Other Litigation and Legal Activity

The Office of General Counsel provides legal services to the Commission concerning its law enforcement, regulatory, legislative, and adjudicatory activities. The office represents the Commission in appeals and in defense of civil litigation, and provides technical assistance to Congress on legislative initiatives.

What We Did

- Played a lead role in coordinating the agency's implementation of the landmark Sarbanes-Oxley Act of 2002.

- Played a significant role in crafting the Commission's proposal to create a private sector oversight board for the accounting profession and advised the Commission on other, novel measures taken to enhance investor confidence, including the Commission's order requiring the 947 largest public companies to certify the accuracy and completeness of their filings.

- Litigated *SEC v. Zanford,* in which the Supreme Court issued an important decision upholding the Commission's longstanding interpretation of the antifraud provisions that assures broad protection for investors.

Significant Litigation Developments

Fraud “in connection with the purchase or sale of any security”

In *SEC v. Zandford*,[149] the United States Supreme Court agreed with the Commission’s argument that, contrary to the view of the court of appeals,[150] a stockbroker’s fraud was committed “in connection with the * * * sale of any security,” and therefore violated Securities Exchange Act of 1934 (Exchange Act) section 10(b), when he sold his customer’s securities for his own benefit and used the proceeds for himself, without authorization and disclosure to his customer. The Supreme Court rejected the view that only a misrepresentation about a particular securities value can constitute a violation.

Stock Manipulation Under Section 10(b) of the Exchange Act

In *Markowski v. SEC*,[151] the court of appeals agreed with the Commission that “manipulation can be illegal solely because of the actor’s purpose” and that, accordingly, a stock price support scheme that involved real rather than fictitious trades constituted unlawful manipulation under section 10(b) because of the manipulators’ purpose to affect the stock price. Markowski’s petition for Supreme Court review was denied.[152]

Insider Trading

In *SEC v. Lipson*,[153] the court of appeals upheld an insider trading judgment against a corporate president who sold stock in his company based on confidential adverse information about the company’s financial performance. On appeal, the defendant argued that the jury instructions improperly shifted to him the burden of persuasion on whether he used the information. The court agreed that such an instruction would be improper, but held that the instruction in this case did not shift the burden of persuasion. It held that the instruction properly told the jury that where a defendant possesses inside information, the jury may infer that his contemporaneous trades were influenced by the information. The court stated that the inference "is sufficiently compelling" to shift to the defendant "the burden of presenting some rebuttal evidence, on pain of suffering an adverse judgment as a matter of law if he does not." The court also rejected the defendant's argument that a legitimate purpose for the trade proves that the defendant was not influenced by the inside information. The court held that a person might have two purposes and "[t]he existence of the legitimate purpose would not sanitize the illegitimate one."

In *SEC v. Yun*,[154] a case involving the tipping of non-public material information by the spouse of a corporate insider and trading by the tippee, the Commission argued that the appellants' contention that severe recklessness is not sufficient to satisfy the scienter requirement for insider trading is contrary to law, and also that there is no requirement of a "tipper benefit" in cases brought under the misappropriation theory of insider trading. The appeal is pending.

Securities Act of 1933 (Securities Act) Registration

In a friend of the court brief filed in *DeMaria v. Anderson*,[155] the Commission took the position that an issuer whose prospectus is subject to rule 3-12 of Regulation S-X, which provides that no interim financial results are required from an issuer that has filed a registration statement containing an audited financial statement as of a date within 135 days, must nevertheless report interim financial results if the failure to do so would amount to a material omission rendering what has been disclosed false or misleading. The Commission further urged that, under rule 304(b)(2) of Regulation S-T, the determination whether a registrant has made a "good faith effort" to describe graphic material not included in an electronically filed EDGAR prospectus requires the court to look at the nature of: (1) the graphic material being described, (2) the discrepancy and the degree to which it is evident, and (3) the steps that the registrant took to check the accuracy of the electronic filing. The appeal is pending.

Definition of a Security; Reliance by Private Section 10(b) Plaintiffs on Oral Misrepresentations that Vary from Written Disclosures

In *Caiola v. Citibank, N.A., New York*[156], the court of appeals agreed with the position taken by the Commission in a friend of the court brief that the term "option" in the Exchange Act's definition of "security" includes both physically-settled and cash-settled options, rejecting the district court's conclusion[157] that only physically-settled options are included. The court of appeals also agreed with the Commission and rejected the district court's interpretation of the Commodity Futures Modernization Act of 2000 (CFMA) as providing that cash-settled options are "security based swap agreements" under the CFMA and excluded from the definition of security. The court of appeals also followed the reasoning urged by the Commission in questioning the correctness of the district court's holding that oral misrepresentations are not actionable by a private plaintiff under section 10(b) as a matter of law when they are contradicted by written disclosures.

In *SEC v. ETS Payphones, Inc.*,[158] the court of appeals held that payphone sale/lease/buyback agreements were not investment contracts, and thus not securities, under the test in *SEC v. W.J. Howey, Co.*,[159] which described an investment contract as "a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter" or a third party. The court ruled that the fixed lease payments did not constitute "profits" as contemplated by *United Housing Found. v. Forman*, [160] because they represented neither capital appreciation nor a participation in the issuer's earnings. The court further held that even if the fixed payments were profits for purposes of the investment contract test, the interests at issue failed to meet another element of the test--the lease payments were not derived from the efforts of others because they were "contractually guaranteed."

In its petition for rehearing in the *ETS Payphones* case, the Commission argued that the panel's holding on fixed returns conflicts with the *Howey* decision itself, which specifically refers to "income" as being a form of "profits" and with the decisions of two other courts of appeals expressly holding that fixed returns are profits under the investment contract test. In addition, the Commission argued that the alternative holding--that any profits involved were not derived from the efforts of others because they were "contractually guaranteed"--conflicts with numerous Supreme Court and court of appeals decisions holding that the "efforts of others" element turns on whether, as represented to potential investors, it is promoters or the investors themselves who are to manage the enterprise expected to generate the profits, not on whether the profits are provided for by contract. Finally, the Commission argued that even if the court of appeals were correct that the payphone interests at issue are not investment contracts, they are securities because they are "notes," "evidences of indebtedness," or interests "commonly known as a security." The rehearing petition was denied.

Broker-Dealer Regulation

In *SEC v. Tuschner*,[161] the court of appeals reversed a district court decision that held that the owner of a broker-dealer violated the federal securities laws by allowing a former registered representative, who had been barred by the Commission from associating with any broker-dealer, to become an associated person of his firm. The former representative was located in Greece, opened accounts for Greek customers at the American firm, sold them securities for which the firm was an underwriter and market maker, and was compensated by the firm for the sales. The court of appeals held by a 2-1 vote that on the facts of the case the firm did not sufficiently control the former representative's activities to make him an associated person within the meaning of the Exchange Act. By a 5-4 vote, the full court denied the Commission's petition for rehearing, which argued that the former representative was controlled to the same extent as independent contractors who are recognized as associated persons of brokerage firms.

In *United States v. Kay*,[162] the Commission argued in a friend of the court brief that, contrary to the district court's decision, the antibribery provision of Exchange Act section 30A (part of the Foreign Corrupt Practices Act) (which prohibits publicly held companies from making payments to foreign officials "for purposes of" inducing them to misuse their office "in order to assist such [company] in obtaining or retaining business for or with, or directing business to, any person....'") encompasses payments to reduce taxes and duties. In its brief, the Commission urged the court of appeals to hold that, read in context, the "in order to assist such issuer in obtaining or retaining business" language covers all cases in which a payor's objective is to *assist* an issuer's efforts to obtain or retain business with any person. Accordingly, prohibited bribes are not limited to those seeking official action that, *in itself*, *directly* results in an issuer's obtaining or retaining specific contracts or business arrangements but also include bribes seeking official action which, *in turn*, will *assist* an issuer in obtaining or retaining business. The Commission therefore urged that, as a matter of common understanding and basic economic principles, the prohibition broadly covers bribes made to induce official action favorable to an issuer's carrying on its business enterprise, such as tax reduction. The appeal is pending.

Cease-and-Desist Authority

In *KPMG, LLP v. SEC*,[163] the court of appeals upheld a Commission cease-and-desist order against KPMG. The court held, in a manner consistent with the Commission's appellate argument, that:

- the Commission properly determined that, under the cease-and-desist provisions of the Exchange Act, negligence is sufficient to establish liability of any person, including a professional, who causes violations of the federal securities laws;

- the Commission can reasonably interpret its cease-and-desist authority as authorizing it to issue orders prohibiting violations of the provisions of law or regulations found to have been violated and not as restricting it to prohibiting only the specific types of violations of those provisions found;

- a cease-and-desist order that prohibits future independence-related violations of certain statutes and rules is not vague even though independence standards may be complex and reasonable professionals may differ as to the application of those standards to discrete sets of facts; and

- the Commission may proceed, in a cease-and-desist proceeding, on the basis of a lower risk of future violation than is required for an injunction.

Arbitrations Conducted by Self-Regulatory Organizations

In *Howsam v. Dean Witter Reynolds, Inc.*,[164] the Commission filed a friend of the court brief urging that arbitrators, rather than courts, should initially apply the National Association of Securities Dealer's (NASD) six-year eligibility requirement for arbitrations conducted under its Code of Arbitration Procedure. The case is pending.

In *NASD Dispute Resolution, Inc. v. Judicial Council of California*,[165] the Commission filed a friend of the court brief, which argued that California's recently adopted disclosure requirements for arbitrators, and companion rules providing for disqualification of arbitrators and vacation of an arbitral award if those requirements are not met, cannot be applied to securities arbitrations conducted by securities industry self-regulatory organizations. The Commission argued that, in light of the Commission's comprehensive oversight of the self-regulatory organizations (SROs) under the Exchange Act, only the Commission can decide what disclosure and disqualification standards are appropriate for the protection of investors in SRO arbitration, and can ensure that those standards are part of an effective national system. Thus, the California requirements, as applied to SRO arbitration, are preempted by federal law. The Commission also argued that the California requirements are preempted by the Federal Arbitration Act. The case was decided on other grounds in an opinion that did not address issues briefed by the Commission.

Private Right of Action Under Contract-Voiding Provision of the Investment Company Act

In *Olmstead v. Pruco Life Insurance Co.*,[166] the Commission filed a friend of the court brief urging that excessive charges imposed on purchasers of variable annuities could be recovered by means of a private action under section 47(b) of the Investment Company Act of 1940 for rescission and restitution of the amount of the overcharge, and that it was therefore not necessary for the court of appeals to decide whether an implied right of action for damages was created by section 26(f) or section 27(i) of that Act. Because the plaintiffs had not raised this argument, the court of appeals decision did not address the applicability of section 47(b).

Private Right of Action under Section 11 of the Securities Act

In *Lee v. Ernst & Young, LLP*, [167] the court of appeals agreed with the Commission's friend of the court brief that standing to sue under section 11 of the Securities Act for misrepresentations in a registration statement is not limited to those who purchased in the offering, but extends to all who bought securities issued pursuant to the registration statement containing material misrepresentations. It thus became the third court of appeals to agree with the Commission's position, and to reject the argument that section 11 standing should be so limited to initial purchasers in light of the Supreme Court's decision in *Gustafson v. Alloyd Holdings, Inc.*[168] No court of appeals has accepted this interpretation of *Gustafson*.

In *Florida State Board of Administration v. Green Tree Financial Corp.*,[169] the court of appeals agreed with the Commission's interpretation in a friend of the court brief of the state of mind pleading standard under the Private Securities Litigation Reform Act of 1995 (PSLRA). Consistent with the position it has urged in briefs in other circuits, the Commission argued that the pleading standard does not eliminate recklessness as a basis for liability and that, in interpreting the pleading standard, courts should rely upon the pre-PSLRA Second Circuit tests, under which a plaintiff may allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness or facts that show that the defendant had both a motive and an opportunity to commit fraud.

The Commission addressed the PSLRA's lead plaintiff provisions in friend of the court briefs in two appeals in securities fraud class actions, *In re Cavanaugh* [170] and *State of Wisconsin Investment Board v. Ruttenberg.*[171] In *Cavanaugh*, the Commission argued that a lead plaintiff applicant's conduct in dealing with counsel, including a failure to make a meaningful effort to negotiate the counsel fee, could be a basis for a finding that the applicant would not adequately represent the class under Federal Rule of Civil Procedure 23, and thus would not qualify as the lead plaintiff under the PSLRA. The Commission also argued that in awarding class counsel fees at the conclusion of a case a district court could rely on the lead plaintiff's fee agreement with its counsel, but only if the court had carefully reviewed that plaintiff's selection and retention of counsel and had determined that the plaintiff had shown the active, effective involvement and oversight of a "model" PSLRA lead plaintiff. Finally, the Commission argued that the PSLRA does not preclude a district court from conducting an auction to select and set a fee schedule for class counsel when the lead plaintiff is unwilling or unable to perform the selection, retention, and monitoring functions envisioned by Congress.

In its decision in *Cavanaugh*, the court of appeals agreed in principle that a lead plaintiff applicant's dealings with counsel could be evidence that the applicant is not adequate under Rule 23, although two of the judges appeared to take a narrower view of the circumstances in which this might happen than did the Commission and the third judge on the panel. As to the other issues, the court acknowledged that the lead plaintiff's fee agreement might be used by the district court to set a cap on class counsel fees, and viewed a counsel auction as "'not generally permissible in a [PSLRA] case, at least as a matter of first resort,'" but did not rule out the use of auctions in appropriate circumstances in PSLRA cases.

In *Ruttenberg*, the Commission argued that the PSLRA does not permit the appointment of competing lead plaintiff applicants as co-lead plaintiffs when one of the applicants satisfies all of the statute's lead plaintiff criteria. The Commission further argued that it is contrary to the PSLRA for a district court to override that applicant's selection of counsel and to set class counsel fees without regard to that applicant's fee agreement with its chosen counsel simply because: (1) the court had erroneously appointed co-lead plaintiffs, (2) the other co-lead plaintiffs selected other counsel and refused to negotiate fees, and (3) class counsel fees have not traditionally been set by reference to fee agreements. The appeal is pending.

Motions to Vacate Permanent Injunctions

In *SEC v. Walsh*,[172] the district court commuted Walsh's permanent injunction to a temporary injunction to be served in full as of the filing of the motion seeking relief from the injunction. The district court found that Walsh had satisfied the standard for obtaining modification of an injunction. He noted that the evidence that Walsh had violated the securities laws was somewhat weak and that during settlement negotiations the parties did not anticipate that the permanent injunction would interfere with Walsh's ability to satisfy state registration requirements.

Plans of Distribution of Disgorged Assets

In *SEC v. Credit Bancorp Ltd.,*[173] the court of appeals affirmed the *pro rata* distribution of assets seized from a ponzi scheme to its defrauded investors. The appellant had argued that it was entitled to the return of securities that it had transferred to the ponzi scheme because the securities were identifiable and purportedly held in trust. In rejecting this argument, the court noted that while the investor may have intended to enter into a trust arrangement, the documents it had executed caused an outright transfer of share ownership. The court then noted that all of the investors' assets were commingled, so the fact that one investor's assets might have been comparatively undisturbed was the "result of the merely fortuitous fact that the defrauders spent the money of the other victims first." In such situations, the court held, the law favors *pro rata* distributions.

Appeals of Interlocutory Commission Orders

In *Abel v. SEC*,[174] the court of appeals denied the request for interlocutory review challenging a Commission order disqualifying an attorney from representing both the respondent and witnesses the Division of Enforcement was calling to testify against the respondent. The court held that it lacked jurisdiction over the appeal as appellants sought review of an interlocutory, non-final Commission order. The court also held the decision was not appealable under the collateral order exception to the rule against interlocutory appeals, noting that Abel could appeal the order following completion of the Commission proceedings against him. It also ruled that because the witnesses faced no liability in the Commission proceedings, they lacked standing to appeal to the court.

Actions to Enforce NASD Restitution Orders

Pursuant to section 21(e)(1) of the Exchange Act, the Commission, working with the NASD, obtained district court orders requiring payments of fines and restitution imposed as NASD disciplinary sanctions. Respondents in two actions, *SEC* *v. McCarthy and Blodgett*,[175] and *SEC v. Vittor*,[176] appealed and questioned the Commission's authority to apply to a district court for an order commanding compliance with a Commission order affirming NASD sanctions. The Commission responded that section 21(e)(1) specifically provides that the Commission can apply to district courts for orders commanding compliance with Commission orders. The appeals are pending.

Equal Access to Justice Cases

In *Adams v. SEC*,[177] the court of appeals held that a respondent in a Commission administrative action had filed a timely claim for attorneys' fees under the Equal Access to Justice Act (EAJA) even though he did not file within 30 days of the Commission order dismissing the claims against him. The court explained that the 30-day period for filing the claim did not start until the Commission order was "not appealable." The Commission had contended the order was not appealable when it was issued because the respondent had obtained the relief he sought. The court rejected that argument and explained that when the "governing statute relevant to the underlying agency proceeding allows an appeal generally, the underlying order is considered 'appealable,'" regardless whether the specific order could be appealed.

Application of the Work Product Doctrine to Work Product Shared with the Commission

The Commission filed friend of the court briefs in three private actions in state court and in a federal criminal action to explain that disclosure of attorney work product to the Commission pursuant to a confidentiality agreement does not waive work product protection. The Commission stated that the work product doctrine should not be waived because the Commission's ability to obtain work product pursuant to confidentiality agreements plays an important role in the Commission's enforcement of the securities laws. In all three state court actions, the courts held work product protection was not waived. The criminal action is pending.

Requests for Access to Commission Records

The Commission received 96 subpoenas for documents and testimony. In certain of the cases, the Commission declined to produce the requested documents or testimony because the information sought was privileged.

The Commission received 3,570 requests under the Freedom of Information Act (FOIA) for access to agency records and 14,150 confidential treatment requests from persons who had submitted information to the Commission. There were 85 appeals to the Office of the General Counsel from initial denials from the FOIA officer. Several of these appeals resulted in district court litigation challenging the decisions.

In *American Legal Media, Inc. & Michael Ravnitzky v. SEC*,[178] the district court largely granted the Commission's motion for summary judgment on a FOIA complaint seeking disclosure of those portions of the *SEC Freedom of Information Training Manual* that the Commission had withheld. The district court ordered the SEC to disclose limited parts of the *Manual* to the extent they provide instruction on how particular FOIA exemptions apply to different types of SEC records. In all other respects, the court upheld the SEC's decision to withhold portions of the *Manual* under Exemption 2.

Significant Adjudication Developments

During fiscal 2002, the Commission issued 28 opinions and 18 orders, and the staff resolved an additional 50 motions. Highlighted are some of the significant opinions and orders issued by the Commission during the year.

Cease-and-Desist Proceedings

The Commission ordered Herbert Moskowitz to cease-and-desist from violations of the Commission's reporting requirements.[179] Under these requirements, the beneficial owner of more than 5 percent of any class of equity securities registered under the Exchange Act must report that beneficial ownership on a Schedule 13D. The owner must also report any material change in beneficial ownership.

The Commission concluded that Moskowitz had investment power over, and therefore beneficially owned, shares of Ferrofluidics Corporation held in the account of Kamrooz Abir, his son-in-law. Moskowitz made certain filings on Schedule 13D but failed to include Abir's shares in those filings and failed to report, as required, the disposition of those shares.

The Commission concluded that a cease-and-desist order was appropriate. The Commission recognized that the complained-of conduct occurred in 1991. While the Commission noted that part of this delay was attributable to a stay for related criminal proceedings, it recognized that this was not the sole cause of the delay and that the passage of time militated against issuing a cease-and-desist order. However, the Commission found that Moskowitz's repeated violations of the reporting requirements provided a compelling reason for imposing a cease-and-desist order. The Commission considered the lateness of both the incomplete Schedule 13D and the subsequent amendment that Moskowitz filed with respect to Ferrofluidics. The Commission also found that, after the period at issue, Moskowitz failed on various occasions to file timely and complete Schedules 13D with respect to his holdings in other public companies

The Commission rejected Moskowitz's argument that the proceeding was barred by the general five-year statute of limitations imposed by 28 U.S.C. §2462. Section 2462 imposes a five-year limitation on any proceeding for enforcement of a civil fine, penalty, or forfeiture. The Commission held that a cease-and-desist order is not subject to section 2462. A cease-and-desist order focuses on a respondent's future conduct and is prospective. The Commission concluded that this remedy does not resemble a penalty within the meaning of section 2462. The Commission further found that the Division of Enforcement had demonstrated Moskowitz's present risk to the public by (1) his continued failures to file and his incomplete and untimely filings on Schedules 13D, (2) his continued promotion of public companies, and (3) his lack of appreciation of the importance of the reporting requirements.

Summary Disposition in Broker-Dealer Proceeding

The Commission barred John Brownson[180] from association with a broker or dealer. Brownson was statutorily disqualified because he pleaded guilty to one count of conspiracy to commit securities fraud, mail fraud, and wire fraud. He was sentenced to five months imprisonment followed by three years supervised release, during which he is prohibited from engaging in the securities industry, and ordered to pay restitution. The indictment alleged that Brownson and others conspired with a stock promoter to recommend certain stocks to customers in return for payments from the promoter that were not disclosed to the customers.

The Division of Enforcement brought an administrative proceeding to bar Brownson. An administrative law judge granted summary disposition in favor of the Division, finding that there was no dispute as to any material fact. The law judge accepted as true Brownson's assertions that he was a minor player in the conspiracy and cooperated with the investigation. The law judge nonetheless concluded that there were no extraordinary circumstances that warranted a sanction other than a bar.

Upon Brownson's appeal, the Commission upheld the law judge's grant of the Division's motion. The Commission noted that summary disposition may be granted where there is no genuine issue of material fact and the party is entitled to summary disposition as a matter of law. The Commission held that summary disposition was particularly appropriate where, as here, the respondent had been convicted of securities fraud. Brownson failed to challenge any of the law judge's evidentiary findings. He also failed to state what evidence he would have presented at an oral hearing or explain how such evidence would establish factors that would counter a determination that it was in the public interest to bar him.

In imposing a bar, the Commission found Brownson engaged in serious misconduct over an extended period of time for personal gain. The Commission also weighed the fact that Brownson is prohibited from engaging in the securities business during his supervised release.

Disqualification of Counsel

The Commission disqualified counsel for a respondent in a pending administrative proceeding. [181] The attorney represented two respondents, Rudolph Abel and Donald C. Berry, who had served successively as chief investment officers of an investment adviser. Berry and four other respondents settled or defaulted. The proceeding was continuing as to Abel. Abel's counsel sought also to represent Berry and four other prospective witnesses in the proceeding. The law judge denied the Division of Enforcement's motion to disqualify counsel, stating that she did not have the authority to disqualify counsel.

The Commission accepted interlocutory review of the law judge's ruling. The Commission stated that Rule of Practice 111(d) granted the law judge the power to regulate a proceeding and the conduct of the parties and counsel. The Commission concluded that the rule authorized disqualification of counsel if the conflict of interest was of sufficient magnitude to render the proceeding unjust.

The Commission concluded that the potential for conflict could not be addressed by the consent of the clients. An attorney before any tribunal must advocate his client's position forcefully in order to preserve the integrity of the proceeding. The Commission found that counsel's representation of Abel with respect to subjects that were substantially related to counsel's representation of the witness clients could result in divided loyalty that would prevent counsel from fulfilling his duty to act in good faith.

The Commission concluded that it did not need to wait until an actual conflict tainted the proceeding where the nature of the multiple representation presented such a serious potential for conflict. The Commission stated that the right to counsel of one's choice is outweighed by the necessity of ensuring the propriety and integrity of its processes.

Legal Policy

The General Counsel's responsibilities include providing legal and policy advice on SEC enforcement and regulatory initiatives before they are presented to the Commission for a vote. The General Counsel also advises the Commission on administrative law matters, and has substantial responsibility for carrying out the Commission's legislative program, including drafting testimony, developing the Commission's position on pending bills in Congress, and providing technical assistance to Congress on legislative matters.

Following enactment of the Sarbanes-Oxley Act, the General Counsel took the lead in coordinating the agency's implementation of this landmark legislation. The General Counsel also played a significant role in the Commission's efforts to respond to investor concerns in the wake of events at Enron and other public companies. This included advising the Commission on its order requiring the 947 largest public companies to certify the accuracy and completeness of their filings and on the Commission's immediate regulatory actions to minimize any potential disruptions to the capital markets that may have occurred due to the indictment and subsequent conviction of Arthur Andersen LLP.

On the regulatory front, the General Counsel was significantly involved in the development of the Commission's proposed Public Accountability Board, which would have ended the self-regulation of the accounting profession by creating an independent overseer for the accounting profession with mandatory funding. The office also assisted in the development of several rulemakings to implement the Commission's disclosure initiatives and begin implementation of the Sarbanes-Oxley Act.

Significant Legislative Developments

In fiscal 2002, Congress passed the USA PATRIOT Act and the Sarbanes-Oxley Act. The USA PATRIOT Act was enacted in response to the terrorist attacks of September 11, 2001 and included electronic surveillance and money laundering provisions of relevance to the Commission's work. The Act specifically directed the Commission to engage jointly in or to be consulted by the U.S. Department of the Treasury on several rulemakings and studies relating to the anti-money laundering efforts of entities regulated by the SEC. The Sarbanes-Oxley Act, among other things, created a new oversight board for the accounting profession, mandated new measures intended to promote auditor independence, added new disclosure requirements for public companies, and strengthened the criminal penalties for securities fraud. The Act contains numerous directives to the Commission to promulgate rules and complete studies. Several other bills that would affect the work of the SEC received significant attention during the year, including accounting, bankruptcy, derivatives, energy, and other measures.

Commission Congressional Testimony

The Commission testified at congressional hearings on the following matters during fiscal 2002:

- events relating to Enron Corp.;
- financial aspects of the war on terrorism and implementation of the USA PATRIOT Act;
- financial literacy;
- the adequacy of current financial accounting standards and roles of the SEC and the Financial Accounting Standards Board in setting generally accepted accounting principles;

- proposals to repeal the Public Utility Holding Company Act of 1935 (PUHCA), and the relationship of PUHCA to the Enron bankruptcy and the energy crisis in California;

- legislative proposals to respond to crises at Enron and other public companies;

- appropriations for the SEC in fiscal 2003 and resource and staffing issues facing the agency;

- telecommunications accounting issues;

- the role of credit rating agencies in the U.S. securities markets;

- pending proposals by the European Commission;

- issues raised by the Frank Gruttadauria matter; and

- legislative proposals to require the SEC to prepare audited financial statements.

Corporate Reorganizations

The Commission, as a statutory adviser in cases under Chapter 11 of the Bankruptcy Code, seeks to assure that the interests of public investors in companies undergoing bankruptcy reorganization are protected. During the past year, the Commission entered a formal appearance in 32 Chapter 11 cases with significant public investor interest. The Commission also monitored 120 new cases involving large public companies and brokerage firm liquidation proceedings under the Securities Investor Protection Act of 1970.

The Commission formally supported a motion for the appointment of an official committee to represent shareholders in one case. Official committees negotiate with debtors on the formulation of reorganization plans and participate in all aspects of a Chapter 11 case. The Bankruptcy Code provides for the appointment of official committees for stockholders where necessary to assure adequate representation of their interests.

A Chapter 11 disclosure statement is a combination proxy and offering statement used to solicit acceptances for a reorganization plan. The bankruptcy staff commented on 182 of the 268 disclosure statements it reviewed during 2002. Recurring problems with disclosure statements included inadequate financial information, lack of disclosure on the issuance of unregistered securities and insider transactions, and plan provisions that contravene the Bankruptcy Code. Most of the staff's comments to debtors or plan proponents were adopted; formal Commission objections were filed in 8 cases.

The Commission was successful in persuading companies to eliminate provisions in 48 plans that improperly attempted to release officers, directors, and other related persons from liability. This is a significant issue for investors because in many cases debtors improperly seek to use the bankruptcy discharge to protect officers and directors from personal liability for various kinds of claims, including liability under the federal securities laws. In 12 cases, the Commission successfully blocked plan provisions that would have resulted in shell companies that could have been used for stock manipulation purposes. Also in 12 cases, the Commission prevented improper use of the Bankruptcy Code exemption from Securities Act registration.