UNITED STATES COURT OF APPEALS
for the
SECOND CIRCUIT

No. 72-1118
No. 72-1196

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

and

SECURITIES INVESTOR PROTECTION CORPORATION,

Applicant-Appellee,

-against-

ALAN F. HUGHES, INC., and
ALAN F. HUGHES,

Defendants-Appellants.

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

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THE ISSUE PRESENTED FOR REVIEW

Did the district court abuse its discretion in an action brought by the Securities and Exchange Commission when it appointed a receiver to oust the management of a broker-dealer firm pending a determination by the Securities Investor Protection Corporation whether to seek appointment of a

trustee under the Securities Investor Protection Act of 1970, in light of the facts that (1) the firm had consented to a permanent injunction against future violations of Commission rules (a) prohibiting unauthorized hypothecation of customer's securities and other deceptive practices; (b) relating to the proper maintenance of books and records; and, (c) relating to net-capital requirements, and (2) a special fiscal agent appointed by the court had found (a) the firm's books and records in a chaotic state and (b) substantial evidence of unlawful hypothecations, self dealing and other deceptive acts and practices by the management of the firm?

STATEMENT OF THE CASE

In this action the Securities and Exchange Commission complained that defendant Alan F. Hughes, Inc. ("Hughes, Inc."), a broker-dealer in securities,[1/] aided and abetted by its president Alan F. Hughes, violated rules adopted by the Commission pursuant to the Securities Exchange Act relating to the proper maintenance of its records,[2/] relating to the main-

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1/ Alan F. Hughes, Inc., is registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(b).

2/ Section 17(a) of the Securities Exchange Act, 15 U.S.C. 78q(a), and Rules 17a-3 and 17a-4 thereunder, 17 CFR 240.17a-3 and 240.17a-4.

tenance of a minimum net-capital position, [3/] prohibiting hypothecation of customer's securities in certain circumstances [4/] and prohibiting fraud in connection with the purchase or sale of securities. [5/] The complaint requested injunctive relief against further violations of the cited provisions and also requested the appointment of a receiver. (See 5a-15a.) [*/]

3/ Section 15(c)(3) of the Securities Exchange Act, 15 U.S.C. 78o(c)(3), and Rule 15c3-1 thereunder, 17 CFR 240.15c3-1. The "net-capital" rule is designed to prevent broker-dealers from overextending themselves to the potential detriment of their customers and other creditors. It basically requires a broker-dealer to maintain a minimum position of cash, or of assets readily convertible to cash, so that its aggregate indebtedness to all persons may not exceed 2,000 per centum of its net capital.

4/ Section 15(c)(2) of the Securities Exchange Act, 15 U.S.C. 78o(c)(2), and Rule 15c2-1 thereunder, 17 CFR 240.15c2-1. "Hypothecation of customer's securities," which is a pledge of those securities that does not involve a transfer of title or possession, is defined in certain circumstances to be a "fraudulent, deceptive or manipulative act or practice" as prohibited by Section 15(c)(2) of the Act. Generally proscribed are hypothecations involving unauthorized commingling of the securities of one customer with another or commingling of the securities of a customer with those of a non-customer (for example, those of the broker) and hypothecations, otherwise permissible, where the aggregate of claims against hypothecated securities exceeds the aggregate indebtedness of all customers with respect to securities in their accounts.

5/ Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5. This basic prohibition against deceptive and manipulative acts and practices in connection with the purchase or sale of any security has been involved in cases before this Court on a number of occasions. See, e.g., Securities and Exchange Commission v. Manor Nursing Centers, Inc., [Current] CCH Fed. Sec. L. Rep. ¶91,862 (Jan. 21, 1972); Securities and Exchange Commission v. North American Research and Development Corp., 424 F. 2d 63 (1970); Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F. 2d 833 (C.A. 2, 1968) (en banc), certiorari denied, 394 U.S. 976 (1969). The Supreme Court has recently mandated a broad, remedial reading of its provisions. Superintendent of Insurance v. Bankers Life & Casualty Co., ___ U.S. ___ (1971), 40 U.S.L.W. 4001 (Nov. 8, 1971).

*/ Pages of the appendix are cited herein as "__a".

At the Commission's request, a temporary restraining order was entered on August 19, 1971. On September 7, 1971, the defendants consented to a permanent injunction against future violations of the cited provisions, without admitting or denying the allegations of the complaint. They did not, however, consent to the appointment of a receiver, and an oral argument on the question of a receivership was held on September 7. The court below, proceeding cautiously, declined to appoint a receiver at once. Instead, on September 9, 1971, the court appointed a Special Fiscal Agent

> " . . . to make a careful examination of . . . [defendant Hughes, Inc.'s] books and records, back-office management and procedures and all of said defendant's financial transactions; . . . assess the ability of defendant Alan F. Hughes, Inc., to meet the Net Capital, Bookkeeping and Hypothecation requirements of . . . [the Securities Exchange Act and Rules thereunder] and report back to this Court . . . concerning the need for the appointment of a receiver and the need, if any, for liquidation of the said defendant's business. . . ." (30a-31a.)

The Report and Supplemental Report of the Special Fiscal Agent (37a-85a; 122a-147a), setting forth the facts disclosed by his investigation, and fully supported by documentary evidence (e.g., 86a-118a), was filed on October 27, 1971. In his report the Special Fiscal Agent advised the court (51a):

> "Errors were found, of considerable magnitude, in inaccurately recording transactions that did happen, in recording transactions that did not happen, and in omitting to record other transactions that occurred and should have been recorded.
>
> "Bank statements showed large items charged against the defendant's account that were not reflected on defendant's books. Deposits of money were shown by the bank but not on defendant's books. Many entries in the books were made indicating receipts of monies without supporting records of deposits in the bank. Further, portions of the books were inconsistent with other parts of the books."

Although the Special Fiscal Agent and his accountants had not had time for a searching inquiry into all of the numerous areas of confusion presented by the books and records of Hughes, Inc., a number of examples were given and documented showing "the general disarray, inconsistency and apparent inaccuracy of the books" (53a). A detailed inquiry had been undertaken, however, as to a few matters. And a particularly egregious situation "reflecting on defendant's integrity as a broker" (53a), was described, involving the apparent diversion to the private use of Mr. Hughes of over $100,000 in cash that he had received from a customer of defendant Hughes, Inc. for the purchase of specified securities (52a-60a). It appeared also in this connection that when the securities were ultimately purchased for that customer, some of them were unlawfully hypothecated by Hughes, Inc. (60a-66a). The Report also showed that Mr. Hughes had been asked to explain the circumstances of this transaction; and the Special Fiscal Agent demonstrated that statements made by Mr. Hughes in an explanatory affidavit were "contrary to fact" in a number of material respects (67a).

The "general condition of defendant's books and records" (70a) was also described in some detail: the defendant's General Ledger, it was found, "was not accurate at anytime in 1971;" cash receipts and disbursements had not been recorded; deficiencies and inconsistencies were cited with regard to the firm's investment account, the customer's control account and the brokers' control account. (70a-72a.)

Thus the district court found in its Memorandum-Decision and Order of December 13, 1971, (150a-155a) that the report filed by the Special Fiscal Agent

> " . . . points up disturbing situations and instances in the operation of the security business of the defendants that beyond question warrant further investigation by a Receiver empowered with the full authority that such court appointment confers" (152a).

The court specifically noted, ibid., the

> "substantial number of supporting exhibits that provide reference support of the highest order for the findings and conclusions reached that justify the proper and reasonable inference that there does exist violations of the Net Capital, Hypothecation Rule and the Bookkeeping Rule as charged by the SEC complaint."

The books of Hughes, Inc., were found to be (153a) "so inaccurate and incomplete as to make practically impossible an orderly and satisfactory ascertainment of defendants' security dealings;" the court found (153a-154a) "unexplained commingling of personal and firm bank account funds with misleading explanations for this irregular banking practice," and found also (154a) that certain bonds had been "hypothecated and pledged without prior written authorization as required . . . ."

The court (153a) explicitly rejected "[t]he offer of the defendants to 'reconstruct' the books, through their own accountants," since this "would deprive the public and investors of the Firm of the independent investigation under the supervision of a Court appointed officer." The court (153a) found the report of the Special Fiscal Agent "unassailable in the conclusion reached that a Receiver under court aegis is imperative."

On December 13, 1971, a receiver was appointed "of all assets and property of and owned benficially or otherwise by defendant, Alan F. Hughes, Inc. . . . and all assets or property which defendant Hughes, Inc. carries or maintains for the accounts of others . . ." (156a-157a). While the receiver was directed "to marshal all such assets and property, prosecute all claims, choses-in-action and suits in equity on behalf of said defendant to collect and take charge of all and singular thereof" (157a), his appointment (ibid.) extended only "until such time as ('SIPC') the Securities Investor Protection Corp. makes a determination whether to install its own trustee pursuant to Section 5(a)(2) of the Securities Investor Protection Act of 1970, (P.L. 91-593), and a trustee is so installed." During the limited period of his appointment the receiver was authorized to liquidate only "if necessary" (ibid.).

Thereafter, the Securities Investor Protection Corporation, acting pursuant to the Securities Investor Protection Act of 1970, 15 U.S.C. 78aaa, et seq., applied for and obtained the appointment of a trustee for Alan F. Hughes, Inc. Section 5(b)(3) of that Act, 15 U.S.C. 78eee(b)(3), authorizes appointment of a trustee when the court has found, under Section 5(b)(1), 15 U.S.C. 78eee(b)(1), that a broker-dealer

> " . . .
>
> "(iii) is the subject of a proceeding pending in any court . . . in which a receiver . . . for such . . . [firm] has been appointed, or
>
> "(iv) is not in compliance with applicable requirements under the 1934 [Securities Exchange] Act or rules or regulations of the Commission . . . with respect to financial responsibility or hypothecation of customers' securities, or

> "(v) in unable to make such computations as may be necessary to establish compliance with such financial responsibility or hypothecation rules or regulations."

Pursuant to an order entered on January 17, 1972, (206a-208a) the trustee superseded the receiver in control of the assets and affairs of Alan F. Hughes, Inc. The defendants have now appealed from the appointments of both the receiver and the trustee.

This memorandum is filed on behalf of the Securities and Exchange Commission in support of the appointment of the receiver. The position of the Securities Investor Protection Corporation in support of the trusteeship is fully set forth in the brief it has filed. Of course, if the appointment of the trustee should be sustained on either of the alternative grounds permitted under Section 5(b)(1) of the Securities Investor Protection Act, supra, the question whether appointment of a receiver was appropriate may be moot. In any event, it appears to the Commission for reasons set forth below and in the brief submitted on behalf of the Securities Investor Protection Corporation that the appointments of both the receiver and the trustee were fully justified in fact and in law.

ARGUMENT

THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION IN APPOINTING A RECEIVER FOR A BROKER-DEALER WHO CONSENTED TO AN INJUNCTION FOR VIOLATION OF THE COMMISSION'S NET CAPITAL, HYPOTHECATION AND ANTITRUST RULES AND WHOSE BOOKS WERE IN A CHAOTIC STATE.

The authority of the district court to appoint a receiver in an action brought by the Commission is not open to serious dispute. In J. I. Case Co. v. Borak, 377 U.S. 426, 433 (1964), the Supreme Court observed in a private action brought to enforce the proxy rules promulgated by the Commission, that "[i]t is for the federal courts to adjust their remedies so as to grant the necessary relief where federally secured rights are invaded." In a similar context that Court further stated in Mills v. Electric Auto-Lite Co., 396 U.S. 375, 391 (1970): "[W]e cannot fairly infer from the Securities Exchange Act of 1934 a purpose to circumscribe the courts' power to grant appropriate remedies." This court has twice explicitly recognized "the above statement [in Mills] to be fully applicable in enforcement actions by the SEC." Securities and Exchange Commission v. Texas Gulf Sulphur Co., 446 F. 2d 1301, 1308, certiorari denied, 40 U.S.L.W. 3288 (Dec. 20, 1971); Securities and Exchange Commission v. Manor Nursing Centers, Inc., ___ F. 2d ___, ___, [Current] CCH Fed. Sec. L. Rep. ¶93,344 at p. 91,862 (January 21, 1972). Thus, "[w]hile it is true that the [Securities Exchange] Act does not explicitly provide for appointment of receivers, there is little reason to doubt that equitable power to do so exists." Lankenau v. Coggeshall & Hicks, 350 F. 2d 61, 63 (C.A. 2, 1965); accord: Securities and Exchange Commission v. S & P National Corp., 360 F. 2d 741, 750 (C.A. 2, 1966).

When it brings "an action for an injunction and the appointment of a receiver, the SEC is . . . concerned with 'the protection of those who already have been injured by a violators' actions from further despoilation of their property or rights.'" Esbitt v. Dutch-American Mercantile Corp., 335 F. 2d 141, 143 (C.A. 2, 1964). And, as this Court has recognized,

> " . . . the primary purpose of the appointment . . . [of a receiver is] promptly to install a responsible officer of the court who could . . . 'ascertain the true state of affairs * * * and report thereon' to the court . . . and preserve the corporate assets."

Securities and Exchange Commission v. S & P National Corp., 360 F. 2d 741, 750-751 (1966).

It is in the context of the foregoing authorities that the decision below appointing a receiver must be evaluated; and unless the defendants can sustain the burden of showing that the district court's appointment of a receiver was an abuse of discretion that appointment must be affirmed.

The opinion of the district court (150a-155a) and the Reports of the Special Fiscal Agent upon which it was based (37a-85a; 122a-147a) demonstrate, as noted above pp. 4-6, the chaotic state of the books and records of Hughes, Inc., the defendants' unlawful hypothecation of customer's securities, Mr. Hughes' apparent diversion of customer's funds to his own account and other fraudulent activities which have materially jeopardized the interests of those persons for whom and with whom the defendants have dealt. In these circumstances, where the absence of a receiver would permit the person responsible

for the present situation to continue in control of the company, we submit that the appointment of a receiver was not merely permitted as a matter of discretion, it was virtually mandatory as a matter of law. See Securities and Exchange Commission v. Bowler, 427 F. 2d 190 (C.A. 4, 1970); Securities and Exchange Commission v. Keller Corp., 323 F. 2d 397 (C.A. 7, 1963).

At least until other means can be found to protect the interests of customers and creditors of the firm,

> " . . . the appointment of a receiver was clearly justified. Such a receivership is apparently the only remedy that will adequately protect the property of defendant's customers. At least, it was within the discretion of the district court so to find."

Securities and Exchange Commission v. Charles Plohn & Co., 433 F. 2d 376, 379 (C.A. 2, 1970).

We do not understand the defendants seriously to question the basis upon which the district court acted, although they undoubtedly question the precise degree of their culpability. They readily concede, Br. p. 11:

> "Throughout this proceeding it has been recognized that the Hughes firm might not be in compliance with SEC bookkeeping rules and with the hypothecation rules which relate to pledging customer's securities. The possibility of a minor net capital violation was also recognized."

Defendants assert, however, that "[n]o loss of any customers' funds or securities had been shown" (Br. p. 14). But, because of the pitiful condition of the books and records of Hughes, Inc., experienced accountants have been unable to determine much more than that defendants have committed serious violations of the law. This would readily explain the lack of a

"showing" of direct injury to customers. In these circumstances it is most unlikely that the customers of Hughes, Inc. have not been and will not be harmed. Defendants suggest (Br. p. 14) that the injunctive decree will suffice to deter wrongful behavior. But if the decree were violated, the prospect of contempt proceedings would be of little solace to investors injured because a receiver had not been appointed where, as here, appropriate grounds clearly appear. 6/

6/ As we have observed, supra p. 8, if this Court should uphold appointment of the SIPC trustee, the correctness of the appointment of the receiver would appear moot. Defendants argue, however, that the "serious collateral effects" of the appointment of a receiver (p. 13) is a basis upon which this Court should in any event pass upon the receiver's appointment. They claim injury to their "business reputation." But this argument purports to apply only if the appointment of a trustee is upheld under the Securities Investors Protection Act, and in that case the "damage" resulting from the trusteeship will assuredly be no greater merely because the trustee had been preceded by a receiver. Moreover, any "damage and stigma to the business reputation of Mr. Hughes and his firm" (Br. p. 13) is a result of their violations of legal requirements designed for the protection of their customers, which provide the basis for the receivership; it does not result from the fact of the receivership itself. In any event, "the necessity of protection to the public far outweighs any personal detriment resulting from the impact of applicable laws," cf. Associated Securities Corp. v. Securities and Exchange Commission, 283 F. 2d 773, 775 (C.A. 10, 1960).

Defendants' primary concern is that the firm not be liquidated. See Br. p. 14. But the appointment of a receiver in an action brought by the Commission serves (a) to replace a management that presents a risk to members of the investing public, (b) to maintain the status quo, and, (c) to marshal assets. In fact, the order by which the receiver was appointed in this case demonstrates (157a) that his role was primarily that of a conservator while a determination would be made whether the protections of the Securities Investor Protection Act might properly be invoked. Cf. Esbitt v. Dutch-American Mercantile Corp., supra, 335 F. 2d at 143; Securities and Exchange Commission v. S & P National Corp., supra, 360 F. 2d at 750-751. 7/ Thus the risk of liquidation by the receiver was

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7/ Consistent with the procedure followed in the instant case, before the Securities Investor Protection Act of 1970 had been adopted, this Court suggested that the receivership of an insolvent broker-dealer should be superseded by a formal bankruptcy proceeding. See, e.g., Lankenau v. Coggeshall & Hicks, supra, 350 F. 2d at 63. Of course, a reorganization under Chapter X of the Bankruptcy Act may be appropriate. See Securities and Exchange Commission v. Bowler, supra, 427 F. 2d at 196. But the Commission is not empowered to invoke procedures under the Bankruptcy Act.

virtually nonexistent at the time he was appointed and, in any event, no receivership liquidation occurred. 8/

CONCLUSION

For the foregoing reasons, the appointment of a receiver for Alan F. Hughes, Inc. by the court below should be affirmed.

Respectfully submitted,

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March 8, 1972

8/ This Court has, of course, indicated that it would be of doubtful propriety "[i]f the only purpose of the receivership were to bring about a quick liquidation" by the receiver. Securities and Exchange Commission v. S & P National Corp., supra, 360 F. 2d at 750. It has held that an equity receiver appointed in an injunctive action brought by the Commission should not "perform the functions of the bankruptcy court" Esbitt v. Dutch-American Mercantile Corp., supra, 335 F. 2d at 143; Lankenau v. Coggeshall & Hicks, supra, 350 F. 2d at 63. But this principle was not violated here. And, as we observed supra n. 7, it is entirely consistent with those cases that the receiver was promptly superseded by a trustee who may liquidate the firm under explicit statutory authority.

It is of no substantial significance that the court also authorized the receiver "to liquidate if necessary . . . in order to pay all just claims and all creditors" (157a). This authority is necessary if the receiver is effectively to perform his functions should the receivership become protracted. In any event, if a different grant of authority were considered appropriate the order below could easily be modified to the necessary extent and the receivership upheld.