IN THE

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

No. 77-1820

ELLIOT HANDLER, *et al.*,

Appellants,

v.

SECURITIES AND EXCHANGE COMMISSION, *et al.*,

Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE CENTRAL DISTRICT OF CALIFORNIA

REPLY BRIEF FOR APPELLANTS ELLIOT HANDLER, RUTH HANDLER and SEYMOUR ROSENBERG

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PRELIMINARY STATEMENT

The Answering Brief of the SEC defendants primarily raises a series of avoidance defenses to our claims that the Amended Judgment violates Article III of the Constitution, the Separation of Powers Doctrine, the Securities Acts, and Rules of the SEC.[1/] We respond to these defenses in Section I of this brief, pp. 2 - 9, infra. The SEC's sole response to the merits of our Article III argument comes in the contention that the

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1/ We shall cite the SEC's brief as "SEC Br." Plaintiffs' first brief is cited as "Initial Br." The designation "App." refers to the Appendix to the Initial Brief. The term "Amended Judgment" is explained at Initial Br., 5 n.5.

Special Counsel-Special Auditor role under the Amended Judgment is analogous to that traditionally assigned an equity receiver. (SEC Br. at 24-30.) We show in Section II of this brief that the analogy is faulty and, indeed, refuted by the very case law relied upon by the SEC. See pp. 10-19, infra. Finally, the SEC responds to our claim that the agency unlawfully delegated its investigative responsibilities to a private lawyer and private accounting firm only by denying there was in fact a delegation. (See SEC Br. 24 n.32.) We respond to this denial in Section III. See pp. 19-27, infra.

ARGUMENT

I.
ALL THE AVOIDANCE DEFENSES FAIL

In an effort to avoid having this Court sit in judgment on the lawfulness of the SEC's private law-enforcement device, the SEC defendants have raised a smoke screen of procedural defenses, none of which is applicable to this case. Accordingly, the SEC's avoidance manuever cannot prevent judicial scrutiny of this investigative technique which it is using with increased frequency and which for several years has managed to escape review.

The SEC's barrage of procedural defenses is based on the collateral attack doctrine (SEC Br. 19-22) standing (id. at 19 n.25), justiciability (id. at 15-16), and waiver (id. at 22-23), all of which merit little comment to establish their inapplicability here.

First, our Article III challenge to the actions of the District Court in creating a Special Counsel to conduct an investigation and to file a report is jurisdictional: thus it is not subject to waiver or consent of the parties. (See Initial Br. at 14 n.9.) See also Rincon Band of Mission Indians v. County of San Diego, 495 F.2d 1, 8 (9th Cir. 1974) ("It is hornbook law that jurisdiction of a District Court cannot be stipulated to by the parties, and that the court sua sponte must satisfy itself that jurisdiction exists"); United States v. DeCamp, 478 F.2d 1188, 1191 (9th Cir. 1973), cert. denied, 414 U.S. 924 (1973) ("Jurisdictional defects cannot, of course, be waived."). 2/ If, as we contend, the actions ordered by the District Court were beyond the scope of its Article III powers, it is irrelevant that the judgment was consented to or that the appellants, who have been injured by the unlawfully ordered actions, were not parties to the earlier suit and have found it necessary to attack its judgment collaterally.

2/ The SEC's consent judgment cases recognize this point. See United States v. Radio Corp. of America, 46 F. Supp. 654, 656 (D.Del. 1942) ("I do not overlook the fact that consent decrees may be set aside for lack of actual consent to the decrees as entered, for fraud in their procurement, or for lack of Federal jurisdiction." Swift & Co. v. United States, 276 U.S. 311, 324 (1928)). None of the cases relied upon by the SEC to support their "collateral attack" defense involved a claim that the prior judgment exceeded the limited powers of a federal court under Article III, and none of them involved claims otherwise falling within the "void judgment" principle. See also 7 Moore's Federal Practice, § 60.25[2] at 303 (2d ed.) ("If, however, the court's action involves a plain usurpation of power, the court's judgment is void, even though it has the (cont'd)

Second, none of the plaintiffs "waived" any rights at issue in this case.[3/] Plaintiff Rosenberg, for example, had no involvement whatsoever in Mattel's corporate decision to acquiesce in the SEC's demand for a special counsel investigation. (See Brief of Appellant Seymour Rosenberg at 3-4.)[4/] And

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2/ (cont'd)
requisite jurisdiction over the parties or res, as the case may be."); United States v. Walker, 109 U.S. 258, 266 (1883). We also note that in the principle case relied upon by the SEC defendants, i.e., McAleer v. American Tel. & Tel. Co., 416 F. Supp. 435, 438-41 (D.D.C. 1976), the court pointed out that (416 F. Supp. at 439):

> "It is unnecessary to elaborate on the obvious fact that the Consent Decree did not and could not have conclusively determined the rights of non-parties such as plaintiff McAleer."

3/ The SEC defendants concede in the midst of their "waiver" argument that it is inapplicable where "basic constitutional rights" are it issue. SEC Br. 23 n.31. Yet "basic constitutional rights" are exactly what is it issue in this case. Plaintiffs' complaint alleges that the investigations undertaken by Special Counsel and Special Auditor, and the publication of their reports, have deprived them, inter alia, of such Fifth and Sixth Amendment rights (Complaint, para. 38, R. 19) as those pertaining to a fair hearing by an impartial trier of fact (id., para. 41, R. 20-21), the right to confront and cross-examine witnesses (id.), the right not to be subject to a totally unlimited investigation conducted without procedural rules resulting in officially sanctioned public accusations of wrongdoing (id., paras. 41-42, 48(a), R. 20-21, 23) and the right to trial by an impartial jury if they are indicted. (Id., para. 48(b), R. 23.) The most stringent standards conceivable for waiver of such basic constitutional rights must be met. See Schneckloth v. Bustamonte, 412 U.S. 218, 236-37 (1973); Johnson v. Zerbst, 304 U.S. 458, 464 (1938).

4/ The SEC's reliance for a claimed "waiver" upon Plaintiff Rosenberg's knowledge that a Special Counsel had been appointed, and upon the Handlers' and Rosenberg's participation in interviews by the Special Counsel is wholly misplaced. At the time the Special Counsel was appointed, none of the parties -- not even the Special Counsel -- knew precisely what his role was to be or how he would use his powers. Moreover, all persons
(cont'd)

respecting the Handlers, each of their acts in voting for the adoption of Mattel resolutions and in executing undertakings with respect to their positions as officers and directors of Mattel was taken in the capacity of an officer, director and fiduciary of Mattel and its shareholders. In that capacity, they were charged with responsibility for management of the affairs of Mattel by both Delaware and California law. (Delaware Corporation Law § 141(a) and California Corporations Code § 800.) The action of a director taken during a board of directors meeting with respect to managment of his company's affairs cannot bind him in his individual capacity or preclude him from alternative courses of action in his own right as long as, in pursuing such course of action, he does not violate his fiduciary duties of care and loyalty to the corporation of which he is a director. See, e.g., Industrial Indemnity Co. v. Golden State Co., 117 Cal. App. 2d 519, 533-534, 256 P.2d 677 (1953). See also Sequoia Vacuum Systems v. Stransky, 229 Cal. App. 2d 281, 40 Cal. Rptr. 203 (1964).

Third, plaintiffs clearly possess the requisite standing to bring this action. Standing, as the Supreme Court has recently emphasized, is based on the posture of the plaintiff with respect to the challenged conduct -- "whether the plaintiff has 'alleged such a personal stake in the outcome of the con-

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4/ (cont'd)
affiliated with Mattel were -- by the Amended Judgment -- under court order "to cooperate" in the Special Counsel's investigation. These hardly are the circumstances to support a finding of a knowing waiver of basic constitutional rights.

troversy' as to warrant his invocation of Federal Court jurisdiction and to justify exercise of the Court's remedial powers on his behalf." Warth v. Seldin, 422 U.S. 490, 498-99 (1975). In this case, the plaintiffs, as the primary and, indeed, the only persons stigmatized by being personally identified in the Special Counsel's report as culpable persons obviously have a substantial stake in the outcome of the present controversy. They are the only individuals against whom Special Counsel recommended suits be filed and they are the very persons against whom Special Counsel's "evidence" is most likely to be used by current and future litigants. Thus, under well-settled principles of standing, the plaintiffs have the right to invoke the Court's jurisdiction to address the claims raised in their complaint. Indeed, they are the persons most likely to raise the important constitutional issues created by the SEC's adoption of a congressionally unauthorized procedure that violates fundamental constitutional principles, but which, because of the consent decree device employed by this powerful public agency, has never before been subject to the careful scrutiny of the federal courts. Cf., Ballerina Pen Company v. Kunzig, 433 F.2d 1204, 1208-09 (D.C. Cir. 1970), cert. denied, 401 U.S. 950 (1971).

Interestingly, under the SEC's approach as to who has standing to challenge the Special Counsel-investigative device, those persons who are likely to suffer the most egregious harms can never be heard to complain. According to the SEC, they

cannot intervene in the original action because it is speculative at that point whether they will be identified as culpable parties. (SEC Br. 19, n.25.) And they cannot collaterally attack the Special Counsel's appointment or the conduct of his investigation because of the SEC's "final judgment" theory. (SEC Br. 19-23.) In short, the SEC would insulate its private law-enforcement device from any attack other than by the corporate entity that is being asked to finance the Special Counsel's venture. Of course, what the SEC knows -- but leaves unstated -- is that corporations in this country, who must retain the good favor of the Commission in order to gain access by public offerings to life-sustaining capital, are the least likely to challenge the Commission's desire for a private inquisition. The targeted corporation is only too pleased to have the SEC forego full-scale litigation in favor of a private house-cleaning in which the corporate entity survives and corporate executives are left to remake their lives elsewhere. It is this fact that has permitted the Commission's new law-enforcement technique to escape close judicial scrutiny to date. The plaintiffs here, however, have suffered -- and will continue to suffer -- the kind of concrete injury that provides them a vital stake in the outcome of this case. There is, accordingly, no question that they possess the requisite standing to raise the issues presented here.

Fourth, the Commission's brief goes to great lengths to characterize this action as appellants' attempt to forestall a criminal indictment. The Commission apparently believes that if it convinces this Court that it has no authority to interfere with a grand jury's quest for evidence, this Court will then find it unnecessary to rule on the constitutionality of the Commission's new investigative device. To this end, the Commission contends that because appellants might someday have the opportunity to move to suppress evidence at a criminal trial, any ruling here as to the lawfulness of the Special Counsel procedure would constitute "an advisory opinion on hypothetical facts." The Commission's "prematurity" or lack of a "case or controversy" defense is premised on a wholly incorrect assessment of the facts and a misunderstanding of the nature of this action. Although various aspects of this suit do relate to matters that would arise should the government someday seek to prosecute the plaintiffs, it is in no way dependent upon any future developments. The Reports of which the plaintiffs complain are still in existence. They stand as official district court documents attributing to plaintiffs misconduct that has never been proven under lawful procedures. The injury that results is real and susceptible of remedy. Of course -- as the SEC argues -- the Court cannot "expunge" the memories or collective knowledge which currently exists in the community because of the dissemination of Special Counsel's Report. (SEC Br. at 24 n.31.) But then, neither could

this Court in United States v. Chadwick, 556 F.2d 450 (1977) and the Fifth Circuit in United States v. Briggs, 514 F.2d 794 (1975) expunge from the public minds the "unindicted co-conspirators" label. What the Court can do, however, is terminate the official status of the Report and eliminate the inference that the findings of Special Counsel are judicially santioned. Moreover, this suit seeks declaratory relief as to the lawfulness of the procedure itself which resulted in the deprivation of plaintiffs' rights. Such a judgment is not "advisory" and certainly is not based on "hypothetical facts."

Finally, as to the contention that this Court cannot preclude a grand jury from obtaining whatever evidence it desires, the fact is it can. (See Rule 17, F.R.Crim.P.; United States v. Calandra, 414 U.S. 338, 346 n.4 (1974).) But even if it were inclined otherwise, it has been nearly a year since the District Court refused to enjoin the defendants from making further use of the evidence obtained from Special Counsel. It is our understanding that all such evidence has been presented to the grand jury and that grand jury access to evidence simply is not an issue in this case. If that is so -- and we believe it is -- it is disingenuous for the defendants to raise the matter as a basis for this Court's refusing to rule upon the meritorious issues properly presented by this appeal.[5/]

5/ A representation by the defendants as to the status of this particular matter is all that is necessary to lay the matter to rest.

II.
THE PRIVATE LAW-ENFORCEMENT DEVICE EMBODIED IN THE AMENDED JUDGMENT IS NOT SUSTAINABLE BY ANALOGY TO TRADITIONAL EQUITABLE REMEDIES

The Amended Judgment at issue in this case authorized an open-ended investigation by a private attorney and private accounting firm. The investigation was carried out under the authority of a Federal District Court which was responsible ultimately for supervising the conduct of the private investigators, but which had no authority to enter any final judgment or otherwise to take any dispositive judicial action respecting the results of the investigation. (See Initial Brief, at 8-9 (unlimited scope of special counsel's and special auditor's investigation); id., 18-19 (court's role in the investigation).) The SEC defendants do not seriously challenge our characterization of the Amended Judgment in these respects.[6/] Nor do they

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6/ In footnote 32 at page 24 of its brief, the SEC states, inter alia,

> And, contrary to the appellant's suggestions . . . the Special Counsel's authority to investigate and make representations to Mattel emanated from Mattel, not the Commission or the Court.

Respecting the Court's power, Special Counsel's own description of his authority flatly contradicts this extraordinary (and otherwise unsupported) assertion. (App. 115, emphasis added):

> I take instruction from the Court and respond for all my authority to the Court but not the Court sitting as a Court, but solely because you are representing Mattel and are able to speak in your powers for Mattel.

See also Initial Brief at 19. Note also that in securing this order from Judge Gesell originally, the SEC stated that "special counsel is responsible to the Court" (App. at 77) and that special counsel's "client, to the extent he has one, would be this Court and Mattel." (Id.)

even attempt to explain how, by court order, a private attorney can be vested with unlimited and unchecked investigatory and enforcement powers. And they do not discuss by what authority a court -- with powers limited by Article III -- can appoint a private attorney who, upon completing a court-ordered investigation, is required to file an advisory report with the court. Instead, the SEC defendants seek to justify the Special Counsel device merely by analogizing it to traditional equitable receiverships. (SEC Br. at 27-30.) But the very cases the SEC cites to support this analogy demonstrate how truly far from the traditional exercise of equity powers the SEC led the District Court in this case.

All of the cases relied on by the SEC demonstrate the extraordinary care Federal courts have taken in each instance to make certain that the receiver be confined to traditional equity powers. The historic function of the equity receiver for solvent corporations is "to prevent threatened diversion or loss of assets through gross fraud and mismanagement of its officers." See Burnrite Coal Briquette Co. v. Riggs, 274 U.S. 208, 212 (1927) (Brandeis, J.). The receivership appointment is an extraordinary remedy to be used only where it is demonstrated that there is danger to the corporate properties if the court does not substitute a receivership for private management. See, e.g., Wickes v. Belgian American Educational Fund, 266 F. Supp. 38, 40 (S.D.N.Y. 1967). In SEC v. Republic National Life Insurance Co., 378 F. Supp. 430

(S.D.N.Y. 1974), for example, the court, in denying the SEC's request for appointment of a receiver, observed (id. at 438):

> The appointment of a receiver pendente lite with the attendant burdensome expense and dislocation of a corporation's operations and particularly the operations of a business of life insurance, is an extraordinary remedy to be employed with the utmost caution and granted only on a showing of clear necessity to protect plaintiff's interest in Republic's property which the SEC seeks to have placed under a euphemistically styled "caretaker" until such time as Republic can comply with the filing requirements of the law.
>
> To warrant such extraordinary relief there must be imminent danger of the loss of the property and of failure to meet obligations due to Republic's shareholders and investors and the public generally.

Federal courts do not simply appoint receivers whenever the SEC avers generally that such an action is in the public interest. Instead, the court must carefully scrutinize the record to assure that the receivership remedy serves the purpose of preserving the corporate property in the face of a management threatening dissipation of the assets through waste or fraud (see SEC v. Manor Nursing Centers, Inc., 548 F.2d 1082, 1105 (2d Cir. 1972); SEC v. Bowler, 427 F.2d 190, 198 (4th Cir. 1970); SEC v. Keller Corp., 323 F.2d 397, 403 (7th Cir. 1963)) or is tied to a specific statutory purpose consistent with the historical role of an equity receiver. Judge Weinfeld's decision in SEC v. H. S. Simmons & Co., 190 F. Supp. 432-33 (S.D.N.Y. 1961) articulates this point

precisely:

> While it is true that section 21(e) [of the 1934 Securities Act] contains no express authorization to the Commission to apply for such appointment, "When Congress entrusts to an equity court the enforcement of prohibitions contained in a regulatory enactment, it must be taken to have acted cognizant of the historic power of equity to provide complete relief in the light of statutory purposes."[1] Thus, the Court's inherent equity power may be resorted to when necessary to prevent diversion or waste of assets to the detriment of those for whose benefit, in some measure, this injunctive action is brought. Although a general purpose of the suit is to protect the investing public from the consequences of continued violations of the Act, a specific purpose is the protection of those who already have been injured by a violator's actions from further despoliation of their property or rights.

Federal judges are not to involve federal courts in the affairs of private corporations simply on the general assertions of the SEC that the public interest or unspecified "statutory purposes" warrant this extraordinary form of judicial intervention. 7/ See also the Second Circuit's treatment of the sta-

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7/ Judge Weinfeld's quote is from Mitchell v. Robert DeMario Jewelry, Inc., 361 U.S. 288, 291-92 (1960). Also cited at footnote one of the passage in text is Porter v. Warner Holding Co., 328 U.S. 395 (1946). Compare the SEC's use of these cases at SEC Br., 26 and note 36.

tutory purposes of the Investment Company Act of 1940 in SEC v. Fifth Avenue Coach Lines, Inc., supra, 435 F.2d at 515 and compare SEC Br. at 29 n.41.

It is in this carefully constructed framework of statutory purposes and traditional equitable powers that the ordinary SEC-requested receivership exercises its powers to file lawsuits against private persons and to conduct investigations preliminary to and in connection with such lawsuits. These lawsuits -- to which the SEC now hopes to analogize the "investigative and prosecutorial functions" (SEC Br., 29 n.41) of the Mattel Special Counsel -- are nothing more than the ordinary trustee chasing down and collecting all the debts and choses in action of the trust beneficiary. A receiver, called upon in such a context to prepare and file lawsuits, takes his guidance from his well-understood role as a substitute for corporate management in marshalling the assets of the company. His investigative mandate is purely "ancillary" to his historic purpose: to pursue through wholly civil lawsuits for entirely private civil purposes the economic interests of his beneficiary.

In sharp contrast to this well-structured, equity receivership arrangement lies the unlimited investigative and

prosecutive powers of the Mattel Special Counsel, who himself explained that his role under the Amended Judgment had "no defined meanings in the fields of law and accounting."[8/]

In further contrast to the equity receiver, the Special Counsel operates in a posture of inherent professional conflict. For example, at a meeting with appellants' attorneys, the Special Counsel stated respecting the naming of individuals in his report and the matter of making his report public that (R. 389-90):

> . . . while his primary responsibility was to Mattel and its present stockholders and that filing and submission of his report could only be harmful to the company and its then present stockholders and could not help them, he felt that he was compelled by the court order to file the report and further to file it in the form he described to us. He said he felt that the filing of the report will benefit no one. He said he felt that his investigation was intended not merely to advise the Board of Directors about their rights and duties and not merely

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8/ As the Special Counsel explained in his Report:

> The concept of using private counsel and auditors to investigate securities violations is relatively new. The terms "Special Counsel" and "Special Auditor" have no defined meanings in the fields of law or accounting; hence, the functions of Special Counsel and Special Auditor must be derived primarily from the Second Amended Judgment itself. (Sp.C.Report, 6.)

But, as the Special Counsel conceded, the Amended Judgment leaves a great deal unstated:

> . . . [T]he Second Amended Judgment specifically directs Special Counsel to "investigate" and the Special Auditor to "conduct an audit"; and it requires both to file reports. However, the nature ofthe investigation, audit and reports is not further defined. (Sp.C. Report, 7.)

> to make corrections, if any, which might be required to accurately represent Mattel's financial condition for 1971 and 1972, but rather to be a much broader investigation conducted in lieu of a full SEC investigation or the appointment of a receiver for Mattel at the request of the SEC.

Thus, it was Special Counsel's conception of himself as a dual private civil claims agent and a public law enforcement official that necessitated his reluctant consent to the SEC's demands for publication of the entire report. (App. 106.)[9/]

Put in its most simple form, the Special Counsel arrangement is wholly different from an equity receivership because they are to serve wholly different functions. The receiver is to act for the benefit of the corporation in marshalling its assets and carrying out its business: the Special Counsel, on the otherhand, was to investigate federal securities law violations which he knew from the start ". . . might ultimately lead to a criminal investigation by the Department of Justice or other law enforcement arm." (R. 414.)

That the Special Counsel's investigative and public disclosure role in primary, and is undertaken at the behest and for the benefit of the SEC is amply demonstrated by the fact that the Amended Judgment itself eliminated any basis for creating a court-controlled general investigator and prosecutor. The Amended Judgment provided for appointment of a majority

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9/ The SEC demanded, in reviewing drafts of special counsel's report, that the entire report be made public and that plaintiffs in this action be individually named. App. 106. In effect, the SEC pressured special counsel to make "maximum disclosure." Id.

of new SEC-approved members on Mattel's Board and on all of its key operating committees. (See Initial Brief at 6.) This structure is clearly more analagous to the traditional receivership. Yet the Commission was not content to have this receivership-type committee control the Special Counsel's investigation as ancillary to its management role. Instead, the Special Counsel was authorized to apply directly to the Court for instructions in the event of a dispute between him and the new SEC-approved directors (App. 43.) And the Amended Judgment mandated that (App. 43):

> Mattel shall not settle or decline to pursue any material claim related to the matters stated in the Commission's Complaint, the Application For Further Relief, the Report of the Special Auditor, or the Report of the Special Counsel except upon prior reasonable notice and explanation to the Commission.

The Amended Judgment even conditioned the firing of Special Counsel on court approval. (Id., at 45.)

The cases the SEC defendants rely on concerning receivers appointed to file financial reports required by statute or court order do not support the reporting function of the Special Counsel here. In SEC v. Koenig, 469 F.2d 198 (2d Cir. 1972), the court approved a limited receiver (469 F.2d at 199) to report on a specific set of financial transactions. This appointment was premised on findings that (a) the material transactions had not been disclosed in required filings before the SEC; (b) the applicable SEC statutes and regulations

required disclosure of the transactions; and (c) the corporation had "failed to file accurate reports even during the period of the present litigation" (469 F.2d at 202).[10/]

Similarly, in SEC v. Beisinger Industrial Corp., 421 F. Supp. 691 (D. Mass. 1976) the court appointed a "Special Agent whose primary responsibility is to bring the registrant into compliance with the reporting requirements of the Exchange Act" (421 F. Supp. at 696). This action was taken only after the defendants had been given an opportunity to remedy their defective filing behavior. As the court put it, (492 F. Supp. at 695):

> The registrant continues its pattern of conduct failing to comply with the reporting requirements. It is, in addition, now flouting an explicit court order requiring compliance. In light of the conduct of the defendants in derogation of the existing injunction, additional equitable relief is necessary.

Once again, the record affirmatively demonstrates the absence of any "analogy" between the Special Counsel's filing of a "report" concerning any and all securities law violations he could unearth, and the type of limited receiverships that have been authorized by some courts to make reports required by statute or court order. First, Judge Gesell, on the occasion the Amended Judgment was entered, observed that nothing in the

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10/ See also id.: "The appellants continued to violate the Federal Securities laws even after a consent decree had been entered enjoining them from such conduct."

record demonstrated a violation of the pre-existing order in the case. (App. at 54.)[12/] Second, Special Counsel, in explanation of his decision to make the report public, stated that

> . . . he felt his investigation was intended not merely . . . to make corrections, if any, which might be required to accurately represent Mattel's financial condition for 1971 and 1972, but rather to be a much broader investigation conducted in lieu of a full SEC investigation or the appointment of a receiver for Mattel at the request of the SEC (R. 390).

Third, there was no showing that the new SEC-approved management -- as opposed to a "special agent" or "limited receiver" under the court's control -- was needed to bring Mattel into compliance with the Securities Acts' filing and disclosure requirements. Cf. SEC v. Republic National Life Insurance Co., supra, 378 F. Supp. at 438.

III.
THE EVIDENCE ESTABLISHES THAT THE SEC DELEGATED A CRITICAL PORTION OF ITS ENFORCEMENT POWERS AND RESPONSIBILITIES TO A PRIVATE LAWYER AND ACCOUNTING FIRM

We contended in our initial brief that the Amended Judgment constitutes an unlawful delegation of the enforcement powers of the SEC to a private party in violation of the Constitution, the various securities acts and the SEC's own regulations. The SEC defendants have not argued that such a delegation is proper. Instead, they assert that the Special Counsel's

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11/ The original order entered by Judge Richey of the U.S. District Court for the District of Columbia is set forth at App. 9-15.

and Special Auditor's powers did not represent a delegation of the authority or functions of the Commission. As they put it, (SEC Br. at 24 n.32):

> The appointment of the special counsel was intended to benefit Mattel and, most importantly, its public investors, who had purchased and sold hundreds of thousands of shares of Mattel securities over the several years Mattel had been disseminating false and misleading reports of the results of its operations. The Commission did not delegate any of its authority to the special counsel, and the special counsel explicitly acknowledged that "I don't represent the SEC in any way nor do I take instructions from the SEC." Transcript of Proceedings, March 1, 1975, at pp. 127-128. Indeed, even though the special counsel conducted his own review, the Commission's staff continued its own, independent investigation of Mattel.

In direct contrast to the representations the SEC made to Judge Gesell at the time the original order was secured, (see App. at 77), the SEC now informs this Court that the Special Counsel is a "Mattel surrogate" (SEC Br. at 11) conducting an investigation "in every respect . . . independent" (id. at 10) whose authority, like any other private attorney retained by a corporation, "emanated from Mattel . . ." (id. at 24 n.32) and not from the Court or the Commission. (Id.)

The prcblem with these self-serving characterizations is that the record does not support them. From the outset, it was the SEC that initiated, consulted, guided and ultimately benefited from the Special Counsel's appointment. When apprised by Mattel of potential violations of securities laws, the SEC staff -- instead of carrying out their responsibilites under

the SEC's lawful charter -- preferred to have Mattel retain a private lawyer who, at Mattel's expense, would do the investigation that the SEC staff would otherwise have performed. The fact that the SEC staff viewed the Special Counsel as their alter ego is evidenced by their relationship from the very start.

The concept of having a Special Counsel to conduct the investigation at issue in this case resulted from a meeting in the SEC offices of defendant Borowski among SEC Enforcement officials and Mattel's corporate attorneys (Mann Dep. at 8). Mr. Borowski explained that at that meeting (Borowski Dep. at 46):

> Well, what was presented to us was an extremely damaging admission by the company itself: Quite frankly, gross violations of Federal Securities laws. We could not believe that a company would come forward with that kind of information making those admissions unless it was true.

Mr. Borowski testified that when he heard these disclosures, he thought that there was a real possibility that crimes had been committed based on [his] experience and knowledge at the time. (Id., at 49.) In the discussions that ensued, Mr. Borowski suggested that a Special Counsel be appointed (Mann Dep., 20-21; id., at 106). Indeed, Mr. Hufstedler himself was proposed, initially, by the SEC as a candidate for Special Counsel (Borowski Dep., 20; 23). And at these initial meetings leading to the Special Counsel concept, the SEC insisted upon approval rights for whoever became Special Counsel (Mann Dep. at 21). That position was, of course, embodied in the terms of the Amended Judgment.

Once Mr. Hufstedler had been appointed and approved by the court, the SEC did not sit back -- as their brief suggests -- and let the Special Counsel operate independently. They consulted with him respecting the scope, the direction and the content of his investigation. They even advised Mr. Hufstedler in at least one respect as to how he should conduct his interviews of witnesses. The SEC staff -- fully aware of the criminal implications of the allegations of wrongdoing -- told Special Counsel he should give Miranda type warnings (Borowski Dep. at 60-61).

The SEC kept close tabs on the Special Counsel's work. Mr. Hufstedler's records reflect nine different meetings with the SEC staff, (Hufstedler Aff. at 7), and defendant Mann testified he called attorneys in Special Counsel's office concerning the investigation "at least once a month" (Mann Dep. at 49-50). As Mr. Mann admitted, "my discussions during that period with the special counsel or his representatives were not infrequent" (id. at 92).

These contacts between the Special Counsel and the SEC were by no means casual or pro forma. Defendant Mann recalled one occasion on which Jerome Craig, a partner of the Special Counsel, called to ask the SEC whether he should interview some broker dealers or research analysts in New York, "and I [i.e., Mr. Mann] indicated that I thought he should do so" (Mann Dep. at 44). On another occasion a branch office of the Commission

received information that a particular person had information about Mattel and would be willing to speak to the SEC about it. Instead of conducting his own investigation, Mr. Mann preferred to utilize the services of the ongoing Special Counsel's investigation. (Id. at 49-50.)

Collaboration between Special Counsel and the SEC staff was not unusual. Indeed, and rather incredibly, the SEC staff treated Special Counsel so much as one of their "in house" lawyers that, without an SEC authorization, they gave him and the private accounting firm (Price Waterhouse & Co.) total access to the SEC's non-public investigative files; files to which even another branch of the federal government cannot gain access without the formal vote of the Commissioners. And finally, when this "independent" private investigation was completed, the SEC requested and received from Special Counsel and Special Auditor the evidentiary material supporting their reports. (See Borowski Dep. at 55-56.)

The process of the drafting of the Special Counsel's reports likewise inspires little confidence in the SEC's assertions concerning the Special Counsel's independence. The SEC received three drafts of the Report prior to its publication and on the basis of those drafts made specific suggestions for changes (Borowski Dep. at 97-98; see also Mann Dep. at 84-88). Indeed,

prior to the filing of the Reports, the SEC staff met with Special Counsel and members of his firm to discuss the Report's content. One area that seemed particularly to concern the SEC staff was "the extent of the description of individual conduct, individual responsibility" (Borowski Dep. at 98). As explained by Mr. Borowski (id. at 99):

> Well, I felt, and I expressed it, and I think Mr. Mann did, too, that we ought to have the maximum disclosure of responsibility of corporate officials to the extent that they were responsible, that this is what Federal Securities law has contemplated, that the stewardship of a corporation by its officials should be disclosed by its directors and that there should be the maximum disclosure that is feasible. I think Mr. Hufstedler really had agreed to a limited -- well he did not want to get too deeply involved in a discussion of individual roles, but I think he did to some extent pick up our suggestions, and in the way in which he discussed individual responsibility.

So, despite Special Counsel's own position on the matter, when the Report was filed, there were the plaintiffs' names as persons against whom Special Counsel had concluded Mattel had claims that should be pursued (Report of Special Counsel at 10-11).

In addition to specifically inspiring the identification by name of the Handlers and Rosenberg as the parties having individual responsibility of the deliberate securities violations, the SEC inspired and insisted upon from the outset that the entire Report become a public document. Thus, Mr. Borowski testified (Borowski Dep. at 95-96):

> . . . the whole purpose of this thing, the primary purpose of this whole exercise was to make disclosure to the public and to the shareholders and people who might want to invest in Mattel stock. That was a primary purpose of this whole exercise and there were things in the judgment that are specifically directed to that so that we have always indicated that we would urge the greatest -- we would also be on the side of the greatest amount of public disclosure possible because that was the objective of the Federal Securities and that was what we were desiring to accomplish.

The conflict between what the SEC wanted and insisted upon to this "independent" Special Counsel and what the obligations of an attorney truly representing only Mattel, or acting as the SEC puts it "for the benefit of the corporation" is striking. At a meeting held on August 7, 1975 attended by, inter alia, some of the lawyers for the defendants in the pending civil class actions and Special Counsel, Special Counsel said that he believed that the filing and submission of his Report could only be harmful to the company and its present stockholders and could not help them. But he felt he was compelled by the court order to submit the Report and further, to submit the Report in the form he described to those at the meeting. Special Counsel also stated that he felt that the filing of the Report would benefit no one, but that his investigation was in lieu of a full SEC investigation or the appointment of a receiver for Mattel at the request of the SEC. (App. 106.) In short, Special Counsel was in an impossible position. His "client's" interests were not to file a public report; but the SEC was insisting on the publicity, and the court order seemed

to compel publication. Thus even when counsel for the Handlers formally requested that the Report be sealed upon filing, the Special Counsel responded that he felt he had no choice since he was sure the SEC would oppose it.

Not only did the SEC staff turn over to the Special Counsel their responsibility to conduct investigations of possible violations of the securities laws, they furnished the individual Commissioners copies of the Report for review in connection with the staff's Request For Authorization to make the SEC's files -- now substantially enlarged by the addition of all the fruits of the Special Counsel's work -- available to the Justice Department for possible criminal action. Relying exclusively on those Reports, the SEC authorized the staff to send all SEC files to the Department of Justice for possible criminal prosecution.

Based on the foregoing, it is too late in the day for the SEC defendants retroactively to disavow their intimate relationship with what they prefer to describe now as "an independent" special counsel arrangement. And the evidence proves that, from the outset, the enforcement personnel of the SEC realized that they had a potential criminal investigation on their hands which they preferred to delegate to a private lawyer. Having delegated the principle investigative task, the staff monitored the Special Counsel's work, gave him suggestions on how to operate, provided assistance through leads and access to files to which no one but SEC personnel are allowed access without Commission authorization, and helped to shape the

content and manner of dissemination of the Special Counsel's Report. And once their work had been finished for them, the SEC staff gathered in the fruits of the Special Counsel's effort, submitted it to the Commissioners and got their authority, on the basis of the Special Counsel's work, to deliver the fruits to the U. S. Attorney.

CONCLUSION

In our initial brief, we presented these issues as matters of first impression raising vital questions of Federal judicial power and the enforcement of the nation's securities laws. (Initial Br., at 1.) That characterization, we submit, still holds. Indeed, through the device of uncontested consent decrees (see id. at note 2) a powerful federal agency has placed the district courts in an investigative and advisory role wholly incompatible with Article III of the Constitution. In addition, private lawyers have performed critical public law enforcement functions in professional roles entailing fundamental conflicts of interest, all without even the sanction of Congress, much less the Constitution. All of this has occurred, as Judge Gesell aptly observed, because the SEC feels it lacks the fiscal appropriations to conduct the public's investigative business itself. (See App. 82.) We do not doubt the SEC's "public interest" motivations in creating these special

counsel investigative arrangements. Cf. Ballerina Pen Company v. Kunzig, 433 F.2d 1204, 1208 (D.C.Cir. 1970).[12/] But their vice is that they make judges "member[s] of the SEC staff" (App. at 64), administering an investigative program (id. at 82) with no final judicial authority to enter any judgment based on the results, yet nonetheless implicated in the inescapable deprivations of due process inherent in a private lawyer called upon to serve too many masters with conflicting interests.

For the reasons stated, the Court should grant the relief prayed for. (See Initial Br. at 32-33.)

12/ The Court in Kunzig observed (433 F.2d at 1208):

> Frequently the motivation of challenged agency action is neither caitiff nor paltry, with the result that the purity of doctrine and the nobility of purpose tend to narcotize completely the searches for legal authorization. The unfortunate result is euphemistic in that the legal wolf is effectively disguised in an emotionally appealing wool. Courts are therefore confronted with the problem of insuring that the idealistic objectives of brave but congressionally unauthorized action, ostensibly undertaken pursuant to a "public interest" provision, are legally bottomed upon something more than a Bourbon Monarch's "L'Etat-c'est Moi."

Respectfully submitted,

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