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The SEC: Friend or Foe?

(Hint: It's Not Looking Good For Investors)

By Adam Wierzbowski

The Securities and Exchange Commission ("SEC") and its Commissioner, Christopher Cox, have recently come under increased scrutiny from Congress, state Attorneys General and investors for taking actions that are harmful to investors and favorable to business — behavior that is contrary to the Commission's regulatory role as investor watchdog. Congress created the SEC in 1934 — in the wake of the 1929 stock market crash — to safeguard investors from the dangers of the capital markets, and to enforce the newly-passed federal securities laws. But recent events call into question whether the Commission is fully satisfying that duty.

One way the SEC has taken anti-investor positions has been by filing "friend of the court," or *amicus*, briefs with the Supreme Court and other courts. As detailed in the last edition of the *Advocate*, in the Supreme Court *amicus* brief it filed in *Tellabs v. Makor*, the SEC argued that plaintiffs should be required to plead in their complaints a "high likelihood" that defendants had an intent to deceive — thus supporting a higher standard for damaged investors to gain entry into the courthouse than to persuade a jury and win the case at trial. The position the SEC expressed in *Tellabs* was both harmful to investors and contrary to the position it had previously, and repeatedly, expressed on over a dozen occasions in the past eight years. The SEC's position was ultimately rejected by the Supreme Court, which issued its decision in *Tellabs* on June 21, 2007. The Court found that "meritorious private actions to enforce federal antifraud securities laws are an essential supplement" to actions brought by the Department of Justice and the SEC, and held that securities fraud plaintiffs need only plead a "strong inference" of fraudulent intent that is as compelling as any opposing inference of nonfraudulent intent.

The SEC's next opportunity to weigh in on an important issue for investors is presented in *Stoneridge Investment Partners v. Scientific-Atlanta*, in which the Supreme Court is set to decide the scope of "scheme liability" under Rule 10b-5 of the Securities Exchange Act of 1934. The investors in Enron have also petitioned the Supreme Court to hear the same issue, and that petition is currently pending. These two cases involve the liability of so-called secondary actors — those who do not themselves issue false public statements but who violate the securities laws by undertaking deceptive acts in concert with those who do issue false public statements.

Stoneridge presented an excellent chance for the SEC to re-affirm the position it recently argued in support of holding secondary actors

liable for their active participation in a fraudulent scheme. In *Simpson v. AOL Time Warner ("Home-Store")*, decided by the Ninth Circuit Court of Appeals in June 2006, the plaintiffs alleged that the issuer had engaged in sham transactions with certain third parties in order to fraudulently boost earnings. In that appeal, the SEC's *amicus* brief supported investors and argued that since the third parties' transactions created the false appearance of fact that misled investors, they were "deceptive acts" actionable under the securities laws. According to the SEC, no public statement by those third parties was required for a finding of liability. Although the Ninth Circuit affirmed the dismissal of the scheme liability claims against the secondary actors for other reasons, the Court largely adopted the SEC's position.

Stoneridge presents the same issues. In *Stoneridge*, investors in Charter Communications brought suit against the cable company for artificially boosting its financial results by entering into sham transactions with two equipment vendors, Motorola and Scientific-Atlanta. The Eighth Circuit found that the claims asserted against the two vendors amounted to mere "aiding and abetting" and were barred by the Supreme Court's 1973 decision in *Central Bank,* which eliminated liability for simply aiding and abetting a fraud committed by another person. According to the Eighth Circuit's reasoning, the vendors had not made false public statements, but had simply "entered into arm's length non-securities transactions" which Charter subsequently used to improve its own financial results and thus, publish false and misleading statements to its investors. Unfortunately, the Eighth Circuit missed the SEC's point in *Homestore* since the vendors' transactions were by their very nature deceptive and clearly sufficient for finding scheme liability.

In the *Enron* class action, *Regents of the University of California v. Credit Suisse First Boston*, the Fifth Circuit recently held, following the Eighth Circuit in

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Stoneridge, that the investment banks involved in the Enron fraud were not liable under a scheme liability theory because they did not directly deceive investors. The defrauded investors have petitioned the Supreme Court to hear their appeal. When the Supreme Court hears a case like *Stoneridge* (and potentially *Enron*) that will significantly impact investors' ability to hold secondary actors liable for securities fraud, shareholders naturally expect the SEC will do everything in its power to assure that the rights of defrauded investors are protected. The SEC's will to do so, however, appears to be significantly diminished.

The Commission had a golden opportunity in *Stoneridge* to reverse course and support private enforcement of the federal securities laws. However, the SEC's reported eleventh-hour efforts to side with investors were rebuffed by others within the Bush administration, including the President himself. The SEC Commissioners, under increasingly vocal pressure from investor groups, voted 3 to 2 to request that Solicitor General Paul Clement (the SEC's advocate before the Supreme Court) file an SEC *amicus* brief supporting investors in *Stoneridge*. This request was consistent with the SEC's prior position and should have finalized the Commission's position on this important issue. However, President Bush and his Chief Economic Adviser disagreed with this view, asserting, among other things, that it is important to reduce "unnecessary lawsuits" and that "the SEC is the right entity to bring [securities] lawsuits." Accordingly, the Solicitor General declined to file the brief — despite the SEC's request — and simply let the deadline pass. Thus, even when the SEC, as the primary regulator of the securities laws, appears to support investors, Administration pressure stops it in its tracks. This public rebuff by the Administration may chill any SEC pro-investor positions in the future. The irony of this situation is that the Bush administration and Republican party have long espoused the virtues of less reliance on big government to solve social problems. Now they want to hamstring private action because, they claim, the SEC will vindicate shareholder rights.

The Commission's recent positions on other securities matters also raise substantial questions about its commitment to protecting investors going forward. For instance, in addition to the pro-business/anti-investor position it took in *Tellabs*, the SEC's anti-investor approach was seen in the antitrust lawsuit, *Credit Suisse First Boston v. Billing*. In *Billing*, the Supreme Court recently decided that certain of the largest U.S. investment banks could not be held liable for allegedly engaging in a vast conspiracy to manipulate the aftermarket prices of some 900 technology stocks sold in initial public offerings in the late 1990s under the anti-trust laws because the conduct in question was governed by the securities laws. In addition to holding that the securities laws precluded application of the anti-trust laws, the Supreme Court also stated that regulation of the underwriters' conduct should be placed with the SEC as securities experts, not in the hands of non-expert judges and juries. Surprisingly, Paul Atkins, an SEC Commissioner, urged the Supreme Court to take the case so that the Court could rule for the banks rather than for

investors. Atkins stated that such lawsuits "could devastate America's process of capital formation, wreak unprecedented havoc on the underwriting business, and accelerate the marginalization of our capital markets." This stance, and the Supreme Court's ruling, ignores the devastating impact that the underwriters' misconduct has caused to capital formation and the markets in this case, and others such as *WorldCom*, and that the practices challenged by the plaintiffs, such as tying arrangements, are quintessential antitrust violations.

In *American Federation of State, County & Municipal Employees v. American International Group*, the SEC opposed investors' ability to include a shareholder proposal in AIG's proxy statement that would require the company to include in its annual meeting materials the names of shareholder-nominated director candidates. In that action, the SEC filed an *amicus* brief with the Second Circuit arguing — again contrary to prior SEC guidance — that companies are not required to include this type of shareholder proposal in their proxy materials. In ruling for the investors against the views supported by the Commission, the Second Circuit specifically found that the SEC had failed to explain why it had drastically departed from its previous interpretations of the proxy rules.

And in the bondholder class action against HealthSouth Corporation, the SEC recently submitted an *amicus* letter brief to the district court in which the Commission directly undercut plaintiffs' theory of Securities Act liability against the investment banks. Plaintiffs had alleged that those banks, which had sold over $3 billion of HealthSouth debt to their clients, claimed an exemption from the Securities Act's registration requirements even though those banks knew about the massive fraud at HealthSouth, and were using the exemption in bad faith to evade their responsibilities under the Securities Act and escape near-strict liability. The Commission, in yet another reversal from a previously espoused view, informed the district court that even if all of plaintiffs' allegations about the bank's knowledge of the fraud and their intent to use the exemption as a scheme to evade liability were true, the exemption would still apply — and no Securities Act liability may be imposed — because the banks' motive is irrelevant to the claimed exemption!

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Unfortunately, the SEC's recent anti-investor efforts go further than the filing of *amicus* briefs with courts. Recent months have seen disturbing trends involving the Commission's enforcement actions and changes to its own internal policies. For example, after the SEC suffered a legal setback regarding its efforts to tighten hedge fund regulation — which would have forced many of the firms in the $1 trillion hedge fund industry to register with the SEC and open their books to government inspection — the SEC inexplicably did not seek to appeal that decision to the Supreme Court. And in October 2006, the Government Accountability Office, Congress's investigative arm, initiated a broad investigation of the SEC's enforcement practices after former SEC lawyer Gary Aguirre said his superiors would not allow him to pursue an insider-trading probe at hedge fund Pequot Capital Management.

Another recent high-profile example of changes to the SEC's enforcement practices relates to the stock options backdating scandal at Apple Corporation. Last year, Apple was forced to restate its financial results by $84 million due to improper options backdating. Despite Apple's conclusions that CEO Steve

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Jobs knew of stock option backdating and even recommended favorable grant dates, the SEC failed to bring charges against him. This failure to bring charges is particularly shocking because Apple's former CFO Fred Anderson — whose settlement with the SEC notably did not include a lifetime ban from serving as a corporate officer — stated publicly that he warned Jobs in 2001 that Apple might have to take an accounting charge on a large backdated grant to executives. The Commission sets a dangerous precedent and sends a clear signal to corporate America by failing to hold these executives accountable.

The Apple enforcement decisions occurred almost at the same time that the SEC announced an $81 million settlement of its claims against HealthSouth's former CEO, Richard Scrushy, in its action alleging Scrushy's responsibility for the massive accounting fraud at the healthcare company. On its face, the announced settlement suggests that the SEC still has some teeth in prosecuting corporate fraud. The catch, however, is that the SEC gave Scrushy credit for $71.5 million of the amount the SEC claimed to have obtained because Scrushy had already paid or forfeited that amount in related private civil cases, with the potential for a further credit of another $6 million in continuing private civil litigation. The SEC's settlement — which currently is no more than $9.5 million, a far cry from the proclaimed $81 million, and as little as $3.5 million — was thus nothing to brag about. And, as in the Apple enforcement actions, the SEC's settlement with Scrushy does not include the customary lifetime ban from acting as a director or officer of a publicly-held corporation, but only prevents him from doing so for five years.

And if those enforcement actions are not disconcerting enough, the SEC is changing its policies for negotiating settlements with companies. Under the revised approach, rather than allowing SEC enforcement lawyers to reach an agreement and then obtain Commission

approval, the new initiative requires enforcement lawyers to seek approval from the SEC's five commissioners before they begin settlement talks that would involve levying fines against corporations. As former SEC Chairman Arthur Levitt has said, this new policy will inject ideology into corporate penalties and undermine the enforcement division.

The SEC's conduct has not gone unnoticed by at least some members of Congress. Representative Barney Frank (D-Mass.), Chairman of the House Financial Services Committee, has scheduled an oversight hearing to air debate over the SEC's recent actions in response to criticism that its policies are increasingly favoring companies over investors. Attorneys General Marc Dann of Ohio and Mark Shurtleff of Utah have submitted a letter to Representatives Frank and Bachus (R-Ala.) of the House Committee, and to Senators Dodd (D-Conn.) and Shelby (R-Ala.) of the Senate Committee on Banking, Housing and Urban Affairs. That letter applauded the House Committee for scheduling the hearing, and urged the Senate to take similar action.

As these hearings and the Commission's failure to file an *amicus* brief in *Stoneridge* demonstrate, the SEC is at a crossroads. Over the past few years, the Commission has been leaning toward measures that would favor business interests over investor rights and corporate reform. *Stoneridge* presented an excellent opportunity for the SEC to choose the road leading to investor protection, however, a divided Commission failed to persuade the Department of Justice that a pro-investor brief was necessary. Critically for investors, and in the words of Robert Frost, the path chosen by the SEC can make "all the difference."

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