otherwise would have occurred or to report inflated trading account profits. At the same time, the Bank entered into an arrangement with the broker-dealer to repurchase the securities at a later time and to guarantee the broker-dealer against any losses on the transactions.

To settle this case, the defendants consented to court-ordered undertakings in lieu of injunctions against future violations of the anti-fraud provisions of the 1934 Act.[82] In addition, the bank holding company and the Bank undertook to establish certain detailed procedures to prevent future violations, which were incorporated in the court order.[83] The undertakings are lengthy, but deserve consideration in their entirety because of their novelty and potential significance. They include the following:

> 1 The preparation and circulation not less frequently than semi-annually to each officer, trader or salesman in the Investment Division of an extract of the applicable current Rules of Fair Practice of the NASD;
> 2 The review of the Investment Division, at least annually, under the direction and guidance of the chief administrative officer of the Company, with the advice and assistance of his chief financial officer and legal counsel, to insure that its policies and procedures with respect to both the Trading Account and Investment Account and the legal, accounting and record keeping requirements and procedures in the Division and its Operations Department are in compliance with applicable law;
> 3 The preparation of written guidelines to Trading Account and Investment Account policies including: types of securities, general mix of securities, maximum underwriting positions, reporting of losses, valuation procedures, reporting slow moving inventory, concessions on purchases and sales, forbidden transactions and approvals and review of transactions;
> 4 The written confirmation by the officers, traders and salesmen in the Investment Division of the trading and investment policies and guidelines;

[82] *Id.*
[83] *Id.*

5 The preparation and circulation to all appropriate personnel of a detailed statement of accounting policies and requirements for security transactions within the Investment Division, covering the trading account, investment account, and special situations such as: short sales, arbitrage transactions, commercial paper and money market activity including federal funds, securites sold under agreements to repurchase, securities purchased under agreements to resell, and certificates of deposits sold to New York banks;
6 The implementation of a continuing training program for the Investment Division's personnel, including a periodic review of previously established policies;
7 The continuous review by the Manager of the Investment Division, with the advice of counsel, of legal developments relating to applicable securities activities and the dissemination of legal advice defining illegal activities, including free riding to all personnel in the Investment Division and periodic confirmation of such personnel that any employee is subject to immediate dismissal who (1) engaged in any practice or activity which is either illegal or contrary to established Bank policy or procedures or (2) invests personally, whether directly or indirectly, in any security other than with the limitations established by the Division without the specific approval of the Manager;
8 The monthly reporting by the Operations Department of the Investment Division, with responsibility for the orderly handling of paperwork, book entries and the implementation in that Division of the Bank's accounting policies and requirements, to both the Manager of the Bond Investment Division and the Bank's Financial Division;
9 The maintenance as soon as practicable hereafter of the books and records of the Investment Division relating to all securities transactions and positions in accordance with the applicable provisions of Regulation 240.17a-3 under Section 17 of the Exchange Act;
10 The establishment of a management committee to include at least three outside directors of the Bank to supervise specifically the Investment Division and transactions involving its Investment Account and Trading Account, which Committee shall meet at least monthly and shall submit to the Board of Directors regular reports on the status and operations of that

Division.[84]

This case has two noteworthy features. The first is the internal procedures and controls which the Bank agreed to adopt. The procedures are quite extensive and relate directly to the internal operations of a national bank which is subject to extensive regulation by federal banking authorities. From the standpoint of regulatory agency jurisdiction, one must wonder why these internal procedures and improvements were not mandated by banking authorities rather than in the context of settlement of an SEC enforcement case. Traditionally, banks have objected vociferously to any efforts by the SEC to exert jurisdiction over banking matters, even in such less controversial areas as bank stock transfer agent operations. The intrusion of the SEC into the internal operations and procedures of a bank in the context of a Rule 10b-5 proceeding potentially represents greater substantive SEC control over banks than many authorities have ever imagined.

The second significant factor of the *Union Planters* settlement is that no injunction was entered. In lieu of injunctions embodying the foregoing procedures as mandatory relief, the Bank agreed to court-ordered undertakings in lieu of injunctions which were made part of the court order. Since this case was settled by consent, the order contains no explanation of the rationale supporting the use of undertakings as opposed to injunctions. A between-the-lines analysis of the complaint and the final decree gives rise to one possibility. That possibility is that the alleged fraudulent scheme was essentially an individual frolic by some of its officers and employees, lacking the approval, condonation or even knowledge of the senior officers and directors of the Bank. If so, this may have been the bargaining tool which convinced the SEC to settle on the basis of undertakings, which seemingly constitute less of a stigma than injunctions.

It is interesting to note that no provision of the '33 or '34 Acts refers to undertakings or to any power of the SEC to seek compliance with undertakings by way of motions for contempt citations. However, it seems highly unlikely that the SEC would accede to such a settlement unless it were confident that it could compel compliance. This apparent power, coupled with the fact that the Bank continues to be subject to internal regulation by banking authorities, may well have been the controlling factors in dictating this unique settlement.

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[84] *Id.*

V. *Political Campaign Contributions and Ancillary Relief*

The Watergate aftermath has produced other interesting examples of ancillary relief in SEC enforcement action. Based on the few cases which have arisen in this context, it seems abundantly clear that the Commission regards this area as one which requires ancillary relief in all instances. The background for these cases generally involves an allegation by the SEC that proxy material or periodic reports filed with the SEC are defective because such documents failed to disclose that the corporation and its executives made illegal campaign contributions from corporate funds.

The first significant example of such a case is *SEC v. American Shipbuilding Co.*[85] In *American Shipbuilding*, the SEC sued American Shipbuilding and its president, George Steinbrenner, also the president and principal owner of the New York Yankees, alleging various violations of the proxy and reporting rules of the SEC in that American Shipbuilding failed to disclose and/or concealed the fact that it was making various political contributions from corporate funds, in violation of federal election and campaign laws. The SEC also alleged that American Shipbuilding maintained a secret slush fund composed of corporate funds, which various executives were using to make political campaign contributions in an effort to elect public officials favorable to the corporation.

To remedy these alleged violations, the SEC sought various forms of relief, including the customary injunction against future violations and the correction of prior filings with the SEC. In addition, the SEC sought repayment by Mr. Steinbrenner of all campaign contributions made by him with corporate funds, and the appointment of a special master to examine American Shipbuilding's books and records to determine its financial position and to report to the stockholders and the SEC all corporate funds illegally used for political purposes. The case was settled by consent without any admission or denial of violations of the securities laws.

The aspect of most significance is the special master, having full access to all corporate records, the power to interview various corporate officials and the power to publish potentially damaging reports. In *American Shipbuilding*, management has not been displaced. In fact, material inaccuracies[86] in financial statements may not exist. In addition, there is no allegation of diversion of funds in the sense of

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[85]SEC Litigation Release No. 6532 (Oct. 4, 1974).

[86]The amount of money involved could easily be immaterial in comparison to the assets of the company, particularly if the company were a major corporation.

personal profit.

Despite the absence of violations of such an egregious nature, a special receiver was still sought. Furthermore, without any basis for concluding that the corporation and its management would not comply voluntarily with a court decree ordering full disclosure,[87] the control over that disclosure was delivered to an outside party. This is the most significant factor in the case, and one can only speculate that the SEC has concluded that violations of federal campaign contribution laws are so outrageous that anyone who has engaged in such activity cannot be relyed upon to comply with a decree of a federal court.

The rationale for such a conclusion by the SEC is weak, if not totally unwarranted, but no other basis for the SEC's actions is readily apparent. There are many instances in which corporate officers cause a corporation to commit acts which violate some provision of state or federal law. But it is inconceivable that such action automatically demonstrates that the executives are so callous that they would disregard a federal court's injunction. The basis for determining that violations of federal campaign contribution laws are more reprehensible than violations of, *e.g.*, the Occupational Safety and Health Act,[88] appears non-existent.

SEC v. Minnesota Mining and Manufacturing Co.[89] may be an even more significant case involving ancillary relief where the alleged securities laws violations are based upon concealment or nondisclosure of illegal corporate political contributions. 3M is one of the largest corporations in the United States and a highly regarded member of the major corporate community, factors which lend great significance to the decree ultimately entered in settlement of the SEC's action.

In its complaint, the Commission charged that 3M, its chairman, and two former officers violated the federal securities laws by concealing the existence of a $634,000 slush fund from which 3M made political contributions. The SEC alleged that 3M and the individual defendants disguised the fund by falsifying the corporation's books and records and by filing false proxy material and false periodic reports with the SEC.

Settlement of the action was by consent, without any admission

[87]A determination by the court that the defendants cannot be relied upon to comply with the terms of an injunction has been cited as the rationale behind ancillary relief, such as a receiver. *See, e.g.*, SEC v. Koenig, 469 F.2d 198, 202 (2d Cir. 1972).

[88]29 U.S.C. § 651, *et seq.* (1970).

[89]SEC Litigation Release No. 6711 (Feb. 10, 1975).

or denial of violation of the law. In addition to injunctions against proxy and periodic reporting rule violations, the court also enjoined the defendants from using corporate funds for illegal political purposes. In sum and substance, this amounts to enforcement by the SEC of the federal laws controlling campaign contributions, not merely the enforcement of the federal securities laws. Furthermore, the court ordered 3M to appoint a special agent approved by the SEC to investigate and report on whether 3M had disguised the real use of other corporate funds. Finally, the three individual defendants were ordered to pay or to arrange for the payment of at least $425,000 in order to reimburse 3M for their improper expenditures.

There are at least two aspects of this consent decree which deserve note. First, the making of illegal campaign contributions is not, in and of itself, a violation of the federal securities laws. The violation would occur only if the transaction rose to the level of materiality[90] requiring its disclosure in SEC filings, and such disclosures were not made. Yet the injunction entered enjoins not only violations of the securities laws arising from nondisclosure, but also violations of federal campaign contribution laws.

Second, a special investigative agent was appointed. This was done notwithstanding the fact that the injunction also enjoined 3M from failing to disclose other such illegal contributions. The appointment of a special agent in addition to a federal court order directing full disclosure must be based on some determination that the defendants could not be relied upon to follow the court's directive, even in light of the powers of the court to compel compliance by way of contempt proceedings, civil and criminal. As was pointed out in *SEC v. Koenig*,[91] one rationale for the appointment of a limited disclosure receiver was the district court's conclusion "that it [could not] rely on defendants to implement the direction [order] of the Court."[92] The question must be asked either whether 3M qualifies as such a recalcitrant defendant or whether the SEC views the concealment of illegal campaign contributions as so abhorrent that its existence proves that defendants cannot be relied upon to comply voluntarily with the Court's injunction.

[90] *See* note 74 *supra*, for a discussion of the term "material." With a corporation the size of 3M, a compelling argument can be made that $634,000 is immaterial in terms of the overall financial position of the company. This factor lends credence to the theory that, in the political contribution area, the SEC is focusing on the nature of the violation rather than the amount involved.

[91] 469 F.2d 198 (2d Cir. 1972).

[92] [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,536, at 92,561 (S.D.N.Y. 1972).

These are serious considerations, especially when corporate defendants with highly respected directors, auditors, and counsel are involved. In addition, the fact that authorities other than the Commission have jurisdiction over the enforcement of federal election laws raises yet another question as to the propriety of such deep SEC involvement.

VI. *Ancillary Relief and Proceedings Against Professionals*

Thus far, only cases involving commercial corporations and individuals associated with them have been discussed. Yet, there is another area of SEC enforcement activity involving forms of ancillary relief of great significance. That involves the growing number of actions involving professionals, primarily accountants and lawyers. As with corporate defendants, some recent proceedings involving professionals have been settled in a manner involving forms of ancillary relief.

In instituting proceedings against professionals, the SEC has general power to commence injunctive actions under the '33 and '34 Acts,[93] as well as special powers contained in the SEC's Rules of Practice.[94] Rule 2(e)(1),[95] which governs professionals practicing before the SEC, provides:

> The Commission may deny, temporarily or permanently the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of and opportunity for hearing in the matter (i) not to possess the requisite qualifications to represent others, or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the federal securities laws (15 U.S.C. § 77a to 80b-20), or the rules and regulations thereunder.

Further powers are conferred upon the SEC by Rule 2(e)(3):[96]

> The Commission, with due regard to the public interest and without preliminary hearing, may by order temporarily suspend from appearing or practicing before it any attorney, ac-

[93]Securities Act of 1933 § 20(b), 15 U.S.C. § 77t(b) (1970); Securities Exchange Act of 1934 21(e), 15 U.S.C. § 78u(e) (1970).

[94]17 C.F.R. § 201.1, *et seq.* (1974).

[95]17 C.F.R. § 201.2(e)(1) (1974).

[96]17 C.F.R. § 201.2(e)(3) (1974).

> countant, engineer, or other professional or expert who, on or after July 1,1971, has been by name
> (a) Permanently enjoined by any court of competent jurisdiction by reason of his misconduct in an action brought by the Commission from violation or aiding and abetting the violation of any provision of the Federal securities laws (15 U.S.C. § 77a to 80(b)-20) or of the rules and regulations thereunder; or
> (b) Found by any court of competent jurisdiction in an action brought by the Commission to which he is a party or found by this Commission in any administrative proceeding to which he is a party to have violated or aided and abetted the violation of any provision of the Federal securities laws (15 U.S.C. § 77a to 80b— 20) or of the rules and regulations thereunder (unless the violation was found not to have been willful).

The SEC views all of its proceedings, including those against professionals, as remedial in nature and not punitive.[97] In fact, the SEC does not have the power to levy punitive sanctions upon professionals, such as fines, but can impose only such sanctions as will correct prior deficiencies and assure future compliance. This general background and the interrelation between the 1933 Act, the 1934 Act and the Rules of Practice should be kept in mind when evaluating the significance of several recent proceedings against professionals which involve novel ancillary relief.

An administrative proceeding against the nationally-known accounting firm of Laventhol, Krekstein, Horwath & Horwath (LKH&H)[98] is the first such proceeding. It arose out of an injunctive action brought by the SEC against a limited partnership engaged in various investment activities.[99] The financial statements of the partnership were certified by LKH&H. The SEC alleged that the financial statements were defective, inaccurate, and presented a misleading picture, and that the audit conducted by LKH&H was not in accordance with generally accepted auditing standards. Without admitting or denying the alleged violations, LKH&H consented to an injunction against future violations.

Subsequently, the Commission commenced an administrative

[97] The Courts have also ruled that the SEC cannot impose or seek to impose penalties but is limited to relief of a remedial nature in all proceedings. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1968).

[98] *In re* Laventhol, Krekstein, Horwath & Horwath, SEC Exchange Act Release No. 10172 (May 23, 1973).

[99] SEC v. Everest Mgt. Corp., 495 F.2d 1236 (2d Cir. 1972).

proceeding against LKH&H under Rule 2(e)(3) of the Rules of Practice, based upon the entry of the injunction against LKH&H by name. As part of the settlement of the administrative proceeding, LKH&H agreed to adopt various internal controls and procedures, some of them subject to prior approval by the SEC, to preclude future violations of the type alleged in the SEC's complaint. The controls and procedures are lengthy but are worth considering in detail in view of the implications of this case.

First, LKH&H agreed to permit an investigation within 15 months from the entry of the injunction, to ascertain whether LKH&H was conducting its accounting and auditing practice in compliance with the standards and procedures they were required to adopt and maintain under the injunction. This investigation was to be conducted in accordance with methods and procedures generally adopted or approved by the SEC, and furthermore, was to be at the expense of LKH&H. At the option of the Commssion, this investigation was to be conducted either by a team of qualified professional accountants composed of persons selected for that purpose by the American Institute of Certified Public Accountants, or by a team of qualified professional accountants composed of persons selected by the Chief Accountant of the SEC: (i) from among persons designated by the AICPA, or (ii) in the event that the AICPA did not designate such persons within twelve months from the date of the injunction, from among members of the AICPA; or (iii) from members of the staff of the SEC. Such an investigation by fellow professionals is often referred to as "peer review" and the concept has generated great controversy among the accounting profession and members of the securities bar. The reasons for the controversy are self-evident, and the implications for other professionals as well as the accounting profession are extensive.

In addition to peer review, LKH&H agreed for one year not to merge with or acquire any other accounting firm without first submitting to the Chief Accountant of the SEC evidence that LKH&H's internal procedures with respect to mergers and acquisitions of other accounting firms required by the injunction were being followed. This control was designed to eliminate the possibility that a newly acquired accounting firm would not be sufficiently familiar with the procedures and controls LKH&H had agreed to adopt and employ in connection with future audits. Finally, for a period of thirty days, LKH&H agreed not to accept or undertake any new professional engagement which could be expected to result in filings, submissions or certifications with the SEC within one year.

Shortly after the *LKH&H* decision, another nationally-known accounting firm settled an SEC administrative proceeding on a similar basis. This case involved the widely-respected accounting firm of Touche Ross & Co.[100] and arose out of Touche Ross' audit of certain financial statements of U.S. Financial, Inc., a controversial and highly publicized company. In the administrative proceeding, the SEC concluded that the audit in question was not conducted in accordance with generally accepted auditing standards. This determination was made despite the fact that Touche Ross was intentionally deceived by U.S. Financial's officers and directors, who furnished false information and made various misrepresentations to Touche Ross in connection with the audit. Touche Ross' principal defense was that a proper audit would not necessarily have uncovered intentional falsification, that any violation lay with the client and that an accounting firm should not be responsible under such circumstances.[101] The SEC found this argument unconvincing.

Touche Ross was censured by the Commission and additionally agreed to adopt internal procedures and controls "designed to improve the firm's professional practices."[102] The procedures include a specific review in all future audit engagements to determine if there was any private involvement by management or other related persons in corporate transactions reflected in the financial statements under examination. Touche Ross also agreed to conduct a review of all of its branch offices by its national staff at least once every two years. Touche Ross further agreed to an investigation after a period of one year under the jurisdiction of the SEC as to the extent of compliance with the procedures adopted. Finally, the San Diego office of Touche Ross was prohibited from accepting any new professional engagements for twelve months, and Touche Ross generally was prohibited from accepting any new clients in the real estate development field until the Commission's Chief Accountant was satisfied that the firm had adopted adequate audit guidelines and programs for such clients.

The *Touche Ross* settlement represents another tailor-made decree. U.S. Financial was involved in real estate development, and the

[100]*In re* Touche Ross & Co., SEC Securities Act Release No. 5459 (Feb. 25, 1974).

[101]The issue of auditors' responsibility for detecting fraud in the normal conduct of an audit is one of the most hotly debated current topics. A great deal of this debate is attributable to the Equity Funding Corporation scandal of 1973, involving willful falsification of corporate records by insiders not detected in annual audits which had the effect of creating millions of dollars of false assets. *See* SEC v. Equity Funding Corp., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,917 (C.D. Cal. 1973).

[102]SEC Securities Act Release No. 5459 (Feb. 25, 1974).

principal alleged deficiencies in their financial statements related to the handling of transactions between the corporation and affiliated persons. Even in light of the neatly tailored nature of the decree, the fact remains that the settlement involved far-reaching remedies, direct intrusion into the affairs of responsible professionals and governmentally-dictated standards of professional responsibility. The desirability of such a development or trend may be either appalling or praiseworthy, depending upon personal viewpoints and political philosophy. To underestimate the significance of these decisions is, however, to ignore reality at substantial risk.

Carrying further the trend initiated by *LKH&H* and *Touche Ross*, more comprehensive sanctions were levied on the accounting firm of Benjamin Botwinick & Co.[103] in early January, 1975. The *Botwinick* administrative proceeding was an off-shoot of a civil injunctive action brought by the SEC against Allegheny Beverage Corporation.[104] Among other things, the SEC alleged that Allegheny and Botwinick caused false and misleading financial statements to be filed with the SEC, which were audited by Botwinick. Both the corporation and the accountants consented to certain injunctions, without admitting or denying the allegations of the SEC's complaint.

The Commission then commenced a companion administrative proceeding against Botwinick under Rule 2(e)[105] of the SEC's Rules of Practice, based upon the entry of the injunction against Botwinick. This administrative proceeding was also settled by consent. Under the terms of the settlement, the SEC barred Botwinick from any audit or accounting engagements for public companies for ten months, barred a Botwinick partner involved in the Allegheny audit from practicing before the SEC as a Botwinick partner for ten months, ordered the partner to take 100 hours of continuing professional education during the ten-month period, ordered that each Botwinick partner annually attend at least forty hours of similar instruction, and ordered peer review of Botwinick's auditing procedures in general.

The bars from practicing and from accepting future business and the peer review sanction are not surprising in light of *LKH&H* and *Touche Ross*. The education requirement is a novel remedy, however. The imposition of such a sanction compels one to surmise that the SEC felt that the underlying defects were the result of inadequate professional training or insufficient familiarity with current develop-

[103] *In re* Benjamin Botwinick & Co., Adm. Proc. File No. 3-3518 (Jan. 15, 1975).
[104] SEC Litigation Release No. 6670 (Jan. 8, 1975).
[105] 17 C.F.R. § 201.2(e) (1974).

ments. Yet the fact remains that the Botwinick partners were all licensed public accountants who had previously demonstrated their professional competence.[106]

By imposing continuing professional education requirements, the SEC is intruding directly into the internal affairs of licensed professionals with potentially far-reaching consequences. In point of fact, it could be argued that this represents a form of "negative licensing power" on the part of the SEC. Accountants, lawyers, and other professionals are not now required to pass a test administered by the SEC, and the trend at administrative agencies has been to eliminate such tests. Nevertheless, in order to maintain its ability to practice before the SEC, the Botwinick firm was required affirmatively to demonstrate its professional competence and a level of current training.

Once again, the implications of this development are extensive. Whether they are desirable or appalling may depend upon one's philosophical viewpoint, but the fact remains that the SEC is involving itself to an increasing degree in the internal operations of accounting firms.

The liabilities of lawyers under the federal securities laws have been and remain ill-defined in comparison to the accounting profession. Until the landmark case of *SEC v. National Student Marketing Corp.*,[107] in which a prominent Wall Street law firm was named as defendant, the legal profession had been relatively unscathed. But *National Student Marketing* was followed by *SEC v. Spectrum, Ltd.*,[108] and it is apparent that lawyers are now fair game. The lawyer

[106] By, among things, passing the necessary examinations to become certified public accountants.

[107] 360 F. Supp. 284 (D.D.C. 1973). *National Student Marketing* is a landmark case dealing with attorney's liabilities under the federal securities laws. Named as a defendant was a prominent Wall Street law firm, which the SEC alleged had participated in various fraudulent acts. This case is still pending against the law firm, but the mere act of the SEC in filing such an action has prompted a broad examination of attorneys' responsibilities under the securities laws.

[108] 489 F.2d 535 (2d Cir. 1973). *Spectrum* arose out of sales of large blocks of unregistered stock which were made in reliance upon counsel's opinion that such sales were exempt from registration. The Second Circuit ruled that the attorney issuing such an opinion could be an "aider and abettor" of a violation (itself a violation of the securities laws) if the opinion were wrong and the attorney had acted negligently in rendering the opinion. This represents a change from earlier cases which held an attorney liable for securities laws violations only if he had actual knowledge of the fraudulent scheme plus an intent to further the scheme. The court grounded its imposition of a negligence standard on the following theory: "In the distribution of unregistered securities, the preparation of an opinion letter is too essential and the reliance

practicing under the securities laws can ill-afford an ostrich-like approach; his livelihood and professional reputation may be at stake.

In re Jo M. Ferguson[109] is a recent administrative proceeding against an attorney which involved ancillary relief comparable to that found in *Botwinick, Touche Ross,* and *LKH&H*. Mr. Ferguson and his law firm acted as bond counsel in connection with an offering of revenue bonds sold publicly to finance the construction of a nursing home. The prospectus used in connection with the offering allegedly failed to disclose certain material facts, including, among other things, that the developer had contracted with a local contractor to build the nursing home for $650,000 less than the price the developer was to be paid by the municipality to build the facility, that the "independent" consultant passing on the need for and feasibility of the project was not independent but had a 50% interest in the developer's profits, and that a second feasibility consultant had issued unfavorable reports on the project.

The SEC alleged that because of his review of the prospectus, his pre-existing relationship with the developer in other municipal bond offerings, and other factors which came to his attention, Ferguson should have known of the material omissions from the prospectus, even if he did not know. The SEC contended that Ferguson therefore had willfully aided and abetted violations of § 17(a) of the 1933 Act[110] and § 10(b)[111] and Rule 10b-5[112] of the 1934 Act.

Ferguson submitted an offer of settlement[113] which the SEC accepted, resulting in a censure of Ferguson. In determining whether to accept the settlement offer, the SEC considered certain mitigating factors.[114] These included the fact that Ferguson and his law firm had voluntarily adopted a number of revised internal procedures and controls relating to their involvement in municipal bond offerings. These

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of the public too high to permit due diligence to be cast aside in the name of convenience." *Id.* at 542.

[109] SEC Securities Act Release No. 5523 (Aug. 21, 1974).

[110] 15 U.S.C. § 77q(a) (1970).

[111] 15 U.S.C. § 78j(b) (1970).

[112] 17 C.F.R. § 240.20b-5 (1974).

[113] Procedurally, the fashion in which SEC administrative proceedings are settled usually involves rounds of negotiation between the SEC staff and respondent's counsel, with the results of the negotiations embodied in an offer of settlement submitted by respondent's counsel to the staff. This is then presented to the SEC for its approval or rejection. Rule 8 of the SEC's Rules of Practice specifically authorizes such offers of settlement. 17 C.F.R. § 201.8 (1974).

[114] Mitigating factors are generally spelled out in detail in the offer of settlement as a means of persuading the SEC to accept the offer. Depending on the circumstances, this part of the offer can be quite extensive, as was the case in *Ferguson*.

procedures required that members of the firm meet and discuss all of their active cases every two weeks. Affirmative approval of each partner was required before the issuance of any legal opinion on bond offerings. The firm was also to undertake appropriate investigation when acting as bond counsel, including among other things, obtaining independently-audited financial statements and inquiring into the background of the parties connected with the bond offering. Written evidence of such investigation and the results thereof were then to be reviewed by the partners of the firm. Third, an appropriate "engagement letter" must be prepared and sent to all interested parties before commencing work on any bond offering, emphasizing that the firm's duty is to the issuer and the prospective bondholders. Such letters are required to define the scope of the firm's work as bond counsel and require submission of certain pertinent information. Fourth, in connection with all bond offerings, the firm must require independently audited financial statements, representations from appropriate interested persons concerning the accuracy and completeness of the statements about them in any offering circulars, and a statement from counsel for any lessee or guarantor that such counsel has reviewed the offering circular and is aware of no inaccuracies therein. Finally, the partners and associates of the firm are required at least annually to attend municipal bond workshops and seminars, as part of a continuing legal education program.

This relief is, of course, similar to the *Botwinick* approach. There is, however, a distinct procedural difference between *Botwinick, LKH&H* and *Touche Ross*, as opposed to *Ferguson*. In the three proceedings involving accounting firms, the order for revision of internal procedures, continuing professional education or peer review constituted part of the SEC's order. In *Ferguson*, the only sanction in the order is a censure; the other "sanctions" represent voluntary procedures adopted by Ferguson and his firm, apparently to persuade the SEC to settle the proceeding with only a censure.[115] While this distinction may seem insignificant, it deserves further analysis. Is it possible that the Commission feels that it has greater jurisdiction over accountants than over lawyers, and that the SEC perceives it has greater latitude in fashioning sanctions in cases involving accountants? While there is no basis for this difference under Rule 2(e), historically the SEC has had greater influence over accounting firms than law firms. The *Ferguson* settlement creates the appearance that the SEC may view lawyers and accountants differently, and this

[115] The adoption of these voluntary procedures was recited in the offer of settlement as mitigating factors to persuade the SEC to confine its sanctions to a censure.

possible distinction is therefore well worth noting.

There is one further development in the area of sanctions against professionals which deserves comment, although its relationship to ancillary relief may be indirect. This involves a proposed SEC rule which was issued in 1974 and withdrawn in March 1975 dealing with administrative proceedings against professionals. If adopted, it would have required that all proceedings under Rule 2(e) "shall be public unless the Commission, on its own motion or at the request of a party should direct otherwise."[116] Presently, all such proceedings are non-public unless the SEC directs otherwise.

This proposed amendment prompted strong criticism from the organized bar on the grounds that the function of such a proceeding is to determine if violations have occurred and if sanctions are appropriate. The bar contended that professional reputations based on long years of practice would be severely damaged merely by the publicity engendered by the public announcement of a Rule 2(e) proceeding. Attorneys argued very strongly that a subsequent dismissal of such a proceeding without the imposition of sanctions or findings of violations would not totally restore the good name and reputation of the attorney or law firm involved.

As a result of these strenuous objections, in March 1975 the SEC withdrew the proposed amendment to Rule 2(e)(7). In announcing the withdrawal, the SEC nonetheless took the opportunity to warn all professionals practicing before it that withdrawal of the proposed amendment did not constitute a determination that all future disciplinary proceedings under Rule 2(e) would be private. It stated that there were certain circumstances which could warrant conducting public proceedings against professionals and that the language of existing Rule 2(e)(7) conferred upon the SEC the discretion to order public proceedings when it deemed such proceedings to be in the public interest. The Commission also stated that it had instructed its staff that all professional disciplinary proceedings were to be conducted as expeditiously as possible in order to achieve a prompt resolution of the issues presented. It further noted that if private proceedings against professionals were unduly delayed by dilatory tactics, the SEC could use that factor as a basis for determining that public proceedings might be more appropriate.[117]

Although the proposed amendment to Rule 2(e)(7) was not adopted, its mere proposal and the warnings of the SEC accompany-

[116]SEC Securities Act Release No. 5477 (Apr. 5, 1974).
[117]SEC Securities Act Release No. 5572 (Mar. 4, 1975).

ing the withdrawal should be sufficient notice to professionals, including lawyers, that they occupy no sacred status in the SEC's eyes and that the full gamut of sanctions will be pursued under appropriate circumstances. These sanctions could include public proceedings, resulting in great notoriety and potential damage to professional reputations. In short, the warning to attorneys should be absolutely clear, notwithstanding the withdrawal of the proposed amendment.

VII. *Conclusion*

The cases and proceedings discussed in this article should serve as an emphatic warning to all companies, corporate officers and directors, and professionals who have any contact whatsoever with the federal securities laws that § 20(b) of the 1933 Act and § 20(e) of the 1934 Act cannot be read as practical limitations on remedies that the SEC may seek in enforcement proceedings. Regardless of whether as a matter of policy or law the SEC should be able to exact sanctions or remedies beyond the literal scope of those two sections, failure to recognize that such exactions occur and are occurring at an accelerating rate is short-sighted. The significance of this trend which has taken place without specific statutory authorization is heightened by an examination of other provisions of the federal securities laws, which in contrast to the '33 and '34 Acts specifically confer upon the SEC extensive statutory powers in certain areas.

Section 6 of the 1934 Act specifically provides that no securities exchange can be registered unless its rules, as filed with the SEC, call for the "expulsion, suspension, or disciplining of a member for conduct . . . inconsistent with just and equitable principles of trade . . . ."[118] In addition, the SEC can deny registration unless the exchange has satisfied the SEC that its operations will comply with all provisions of the 1934 Act and the rules and regulations promulgated thereunder. In addition, "the rules of the exchange must be just and adequate to insure fair dealing and to protect investors . . . ."[119]

On a continuing basis, the SEC is given further specific statutory powers over the internal affairs of exchanges by § 19 of the 1934 Act,[120] including the power to withdraw the registration of an exchange if the exchange is found to have violated any provision of the 1934 Act or to expel any member or officer of a national securities exchange upon findings of similar violations and to suspend trading on an exchange.

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[118] Securities Exchange Act of 1934 § 6(b), 15 U.S.C. § 78f(b) (1970).

[119] Securities Exchange Act of 1934 § 6(d), 15 U.S.C. § 78f(d) (1970).

[120] 15 U.S.C. § 78s (1970).

The SEC is also empowered under § 19(b) of the 1934 Act "to alter or supplement the rules of such exchange"[121] upon making certain findings.

The Investment Company Act of 1940,[122] which regulates "registered investment companies," provides further examples of the SEC's specific statutory powers over internal corporate matters. The 1940 Act is a combination of a disclosure act and an act embodying substantive, internal regulatory features. Such substantive features are exemplified by § 9(a),[123] which makes it illegal for certain persons to serve as officers, directors, or employees of a registered investment company. These ineligible persons include persons convicted of certain felonies, as well as persons enjoined from violations of the federal securities laws. In addition, § 10(a)[124] requires that the board of directors of a registered investment company be composed of at least 40% unaffiliated persons, or independent directors. Section 10(b)[125] of the 1940 Act further requires that a majority of directors of an investment company be independent of investment bankers with whom the investment company does business, and § 10(c)[126] precludes a registered investment company from having as a majority of its directors persons affiliated with any one bank.

Substantive controls over the internal details of reorganizations of investment companies are conferred by § 25[127] of the 1940 Act. Under § 25(b),[128] the SEC is empowered under certain circumstances to render advisory reports on the fairness to security holders of a proposed reorganization, and under § 25(c),[129] the Commission can seek to enjoin a proposed reorganization on the grounds that the "plan is not fair and equitable to all security holders."[130]

The 1940 Act proceeds to give the SEC specific power to seek a

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[121] 15 U.S.C. § 78s(b) (1970). The SEC from time to time has invoked this power to require major revisions of rules of registered securities exchanges. Examples are Rule 19b-2, 17 C.F.R. § 240.19b-2 (1974), which requires each member of a registered exchange to engage principally in a public securities business, and Rule 19b-3, 17 C.F.R. § 240.19b-3 (1974), which orders exchanges to eliminate their fixed commission structure. Rule 19b-2 has been partially suspended since March 1973. *See* 39 Fed. Reg. 27909. Rule 19b-3 is effective on May 1, 1975.

[122] 15 U.S.C. § 80a-1, *et seq.* (1970).

[123] 15 U.S.C. § 80a-9(a) (1970).

[124] 15 U.S.C. § 80a-10(a) (1970).

[125] 15 U.S.C. § 80a-10(b) (1970).

[126] 15 U.S.C. § 80a-10(c) (1970).

[127] 15 U.S.C. § 80a-25 (1970).

[128] 15 U.S.C. § 80a-25(b) (1970).

[129] 15 U.S.C.§ 80a-25(c) (1970).

[130] *Id.*

receiver of investment companies which are required to register under the 1940 Act but have failed to do so. Section 41(e)[131] of the 1940 Act authorizes the court to "take exclusive jurisdiction and possession of the investment company or companies involved and the books, records, and assets thereof. . .; and . . . to appoint a trustee, who with the approval of the court, shall have the power to dispose of any and all of such assets . . . ."[132] This section is especially worth noting, for it is the only provision in either the 1933, 1934 or 1940 Acts which specifically authorizes the SEC to seek the appointment of a receiver. But, even under § 41(e), the power to seek a receiver is specifically limited to instances involving failure to register as an investment company and cannot be sought as a remedy for other violations. The existence of such a specific, yet limited, power in the receivership area must engender some question as to the SEC's statutory powers under the 1933 and 1934 Acts.

A final contrasting example of specific substantive powers of the SEC over the internal workings of corporations is found in Chapter X of the Bankruptcy Act.[133] Under Chapter X the SEC is empowered to act as an adviser to federal courts supervising reorganizations in bankruptcy of publicly-owned companies with 300 or more stockholders and $3,000,000 or more in debts. The SEC is authorized to participate in such reorganization proceedings by submitting reports upon the fairness and feasibility of proposed plans of reorganization. Since the SEC can recommend, *e.g.*, whether certain classes of stockholders are being treated fairly, Chapter X thus provides another example of specific statutory powers of the SEC relating to the internal affairs of corporations. Even so, in a Chapter X proceeding, the court is not bound by the SEC's conclusions and the Commission's role is strictly advisory.

Having focused briefly upon some of the broad powers which certain statutory provisions *expressly* confer upon the SEC, several basic questions must again be posited as a result of the remedies developed in the recent cases brought under the 1933 Act and the 1934 Act: What factors prompt the SEC to seek ancillary relief and what determines the form of relief sought; is ancillary relief of the nature and extent discussed herein consistent with the disclosure philosophy of the '33 and '34 Acts; and should the SEC be so involved in the internal affairs of corporations, law firms, and accounting firms without specific statutory authorization?

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[131] 15 U.S.C. § 80a-41(e) (1970).
[132] *Id.*
[133] 11 U.S.C. § 501, *et seq.* (1970).

From a realistic standpoint, ancillary relief may be highly effective in assuring future compliance with the federal securities laws, but that rationale alone seems a weak justification for the exercise of potentially unlimited authority in fashioning ancillary relief. After all, total banishment from the corporate world of any person found in violation of any provision of the federal securities laws would be one way effectively to assure future compliance, but it is unlikely that anyone would seriously contend that such a remedy is within the SEC's enforcement powers.

The answer to the dilemma which these developments create — *i.e.*, achieving a balance between effective and innovative enforcement of the federal securities laws while not exceeding the statutory powers granted by Congress — requires careful and constant attention. The achievement of such a balance is a desirable and necessary objective, and whether the SEC achieves this balance requires a dispassionate analysis on a case by case basis.

Excessive restrictions upon the Commission's enforcement powers are not desirable. On the other hand, since neither statutes nor published rules or regulations of the SEC clarify the authority and procedures of the Commission in this sensitive area, there is no published, objective standard which assures an alleged violator that he is being treated on the same basis as other violators. The absence of clarification of the SEC's powers could ultimately lead to charges that decrees involving ancillary relief are overly harsh, punitive in nature, and the result of oppressive bargaining procedures used to compel settlement of enforcement cases by consent. Conceivably, alleged violators could also charge a denial of equal protection of the law.

Administrative agencies historically have been reluctant to publish objective rules in many areas, generally arguing that objective rules merely result in loopholes for violators. This argument is valid in some circumstances, but clarification of the SEC's powers in the area of ancillary relief by way of statute or rule is highly desirable. Otherwise, public confidence in the fairness of the SEC's enforcement process may ultimately be undermined.

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CHARLES V. LAUGHLIN, A.B., LL.B., LL.M., J.S.D.
Professor of Law

ANDREW W. MCTHENIA, JR., A.B., M.A., LL.B.
Professor of Law

WILFRED J. RITZ, A.B., LL.B., LL.M., S.J.D.
Professor of Law

JAMES W. H. STEWART, B.S., LL.B., LL.M.
Professor of Law

JOSEPH E. ULRICH, A.B., LL.B.
Professor of Law

SAMUEL M. DAVIS, B.A., J.D., LL.M.
Visiting Associate Professor of Law

ROGER D. GROOT, B.A., J.D.
Associate Professor of Law

PEYTON R. NEAL, JR., B.S., J.D.
Law Librarian and Associate Professor of Law

BENJAMIN M. VANDEGRIFT, A.B., J.D.
Associate Professor of Law

JAMES S. HALPERN, B.S., J.D., LL.M.
Assistant Professor of Law

LAWRENCE K. HELLMAN, B.S., M.B.A., J.D.
Assistant Professor of Law

JAMES M. PHEMISTER, B.S., J.D.
Assistant Professor of Law

ROBERT M. CAMPBELL, A.B., LL.B.
Visiting Lecturer in Law

EDWARD S. GRAVES, A.B., M.A., J.D.
Visiting Lecturer in Law

PAUL A. HOLSTEIN, LL.B.
Visiting Lecturer in Law

DAVID A. PENROD, B.A., J.D.
Visiting Lecturer in Law

WILLIAM W. SWEENEY, A.B., LL.B.
Visiting Lecturer in Law

HENRY L. WOODWARD, B.A., LL.B.