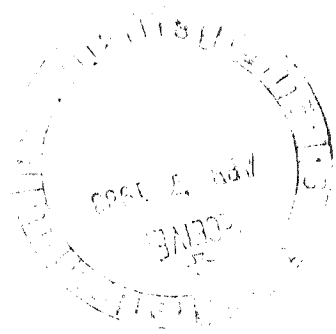
→ Richard Bragg



UNITED STATES DISTRICT COURT
FOR THE
DISTRICT OF COLUMBIA

LUCIUS G. HILL, et al.,	:	
Plaintiffs,	:	
v.	:	Civil Action No. 82-2675
SECURITIES AND EXCHANGE COMMISSION, et al.,	:	
Defendants.	:	

MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF DEFENDANTS' MOTION FOR SUMMARY JUDGMENT OR, IN THE ALTERNATIVE, TO DISMISS

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April 7, 1983

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PRELIMINARY STATEMENT

This lawsuit arises from a routine examination under the Securities Exchange Act 1/ of the books and records of a registered broker-dealer, Lucius G. Hill Securities, Inc., which took place almost three years ago. Plaintiffs, the broker-dealer and its principal, now challenge that examination and the statutory provision pursuant to which it was conducted, under the fourth amendment. Defendants, the Securities and Exchange Commission and its individual Commissioners (collectively, "the Commission"), have moved this Court to grant them summary judgment on all claims. Warrantless examinations of books and records under the Securities

1/ 15 U.S.C. 78q(b).

Exchange Act ("Exchange Act") are reasonable under the fourth amendment; they involve only a minimal intrusion of commercial property in a single, pervasively regulated industry, with a long history of government supervision, and are necessary for effective enforcement of the Act.

In any event, the statute is not unconstitutional as applied to plaintiffs. As is clear from the face of their complaint, plaintiffs' agent consented to the records' examination, and plaintiffs' themseleves ratified this consent. Thus, the complaint fails to state a constitutional claim and should be dismissed. Rule 12(b)(6), Federal Rules of Civil Procedure.

The Commission also requests this Court to dismiss, pursuant to Rule 12(b)(1), all claims for an injunction against use of any documents obtained in the examination. Those claims are not ripe because the Commission has not sought to use the documents in any proceeding; if the Commission should seek to do so at some later time, plaintiffs will have an adequate remedy at law in that proceeding.

STATEMENT OF THE CASE

I. STATUTORY AND REGULATORY SCHEME 2/

Almost 50 years ago, when Congress first enacted legislation governing the securities markets, it directed

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2/ To place in context the routine examination of plaintiffs' books and records (the issue in this case), the Commission sets forth a summary description of the statutory and regulatory framework pursuant to which that examination took place.

pervasive regulation of securities broker-dealers 3/ because it found that unscrupuluous or financially irresponsible broker-dealers had posed particular dangers to investors and interstate commerce. 4/ In enacting federal securities legislation, Congress was concerned that securities dealers adhere to "standards of fair, honest and prudent dealing that should be basic to the encouragement of investment in any enterprise." H.R. Rep. No. 85, 73rd Cong., 1st Sess. 2 (1933). 5/ Accordingly, broker-dealers in securities listed

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3/ A broker is a person in the business of effecting securities transactions for the accounts of others; a dealer is a person in the business of effecting securities transactions for his own account. Sections 3(a)(4) and 3(a)(5) of the Exchange Act, 15 U.S.C. 78c(a)(4) and 78(c)(a)(5). As most persons in the business engage in both types of transactions, they are commonly referred to as "broker-dealers." E.g, United States v. Nat'l Ass'n of Securities Dealers, 422 U.S. 694, 701 (1975).

4/ Securities brokers have been subject to licensing requirements and prosecution for violating those requirements since 1285. Even prior to enactment of federal securities legislation, most states regulated the activities of brokers and dealers. For the history of broker-dealer regulation in England and this country, see generally 1 L. Loss, Securities Regulation §1 (2d ed. 1961).

5/ See also Proposed Amendments to the Securities Act of 1933 and Securities Exchange Act of 1934: Hearings before the House Comm. on Int. and For. Commerce, 77th Cong., 1st Sess. (1941) 20-24 (noting need for financial safeguards for broker-dealers); United States v. Naftalin, 441 U.S. 768, 775 (1979) ("Prevention of frauds against investors was surely a key part of [the federal securities laws], but so was the effort 'to achieve a high standard of business ethics * * * in every facet of the securities industry'") (emphasis in original).

on a national securities exchange have been regulated by the Commission since 1934, the year the stock exchanges first became regulated. 6/ In 1938 Congress extended the Commission's regulatory authority to include broker-dealers operating in the over-the-counter market. 7/

Today, as we describe below, federal regulation of securities broker-dealers is far-reaching and extensive. Regulatory authority is shared by the Commission and a number of self-regulatory organizations (SROs) registered with the Commission. 8/ SROs are stock exchanges or other private registered securities associations to which Congress has delegated certain regulatory authority under the general supervision of the Commission. The SROs have responsibility to assure their members' compliance with the federal securities laws, as well as with rules and regulations they have promulgated. 9/

6/ Exchange Act, 15 U.S.C. 78(a) et seq.

7/ Maloney Act of 1938, 15 U.S.C. 78o(c)(i), 78o(c)(2) and 78o-3. The over-the-counter market encompases securities transactions that take place other than on a national securities exchange. See V. Loss, Securities Regulation § 8 (2d ed., 1961).

8/ See 15 U.S.C. 78o(b)(8) and United States v. Nat'l Ass'n of Securities Dealers, 422 U.S. at 700-01 n.6; Silver v. New York Stock Exchange, 373 U.S. 341, 350-53 (1963).

9/ See Section 6, Exchange Act, 15 U.S.C. 78f (provisions governing exchanges); Section 15A, Exchange Act, 15 U.S.C. 78o-3 (provisions governing registered associations); and Section 19, Exchange Act, 15 U.S.C. 78s (provisions governing all SROs).

Members of stock exchanges, as well as non-member broker-dealers, may join the National Association of Securities Dealers (NASD), the primary SRO for broker-dealers limiting their trading activity to the over-the-counter market. 10/ Currently over 90% of registered broker-dealers (7,250 of 7,800) are members of the NASD (Kwalwasser Declaration ¶ 3). The remaining (about 550), called SECO (SEC Only) broker-dealers, are regulated directly by the Commission pursuant to Commission rules that are comparable to NASD rules. 11/

A. Survey of Broker-Dealer Regulation 12/

1. Registration

With very limited exceptions, all broker-dealers engaging in interstate commerce must register with the Commis-

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10/ The only other such SRO is the Municipal Securities Rulemaking Board.

11/ See Comparability of NASD and SECO Regulation, Securities Exchange Act Rel. No. 9420 (December 20, 1971); and, e.g., 17 C.F.R. 240.15b8-1, and 240.15b10-1 et seq. Legislation has been introduced that would require all broker-dealers effecting transactions in the over-the-counter market to join a registered securities association. See H.R. 562, 98th Cong. 1st Sess. (1983) and S. 896, 98th Cong. 1st Sess. (1983). If enacted, this legislation would eliminate the SECO program.

While SEC and NASD supervision are comparable, to the extent there are any differences we discuss in this memorandum rules affecting SECO broker-dealers since Mr. Hill did not join an SRO.

12/ Examinations of broker-dealers are discussed separately in part I.B., infra, p. 13.

sion. 13/ To register, the broker-dealer files an application requiring extensive disclosures about the registrant's background, financial condition, and the type of business in which he intends to engage. 14/ A separate registration form must be filed with the Commission or the appropriate SRO for each employee of the firm who directly or indirectly effects securities transactions. 15/ Broker-dealers are under a continuous obligation to amend their registration form should circumstances render it inaccurate. Moreover, to withdraw from registration, a broker-dealer's notice of withdrawal must be accepted by the Commission. 16/

The Commission has extensive disciplinary authority to deny, suspend, or revoke any broker-dealer registration upon a finding of, among other things, a willful violation of the federal securities laws or a failure reasonably to supervise an employee who commits such a violation. The Commission

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13/ Section 15(a) of the Exchange Act, 15 U.S.C. 78o(a).

14/ See 17 C.F.R. 240.15b1-1 and Securities Exchange Act Form BD (reproduced in Fed. Sec. Laws (CCH)).

15/ 17 C.F.R. 240.15b8-1.

16/ Section 15(b)(5) of the Exchange Act, 15 U.S.C. 78o(b)(5). See Shuck v. SEC, 264 F.2d 358 (D.C. Cir. 1958) (Commission may order revocation of registration even when registrant wishes to withdraw voluntarily).

may also limit a broker-dealer's activities, functions or operations. 17/

2. Financial Responsibility

Broker-dealers must comply with Commission regulations governing financial responsibility and related practices affecting customers' funds, including segregation of funds and financial reporting. 18/

(a) Net Capital Rule

The net capital rule is the "principal regulatory tool" that the Commission uses to "monitor the financial health of brokerage firms and protect customers from the risks involved in leaving their cash and securities with broker-dealers." Touche Ross & Co. v. Redington, 442 U.S. 560, 570 (1979). The rule, which requires each broker-dealer daily to compute its net capital, 19/ has, as its basic purpose, to ensure that the broker-dealer always has sufficient, liquid assets to cover

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17/ Section 15(b)(4), Exchange Act, 15 U.S.C. 78o(b)(4).

18/ E.g., Section 15(c)(3), Exchange Act, 15 U.S.C. 78o(c)(3); Section 17(e), Exchange Act, 15 U.S.C. 78q(e).

19/ 17 C.F.R. 240.15c3-1. Net capital is the firm's net worth minus non-liquid assets, plus certain subordinated liabilities. Certain assets are reduced by a percentage called a "haircut." No broker-dealer can permit aggregate indebtedness to exceed 15 times net capital.

debts to customers. 20/ Broker-dealers nearing violation of the net capital requirement must immediately notify the Commission by telegraph and file certain additional financial reports. 21/

(b) Safeguarding Customer Funds and Securities

Congress has authorized the Commission to promulgate rules to protect customer funds and securities in the broker-dealer's possession, in the event a broker-dealer fails. 22/ Accordingly, most broker-dealers must determine, on a daily basis, which of their customers' securities are fully paid for, or, as to securities purchased on margin, which portion is fully paid for. 23/ In addition, firms that hold customer funds and securities must keep a reserve bank account for the special benefit of customers. The amount to be deposited, which must be enough to cover certain losses, must be computed every Friday and placed in the bank by the following Tuesday

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20/ Securities Exchange Act Rel. No. 11497 (June 26, 1975). The rule is "one of the most important weapons in the Commission's arsenal to protect investors." Blaise d'Antoni & Associates, Inc. v. SEC, 289 F.2d 276, 277 (5th Cir.), cert. denied, 368 U.S. 899 (1961).

21/ 17 C.F.R. 240.17a-11. The Commission also imposes minimum capitalization requirements ranging from $2,500 to $50,000. 17 C.F.R. 15c3-1.

22/ Section 15(c)(3) of the Exchange Act, 15 U.S.C. 78o(c)(3). See 17 C.F.R. 240.15c3-3.

23/ Section 15(c)(3) of the Exchange Act, 15 U.S.C. 78o(c)(3); 17 C.F.R. 15c3-3.

before opening of business. 24/

Many other rules are also designed to protect customers' funds or securities. For example, every quarter each broker-dealer must make a "box count" to determine the number of securities it holds. 25/ Whenever effecting securities transactions for any customer, the broker-dealer must send written confirmation containing prescribed information. 26/ To prevent broker-dealers from using their customers' securities as collateral to finance the firm's business, hypothecation rules regulate the manner in which securities may be pledged as collateral for a loan. 27/

3. Trading Practices

The Commission has broad authority, pursuant to Sections 10(b) and 15(c) of the Exchange Act and 17(a) of the Securities

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24/ 17 C.F.R. 240.15c3-3.

25/ 17 C.F.R. 240.17a-13.

26/ 17 C.F.R. 240.10b-10.

27/ 17 C.F.R. 240.8c-1 and 240.15c2-1.

In addition, most registered broker-dealers must become members of the Securities Investor Protection Corporation (SIPC), which insures customer's funds and securities up to $500,000 of which $100,000 can be cash. Section 3(a)(2) and (9) of the Securities Investor Protection Act, 15 U.S.C. 78fffc(a)(2) and (9). They also must carry a fidelity bond (17 C.F.R. 240.15b10-11) and provide fingerprints for certain employees (17 C.F.R. 240.17f-2). The Commission also requires most broker-dealers to register in the Lost and Stolen Securities Program. 17 C.F.R. 240.17f-2.

Act, to prohibit fraud by broker-dealers. 28/ As a result of decisions in administrative and court proceedings instituted by the Commission under these statutes, a comprehensive code of broker-dealer conduct has developed. 29/

SECO broker-dealers also must obey rules prescribed by the Commission to "promote just and equitable principles of trade," to foster a free market, and to protect investors and the public interest. 30/ For example, a broker-dealer may not recommend securities to a customer unless he has determined that the security is suitable to the customer's investment objectives and financial situation. 31/ Prior to effecting transactions for securities in which the broker-dealer has a "control" interest, broker-dealers must disclose that fact to customers in writing. 32/ Broker-dealers managing customers'

28/ Section 10(b) and 15(c) of the Exchange Act, 15 U.S.C. 78j(b) and 78o(c); Section 17(a) of the Securities Act, 15 U.S.C. 77q(a).

29/ See generally N. Wolfson, R. Phillips and T. Russo, Regulation of Brokers, Dealers and Securities Markets §2 (1977); Samuel B. Franklin & Co. v. Securities and Exchange Commission, 290 F.2d 719 (9th Cir.), cert. denied, 368 U.S. 889 (1961); Hughes v. SEC, 174 F.2d 969, 975-76 (D.C. Cir. 1949); and Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir.), cert. denied, 321 U.S. 786 (1943).

30/ Section 15(b)(9) of the Exchange Act, 15 U.S.C. 78o(b)(9).

31/ 17 C.F.R. 240.15b10-3. The broker-dealer must keep records on each customer to make suitability determinations. See 17 C.F.R. 240.15b10-6(a).

32/ 17 C.F.R. 240.15c1-5. A "control" interest exists when the dealer is "controlled by, controlling, or under common control with, the issuer of any security." Id. See also 17 C.F.R. 240.15c1-6.

discretionary accounts 33/ must have the customer's written authorization 34/ and bear fiduciary responsibilities. 35/

4. Recordkeeping and Reporting Requirements

The recordkeeping and reporting provisions governing broker-dealers elicit information designed in part to provide the Commission and SROs "sufficiently early warning to enable them to take appropriate action to protect investors before the financial collapse of the particular broker-dealer involved." Touche Ross & Co. v. Redington, 442 U.S. at 570. Thus, Commission Rules 17a-3, 17a-4, and 15b10-6 (17 C.F.R. 240.17a-3, 17a-4, and 15b10-6), among others, require broker-dealers to make detailed books and records pertaining to their business, to preserve these and any other records they make, and to provide copies to the Commission. 36/ Implicit

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33/ Generally, in a discretionary account, the customer has given the broker certain authority to effectuate transactions; the broker need not obtain express approval as to these transactions. See United States v. Kendrick, 692 F.2d. 1262, (9th Cir. 1982) (pet. for cert. pending).

34/ 17 C.F.R. 240.15b10-5 and 240.15b10-6(d)(1).

35/ 17 C.F.R. 240.15b10-6(d)(2). For example, the broker-dealer managing such an account may not effect transactions that "are excessive in size or frequency in view of the financial resources and character of such account." 17 C.F.R. 240.15c1-7(a).

36/ Examples of books and records broker-dealers must make or keep include cancelled checks, customer complaint letters, order tickets, blotters or other records of original entry giving a daily record of all purchases and sales of securities, general ledgers and a securities position record (a ledger reflecting all long and short stock positions carried by the broker). 17 C.F.R. 240.17a-3.

in the requirement to keep books and records is the assumption that they will be kept accurately. 37/

Additionally, SECO broker-dealers must file with the Commission very detailed periodic and annual reports of their financial condition called FOCUS reports. 38/ FOCUS reports include statements of income, net capital and aggregate indebtedness computations and reserve bank account figures. Broker-dealers also must contract with an independent public acountant to perform a certified audit on an annual basis. 39/

5. Training and Supervision

SECO broker-dealers and their "associated" employees 40/ must meet standards of training, experience, competence and other qualifications as set by the Commission. 41/ These requirements include passing a general securities examination that must include coverage of the Commission's rules and

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37/ See Armstrong, Jones & Co., Securities Exchange Act Rel. No 8420 (1968); V L. Loss, Securities Regulation 1346 and n.215 (2d ed. 1961).

38/ 17 C.F.R. 240.17a-5; Form X-17a-5. FOCUS stands for "financial and operational combined uniform single report."

39/ 17 C.F.R. 240.17a-5(f)(2).

40/ Those associated with broker-dealers include any persons except those whose functions are solely clerical or ministerial. See Section 3(a)(18) of the Exchange Act, 15 U.S.C. 78c(3)(a)(18).

41/ Section 15(b)(7) of the Exchange Act, 15 U.S.C. 78o(b)(7).

regulations governing broker-dealers. 42/ Broker-dealers have statutory duties to supervise all their employees, 43/ and are liable for their acts under certain circumstances. 44/ Broker-dealers must maintain extensive background files on all their personnel dealing with securities or handling customer funds to help ensure those persons' integrity. 45/

B. The Examination Program

Congress has directed the Commission to examine broker-dealers' books and records periodically "in the public interest" and "for the protection of investors." 46/ These examinations serve two basic purposes: first, to determine whether the firm is complying with all the federal securities laws; second, to educate broker-dealers about their legal responsibilities and to help them correct minor deficiencies

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42/ 17 C.F.R. 240.15b8-1(a)(1)(i) and (ii). The examination also must cover corporate structure, accounting, and legal obligations; investment companies; distribution of securities; stock exchanges and over-the-counter markets, among other things. Id.

43/ Section 15(b)(4)(E) of the Exchange Act, 78o(b)(4)(E), and Section 20(a), 15 U.S.C. 78t(a).

44/ 17 C.F.R. 240.15b10-4(c).

45/ 17 C.F.R. 240.17a-3(a)(12). For example, the file must contain a description of each person's business associations during the preceding 10 years. 17 C.F.R. 240.17a-3(a)(12)(A)(4).

46/ Section 17(b) of the Exchange Act, 15 U.S.C. 78q(b). See also Section 15(b)(2)(c) of the Exchange Act, 15 U.S.C. 78o(b)(2)(C).

informally. See Securities Industry study, Report of the Subcomm. on Com. & Fin. of the House Comm. on Int. and For. Commerce, 92nd Cong., 2d Sess. 23 (1972).

The Commission's inspection program is administered by its nine Regional and six Branch Offices together with the Division of Market Regulation. See, e.g., 46 SEC Ann. Rep. 8 (1980). The Commission conducts three basic types of examinations -- routine SECO, oversight, 47/ and cause, 48/ only the first of which is relevant here.

Routine SECO Examinations

The routine examination is the primary method by which the Commission carries out its obligation to ensure that SECO broker-dealers are complying with the federal securities laws. The Commission examines all aspects of a SECO broker-dealer business to determine the firm's financial and operational condition as well as its sales practices. The Commission's regional offices conduct the examinations on a surprise basis

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47/ As noted, broker-dealers that are members of SROs are routinely examined by the SRO, subject to oversight by the Commission. The Commission conducts oversight examinations of SRO member broker-dealers as well as of the SROs themselves, to verify, among other things, that each SRO is capable of ensuring that its members comply with the Exchange Act. See Sections 6(a)(1), 15A(b) and 19 of the Exchange Act, 15 U.S.C. 78f(i) and 78o-3(b) and 78s.

48/ The Commission conducts cause examinations of broker-dealers that belong to SROs and of SECO broker-dealers whenever a possible financial, operational, or other problem is suspected (Hochmuth Declaration ¶ 4).

so that firms do not have the opportunity to alter their books and records or transfer funds or securities to conceal net capital or other violations (Kwalwasser Declaration ¶ 6; Hochmuth Declaration ¶ 8). 49/

Although specific examinations are not announced, the Commission notifies all broker-dealers of its examination policy. For example, all persons who apply for registration as broker-dealers are mailed "Information on Regulation of Broker-Dealers" which states that they will be responsible for compliance with the federal securities laws (Kwalwasser Declaration ¶ 4 and Exhibit A thereto). In addition, the Commission provides every applicant with a pamphlet entitled "General Information on the Registration and Regulation of SECO Broker-Dealers" (Kwalwasser Declaration ¶ 4 and Exhibit B thereto). That pamphlet, first distributed in March 1982, notifies registrants that they

> should be aware that the Commission has authority to inspect all books and records at any time. The Commission has a routine examination program in which it inspects SECO broker-dealers on a cyclical basis. (Id., Exhibit B at 13).

49/ Regional offices conduct conferences with new SECO firms shortly after their registration becomes effective and before the first on-site examination. In these post-effective conferences, Commission compliance examiners speak with principals of the firm to educate the registrant about the applicable Commission rules and regulations and to review with the registrant what type of securities business it will operate (Kwalwasser Declaration ¶ 4; Hochmuth Declaration ¶ 5; Mahoney Declaration ¶ 3).

(footnote continued on next page)

Most compliance examiners divide routine examinations into three parts: interview, books and records, and sales practices. In the interview, the examiner discussses with the registrant's principal the type of business he operates. This helps the examiner to determine what particular type of books and records the broker-dealer keeps or should keep. In the review of books and records, the examiner requests books and records relating to the business. He checks them for accuracy and currency, and determines whether the broker-dealer is complying with applicable aspects of the federal securities laws. In the sales practices portion of the examination, the examiner looks primarily at records of customer accounts to determine compliance with such requirements as

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(footnote continued from previous page)

For example, examiners attempt to determine whether the broker-dealer is familiar with the books and records and financial reporting requirements, as well as the net capital rule (Hochmuth Declaration ¶ 5; Mahoney Declaration ¶¶ 3,4). Registrants are advised to read the Exchange Act. If the registrant demonstrates lack of familiarity with its legal responbilities, it is requested to obtain a copy of the applicable statutes and regulations. (Mahoney Declaration ¶ 3).

During this "get-acquainted" conference, the staff notifies the broker-dealer that its books and records will be inspected once during its first year of operation and periodically thereafter (Kwalwasser Declaration ¶ 4; Hochmuth Declaration ¶ 5; Mahoney Declaration ¶ 3). The Miami Branch Office conducted such post-effective conferences during the period relevant to this case. (Mahoney Declaration ¶¶ 3, 4).

suitability, 50/ proper mark-ups, 51/ prohibitions against excessive trading, and fairness 52/ (Mahoney Declaration ¶¶ 7-8; Kwalwasser Declaration ¶ 5).

All new SECO firms are examined during their first six months or no later than their first year of operation, as required by Congress in Section 15(b)(2)(C) of the Exchange Act, 15 U.S.C. 78o(b)(2)(C). 53/ Congress "believe[d] that such early and frequent inspections of new entrants by the SEC * * * are critically important to nip incipient problems in the bud * * *." 54/ After the first year, the

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50/ See, supra, p. 10 and 17 C.F.R. 240.15b10-3 and 240.15b10-6(a).

51/ A "mark-up" is the difference between the prevailing wholesale, or inter-dealer, market price for a security and the retail price a dealer charges its public customers. L. Engel, How to Buy Stocks, 130-31 (6th rev. ed. 1977).

52/ Charles Hughes & Co. v. SEC, 139 F.2d at 434.

53/ Section 15(b)(2)(C), enacted in 1975, permits the Commission to extend the 6 month period to 12 months for classes of broker-dealers it designates. The examination in this case was conducted in the seventh month, and thus technically under Section 17(b), because the Commission had not yet officially designated the classes of broker-dealers whose examination could be postponed until the second half of the year. However, the Commission policy to examine all SECO broker-dealers in the first 12 months, pursuant to which plaintiffs' examination was scheduled, arose out of the same concerns as Congress expressed in enacting the 1975 Amendments (see text and note 54, infra).

54/ Securities Industry Study, Report of the Subcomm. on Com. & Fin. of the House Comm. on Int. and For. Commerce, 92nd Cong., 2d Sess. 23 (1972).

examination schedule depends on the type of business the broker-dealer operates. If the firm is an "introducing" broker, i.e., it does not hold customer funds or securities or clear its own transactions, it is generally inspected every three years (Kwalwasser Declaration ¶ 5; Hochmuth Declaration ¶ 6). Since firms that hold customer funds or securities, or firms that clear their own transactions, pose a greater risk of loss to investors, the Commission inspects them on a yearly basis. 55/ Of course, SECO, as well as other, firms may also be inspected for cause (Kwalwasser Declaration ¶ 3; Hochmuth Declaration ¶¶ 4, 6).

II. THE JUNE, 1980 ROUTINE EXAMINATION OF LUCIUS G. HILL SECURITIES, INC. 56/

In summary, this case arises out of a routine examination of books and records of a SECO broker-dealer on June 26 and 27, 1980. John Mahoney, a Commission securities compliance

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55/ Typically, an introducing broker is one unable or unwilling to meet either (1) the expense of maintaining an operational capacity to handle money and securities, commonly known as "back-office" operations, or (2) the minimum net capital requirements imposed on firms handling customer funds and securities. An industry practice has thus emerged in which a smaller broker-dealer contracts with a larger broker-dealer for performance of back-office services. Under this arrangement, the "introducing" broker will "introduce" accounts and transactions to a "clearing" or "carrying" broker which agrees to perform the necessary back-office operations for a percentage of the commissions to be generated by the transactions introduced. See generally, 1 S. Goldberg, Fraudulent Broker Dealer Practices §7.5(a)(1978).

56/ The Commission respectfully incorporates by reference the Statement of Material Facts As To Which There Is No Genuine Issue submitted in support of the Commission's motion.

examiner, visited the West Palm Beach, Florida offices of Lucius G. Hill Securities, Inc. (Registrant) to examine its books and records for compliance with the federal securities laws (Mahoney Declaration ¶¶ 5, 9, 13). The examination was scheduled in accordance with the Commission's policy of examining all new SECO broker-dealers in the first year after their registration. (Hochmuth Declaration ¶¶ 5-6; Mahoney Declaration ¶ 5). Although Lucius Hill, principal of the Registrant, was not present when Mr. Mahoney arrived on June 26, Mr. Mahoney had previously advised him to expect such an unannounced examination (Mahoney Declaration ¶¶ 3-4, 9).

Upon his arrival at the Registrant's office, Mr. Mahoney showed his Commission credentials to the woman who identified herself as Registrant's bookkeeper and asked to see the broker-dealer books and records. She left the room and appeared to make a telephone call. When she returned, she indicated that she had obtained permission for him to examine the records. Mr. Mahoney requested to see a number of documents related to Registrant's business, all of which were required to be maintained under Commission rules. After he had completed his examination of these records, Mr. Mahoney asked the bookkeeper to photocopy some of the documents for him, which she did. At no time did Mr. Mahoney view documents other than those the bookkeeper brought to him. Nor did he examine documents other than those of the Registrant (Mahoney Declaration ¶¶ 9-11).

Mr. Mahoney returned to the offices of the Registrant to complete his examination on the next day. When Mr. Hill arrived a short time later, Mr. Mahoney asked him a number of questions about his business operations. Mr. Hill answered all Mr. Mahoney's questions and gave him additional documents, including documents concerning an A.T. Bliss & Co. tax shelter offering. Later that day, Mr. Mahoney accompanied Mr. Hill to a bank, where Mr. Mahoney performed a box count of Registrant's securities. (id. ¶¶ 13-14).

At no time in June, 1980, or during their subsequent discussions regarding A.T. Bliss & Co., did Mr. Hill state or indicate that he believed Mr. Mahoney had acted improperly on either day of the examination (id. ¶ 15). It was not until May, 1981, after the staff had notified Mr. Hill and Registrant of a non-public 57/ Commission investigation of possible violations of the federal securities laws, that plaintiffs informed the Commission staff that they were alleging that Mr. Mahoney had acted improperly almost three years earlier (Harper Affidavit ¶ 2). 58/

57/ See 17 C.F.R. 202.5(a) and 203.2

58/ 17 C.F.R. In May 1981, when Mr. Hill was subpoenaed to testify in that investigation plaintiffs' counsel informally alleged that Mr. Mahoney had "ransacked" the firm's office; Charles C. Harper, head of the Commission's Miami Branch Office inquired into the allegation and determined that it was without merit (Harper Affidavit ¶¶ 2-3).

In May 1981, the Commission provided plaintiffs with copies and a list of all documents photocopied for Mr. Mahoney on June 26, 1980. Plaintiffs did not contest the accuracy of this list until the filing of this lawsuit (id. ¶¶ 5-6).

ARGUMENT

I. THE COMMISSION'S EXAMINATIONS OF REGISTERED BROKER-DEALERS' BOOKS AND RECORDS PURSUANT TO THE SECURITIES EXCHANGE ACT ARE REASONABLE UNDER THE FOURTH AMENDMENT.

Plaintiffs seek a declaratory judgment that the provision in Section 17(b) of the Exchange Act, 15 U.S.C. 78q(b), for warrantless broker-dealer examinations is unconstitutional under the fourth amendment (Complaint ¶¶ 1 and 21(a) and First Prayer for Relief). 59/ They also seek an order enjoining the Commission from applying Section 17(b) to them (Second Prayer for Relief). 60/

Section 17(b) authorizes the Commission to make "reasonable periodic, special, or other examinations" of registered broker-dealers' records as the Commission deems "necessary

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59/ Plaintiffs also allege that the Act deprives them of a due process right to privacy in violation of the fourth, fifth and fourteenth amendments (Complaint ¶ 21(b)). The constitutional right to privacy, however, is narrowly limited to certain familial interests. Paul v. Davis, 424 U.S. 693, 713 (1976). See Carey v. Population Serv. Int'l, 431 U.S. 678, 684-85 (1977). It does not protect commercial records, such as those examined under Section 17(b). The fourteenth amendment, of course, does not apply to the federal government. Cf., Hurd v. Hodge, 334 U.S. 24 (1948).

Plaintiffs also allege an Article I and III violation in so far as examinations are conducted without "a judicial determination [of probable cause] or . . . a neutral inspection scheme" (Complaint ¶ 21(c)). This allegation is legally the same as the fourth amendment claim; hence we do not address it separately.

60/ Plaintiffs' other requests for injunctive relief -- in essence a motion to suppress and for return of property (see third, fourth, and fifth prayers for relief) -- are discussed, infra, Part III.

or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Securities Exchange Act." 61/ Plaintiffs' contention that the Court should nullify this statute is without merit.

The touchstone of the fourth amendment is reasonableness. 62/ Although warrantless searches, as a general rule, may be unreasonable, the Supreme Court has upheld exceptions when the public interest requires a more flexible view. See United States v. Martinez-Fuerte, 428 U.S. 543, 555 (1976). In a series of cases decided since 1970, the Supreme Court has enunciated an exception for inspections of "pervasively regulated" industries. The Court has applied this exception to the liquor industry (Colonnade Catering Corp. v. United States, 397 U.S. 726 (1970)), to firearms dealers (United States v. Biswell, 406 U.S. 311 (1972)), and to the mining industry (Donovan v. Dewey, 452 U.S. 594 (1981)); cf. California Bankers Association v. Shultz, 416 U.S. 21, 52, 66 (1974) (provisions of the Bank Secrecy Act of 1970 requiring banks to keep records and report financial transactions do not violate the fourth amendment). In Marshall v. Barlow's, Inc., 436 U.S. 307, 313-14 (1978), the Court declined to

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61/ The books and records of other regulated institutions subject to the federal securities laws (such as the stock exchanges and their members) are also subject to Commission examination. See Section 17(a), Exchange Act, 15 U.S.C. 78q(a).

62/ See Delaware v. Prouse, 440 U.S. 648, 653-55 (1979).

apply the Colonnade-Biswell exception to all industries operating in interstate commerce because the exception would have swallowed the rule. However, as the Court carefully reiterated, 63/ the reasonableness of warrantless inspection programs must be resolved on a case by case basis by balancing "the specific enforcement needs and privacy guarantees of each statute." Marshall v. Barlow's, Inc., 436 U.S. at 321. The Colonnade-Biswell precedent teaches that this exception applies to an administrative agency's statutorily authorized examination when 1) there is a minimal expectation of privacy in the property to be inspected, 64/ and 2) Congress has reasonably determined that warrantless examinations are necessary to further a regulatory scheme.

As we demonstrate, broker-dealers have a long history of government oversight and are subject to such detailed federal regulation that the privacy interests at stake are non-existent or minimal. A warrant requirement would impose a heavy burden on the examination program, which is tailored specifically to the problems in this industry, and would seriously jeopardize enforcement of the investor protection scheme

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63/ See Colonnade, 397 U.S. at 77.

64/ See Rakas v. Illinois, 439 U.S. 128, 143 (1978). See also Katz v. United States, 389 U.S. 347, 353 (1967).

enacted by Congress. Thus, Congress's authorization in Section 17(b) for warrantless examinations of broker-dealer records satisfies both prongs of the Colonnade-Biswell test and should be sustained.

A. Warrantless Examinations of Broker-Dealers' Books and Records Under the Securities Exchange Act Do Not Infringe Any Legitimate Expectation Of Privacy.

1. Broker-Dealers, who have a long history of government supervision, are pervasively regulated by the Securities Exchange Act and its rules.

In Colonnade, 397 U.S. 76, the Court held that warrantless inspections to enforce liquor laws were not barred by the fourth amendment because Congress had long exercised control over the liquor industry and "has broad power to design such powers of inspection under the liquor laws as it deems necessary to meet the evils at hand." See also Donovan v. Dewey, 452 U.S. at 602-03. Regulation of securities brokers, like federal regulation of liquor in interstate traffic, is "deeply rooted in history." United States v. Biswell, 406 U.S. at 315. The statutory framework authorizing warrantless examinations of securities broker-dealers, like other warrantless inspection schemes that have been held to satisfy the fourth amendment, 65/ has been in place since the beginning of federal regulation of the securities industry (see supra, pp. 2-3).

65/ In addition to Colonnade, 397 U.S. at 75, see Frey v. Panza, 621 F.2d 596, 598 (3d Cir.) cert. denied, 449 U.S. 1035 (1980); Marshall v. Stroudt's Ferry Preparation Co., 602 F.2d 589, 593 (3d Cir. 1979), cert. denied, 444 U.S. 1015 (1980); cf. Biswell, 406 U.S. at 315.

In Biswell, the Supreme Court observed that any person who chooses to deal in a "pervasively regulated business and to accept a federal license does so with the knowledge that his business records * * * will be subject to effective inspection." 406 U.S. at 316. Securities broker-dealers are at least as pervasively regulated, and perhaps more so, as other industries in which "the federal regulatory presence is sufficiently comprehensive and defined" that the property owner has constructive notice that his property will be inspected. Donovan v. Dewey, 452 U.S. at 600.

Federal securities laws regulate every facet of a broker-dealer's business from its first day of operation (see supra, pp. 5-13). For example, any broker-dealer operating in interstate commerce must first register with the Commission and remains subject to federal regulation until the Commission approves its withdrawal (supra, pp. 5-7). Each of its employees handling securities transactions must be registered (supra, pp. 6, 13). It must make and preserve documentation of every securities transaction in which the firm engages (supra, pp. 11-12). These transactions are strictly limited by a comprehensive code of conduct designed to prevent fraud on customers or the appearance of unfairness (supra, pp. 9-11). The broker-dealer must make daily computations of its net capital and immediately notify the Commission if it approaches a violation; it must make detailed periodic and annual reports of its financial condition to the Commission (supra, pp. 7-8, 12).

Since there is simply no aspect of the brokerage business that is not regulated in some manner by the federal securities laws and rules promulgated thereunder, there is a sufficiently "predictable and guided federal regulatory presence" 66/ to bring this single industry within the Colonnade-Biswell exception. 67/

Further, the examination program Congress authorized in the Exchange Act concerns only the securities industry. Examination of SECO broker-dealers' books and records, the inspection program challenged in this case, involves only a small fraction of the businesses in this single industry. The routine SECO broker-dealer examination program includes less than 10% (550) of the 7,800 registered broker-dealers (Kwalwasser Declaration ¶ 3). Thus, the examination program mandated by Section 17(b) is far narrower than the searches of all employers in all industries and businesses in interstate commerce held unconstitutional in Marshall v. Barlow's, Inc., 436 U.S at 314. 68/

66/ Donovan v. Dewey, 452 U.S. at 604.

67/ Indeed, the Supreme Court has noted in another context that Congress has invested the Commission, "which is charged with protection of the public interest as well as the interests of share-holders," with "extensive" and "pervasive supervisory authority." U.S. v. Nat'l Ass'n of Securities Dealers, 422 U.S. 694, 732-33 (1975) (discussing Commission regulation of self-regulatory organizations).

68/ As of 1981, OSHA covered an estimated 4.5 million establishments. See U.S. Dept. of Labor, President's

(footnote continued)

However, broker-dealers enjoy far more than constructive notice of "the restrictions placed upon [them]." Marshall v. Barlow's, 436 U.S. at 313, quoting Almeida-Sanchez v. United States, 413 U.S. 266, 271 (1973). As previously noted (supra, p. 15), the Commission notifies new broker-dealer registrants that it inspects them on a routine, cyclical basis and specifically advises them that they are responsible for compliance with the federal securities laws (Kwalwasser Declaration, Exhibit A at 1; Exhibit B at 13). Indeed, Mr. Hill was notified personally at the post-effective conference held November 26, 1979, that the Commission would periodically examine his broker-dealer business records and that he should expect an unannounced examination within the next 12 months. (Mahoney Declaration ¶3).

68/ (footnote continued)

Report on Occupational Safety and Health: Calendar Year 1981 at 54. Examinations under the Exchange Act cover a much more limited group than do other warrantless inspections held not to violate the fourth amendment. As of 1979, there were approximately 180,000 registered firearms dealers covered by the law sustained in United States v. Biswell, 406 U.S. 311. Bureau of Alcohol, Tobacco & Firearms, U.S. Dept. of Treasury, Annual Report Publication No. 122 (May 1980) 19. As of 1979, there were almost 400,000 liquor dealers subject to the inspection scheme sustained in Colonnade Catering Corp. v. United States, 397 U.S. 72. Alcohol, Tobacco & Firearms Summary Statistics for Distilled Spirits, Wine, Beer Tobacco Enforcement Taxes, ATF Publication No. 1323.1 (July 1982) at 1-4. Cf. Donovan v.Dewey, 452 U.S. 594 (inspection of all coal mines; there were over 7,000 coal mines in 1981. Injury Experience in Coal Mining (1981), U.S. Dept. of Labor Informational Report No. 1138 (1982) 13).

In short, broker-dealers, especially those like plaintiff that elect to join the SECO program, are on notice that inspections will not be "so random, infrequent or unpredictable that the owner has no real expectation that his property will be inspected from time to time." U.S. Nuclear Regulatory Commission v. Radiation Technology, Inc., 519 F. Supp. at 1288. 69/

2. Warrantless examinations of books and records required to be kept by law involve no or little invasion of privacy.

Commission examinations under Section 17(b) are limited to examination of books and records required to be kept pursuant to Section 17(a) 70/ and the regulations thereunder, or other regulations that explicitly require records to be kept (Hochmuth Declaration ¶ 7; Mahoney Declaration ¶ 8).

69/ Certainty and regularity in administration of this examination program also provide adequate notice and hence a constitutionally adequate substitute for a warrant. See Marshall v. Barlow's Inc., 436 U.S. at 320-21, 323; Camara v. Municipal Court, 387 U.S. 523, 538 (1967); U.S. v. Missippi Power & Light Co., 638 F.2d 899, 907 (5th Cir.), cert. denied, 454 U.S. 892 (1981). The SECO examination program involves routine examinations of all new SECO brokers within the first twelve months, and on one and three year cycles thereafter (Kwalwasser Declaration ¶ 5; Hochmuth Declaration ¶ 6). Since the examination is limited to books and records required by law to be kept (see, infra, pp. 28-30), "it is difficult to see what additional protection a warrant requirement would provide." Donovan v. Dewey, 452 U.S. at 605.

70/ 15 U.S.C. 78q(a).

Accordingly, these records are not protected by the fourth amendment.

In Shapiro v. United States, 335 U.S. 1 (1948), the Supreme Court held that the Constitution does not protect records such as these that are required to be kept by law. 71/ See also California Bankers Association v. Shultz, 416 U.S. 21. Such records assume characteristics of public, or quasi-public, documents 72/ such that their custodians have "no reasonable expectation of privacy" in them. 73/

Subsequent to Shapiro, courts expressly considering the question have held that required broker-dealer records are not constitutionally protected. United States v. Mahler, 254 F. Supp. 581, 582 (S.D.N.Y. 1966). Cf. United

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71/ Observing that effective law enforcement depends upon government access to books and records, id. at 13-14, the Court ruled that "the privilege which exists as to private papers cannot be maintained in relation to records required by law to be kept." 335 U.S. at 33 (citations omitted).

While the Shapiro decision concerned the recordkeeping provisions of the Emergency Price Control Act, Justice Frankfurter in a dissenting opinion, recognized the applicability of the decision under all federal record-keeping statutes. 335 U.S. at 50-54.

72/ See, e.g., Donovan v. Mehlenbacher, 652 F.2d 228, 231 (2d Cir. 1981); United States v. Silverman, 449 F.2d 1341 (2d Cir.1971), cert. denied, 405 U.S. 918 (1972); Cooper's Express, Inc. v. ICC, 330 F.2d 338, 340 (1st Cir. 1964); United States v. Pine Valley Poultry Distributors Corp., 187 F. Supp. 455, 457 (S.D.N.Y. 1960).

73/ See, e.g., United States v. Snyder, 668 F.2d 686, 690 (2d Cir.), cert. denied, 102 S.Ct. 3494 (1982). See generally In re Grand Jury Proceedings, 601 F.2d 162, 168 (5th Cir. 1979), discussing 8 Wigmore, Evidence § 2259c (McNaughton rev. 1961).

States v. Kaufman, 429 F.2d 240, 247 (2d Cir.), cert. denied, 400 U.S. 925 (1970) (no fifth amendment protection under Shapiro for records a registered broker-dealer was required to make and keep); SEC v. Olsen, 354 F.2d 166 (2d Cir. 1965) (no fifth amendment protection under Shapiro for records a registered investment advisor was required to make and keep pursuant to the Investment Advisers Act of 1940, 15 U.S.C. 80-b4). 74/

Where, as here, there is either no or only a de minimis expectation of privacy, "the incremental protections afforded * * * by a warrant are so marginal that they fail to justify the administrative burdens that may be entailed." Marshall v. Barlow's, Inc., 436 U.S. at 322.

74/ Moreover, examinations of business records differ from searches of premises like the one at issue in Barlow's, in that they "do not infringe on individual rights to the extent that warrantless searches would if allowed." In re Grand Jury Proceedings, 601 F.2d at 168 n.1. The Commission's examination program does not involve, nor even contemplate, the use of any forcible entry; rather, the statutory scheme provides for resort to the federal courts if a compliance examiner is refused entry. The Commission, pursuant to Section 21(e) of the Exchange Act, 15 U.S.C. 78u(e), may seek an injunction requiring that the broker-dealer make its books and records available for examination. See, e.g., SEC v. Sloan, 535 F.2d 679 (2d Cir. 1976), cert. denied, 430 U.S. 966 (1977); SEC v. Midland Equity Corp., [1973] (CCH) Fed. Sec. L. Rep. 94,305 (S.D.N.Y. 1973); SEC v. Sharkey, 4 S.E.C. Jud. Dec. 574 (W.D Wash. 1945) (granting injunction in face of fourth amendment challenge to examination authority). See also Mahoney Declaration ¶ 6.

B. Warrantless Examinations Of Broker-Dealers Are Tailored To Serve Important Governmental Interests And Are Crucial To Effective Enforcement Of The Statute.

The Commission's statutory obligation is to protect and safeguard the investing public. See Section 2 of the Exchange Act, 15 U.S.C. 78b. 75/ The Commission strives to accomplish this goal in part through its congressionally-mandated broker-dealer examination program (see Touche Ross Co. v. Redington, 442 U.S. at 569-70), which "is specifically tailored to address the particular concerns that are unique" to the securities industry. U.S. Nuclear Regulatory Commission v. Radiation Technology, Inc., 519 F. Supp. at 1290. 76/ Indeed, as the Court of Appeals for this Circuit has recognized, "[t]he securities field, by its nature, requires specialized and unique legal treatment." Hughes v. SEC, 174 F.2d 969, 975 (D.C. Cir. 1949).

75/ Because of the substantial and immediate financial harm to investors and interstate commerce resulting from illegal broker-dealer trading practices and broker-dealer failures, the federal government has a valid and overriding interest in the regulation and examination of the nation's securities broker-dealers. "[I]nspection is a crucial part of the regulatory scheme," United States v. Biswell, 406 U.S. at 315, because it helps to ensure that funds and securities will be safeguarded. See Touche-Ross Co. v. Redington, 442 U.S. at 570.

76/ See Donovan v. Dewey, 452 U.S. at 603 (Mine Safety and Health Act is specifically tailored to address health and safety conditions peculiar to mines); Marshall v. Stroudt's Ferry Preparation Co., 602 F.2d 589, 593; U.S. Nuclear Regulatory Commission v. Radiation Technology, Inc., 519 F. Supp. 1266, 1288-1291.

Trading markets in securities are uniquely susceptible to broker-dealer fraud and manipulation which "may take on more subtle and involved forms" than in "cruder" businesses. Id., quoting Archer v. SEC, 133 F.2d 795, 803 (8th Cir.), cert. denied, 319 U.S. 767 (1943). Broker-dealers, like banks, may hold their customers' cash and securities. Examination of their books and records is designed specifically to determine whether the firms are complying with financial, operational and trading standards that are distinctive to the industry and have a significant impact on customers (see, supra, pp. 13-18). 77/

Congress recently reexamined and reconfirmed the necessity for these examinations in the wake of failures of numerous brokerage firms caused primarily by breakdowns in recordkeeping. 78/ In this "most searching reexamination"

77/ Broker-dealer failures associated with recordkeeping deficiencies may also cause a chain reaction of failures among other financial institutions. See Remarks of SEC Commissioner Bevis Longstreth before the New York Regional Group of the American Society of Corporate Secretaries (February 10, 1983) (attached as Exhibit A) (hereinafter Longstreth Remarks).

78/ SEC Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 229, 92d Cong., 1st Sess. 11, 28 (1971). "Since books and records of a broker-dealer represent the cornerstone of his operations," any errors or incompleteness "exposed customers to loss of their cash and securities," and threatened loss of public confidence in the securities markets. Id. at 11-12, 19. Broker-dealer failures or near failures have continued in more recent years. See Longstreth Remarks, supra note 77.

of the federal securities laws since the 1930's, 79/ Congress reaffirmed the Commission's power to examine records of broker-dealers under Section 17 80/. Congress further mandated, in Section 15(b)(2)(C), that all broker-dealers be examined for compliance during their first months of operation, noting that "early and frequent" examinations are "critically important to nip incipient problems in the bud." 81/ The House Report accompanying the final bill observed that "examination authority * * * is, of course essential to any effort by the Commission to discharge its responsibilities under the Act." H.R. Rep. No. 229, 94th Cong., 1st Sess. 119-20 (1975).

Courts also have recognized that the Commission must have unimpaired access to broker-dealer records to protect the public against abuse or incompetence. The records required to be made or preserved by Section 17(a) of the Exchange Act and the examination of those records authorized by Section 17(b) "provide the regulatory authorities with the

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79/ Conf. Rep. 229, 94th Cong., 1st Sess. 91 (1975).

80/ The examination provision previously included in Section 17(a) was re-enacted in Section 17(b) and language was added to require cooperation among regulatory agencies. See Touche Ross Co. v. Redington, 442 U.S. at 562 n.2. Congress also enacted a number of other measures strengthening regulation of broker-dealers. E.g., 15 U.S.C. 15(b)(7) and 15(c)(3).

81/ Securities Industry Study, Report of the Subcomm. on Com. & Fin. of the House Comm. on Int. & For. Commerce, 92d Cong., 2d Sess. 23 (1972).

necessary information to oversee compliance" with the federal securities laws, and to "monitor the financial health of brokerage firms and protect customers from the risks involved in leaving their cash and securities with broker-dealers." Touche Ross & Co. v. Redington, 442 U.S. at 569-70. Indeed, "how the Commission could carry on its task of protect[ing] the public investor without [such] financial information * * *" is difficult to apprehend. Boruski v. SEC, 340 F.2d 991, 992 (2d Cir.), cert. denied, 381 U.S. 943 (1965). See also In re Wanda O. Olds, 37 SEC 23, 26-27 (1956) (books and records requirements are "keystone of surveillance of registrants").

Moreover, warrantless examinations of broker-dealers are indispensable to enforcing the Exchange Act. First, as one Congressional Committee found with respect to examination authority challenged in this case, "[t]he prospect of an unannounced visit of a government inspector is an effective stimulus for honesty and bookkeeping veracity" S. Rep. No. 1760, 86th Cong., 2d Sess. 3-4 (1960). See also Hochmuth Declaration ¶ 8.

Second, since warrants would give broker-dealers advance notice of examinations, 82/ violations of Commission statutes

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82/ Advance notice of examinations would result from a warrant requirement even if warrants were obtained on an ex parte basis because the firm could simply refuse entry upon the compliance examiner's arrival. E.g., Donovan v. Wollaston Alloys, Inc., 695 F.2d 1 (1st Cir. 1982).

and rules could be easily disguised by falsification of records or transfers of cash and securities. (Kwalwasser Declaration ¶ 6; Hochmuth Declaration ¶ 8). For example, a broker-dealer could temporarily transfer funds from affiliated companies or provide a duplicate bank deposit slip when no deposit had been made, in violation of the net capital rule. Customer complaint files could be purged and non-current books and records could be brought up to date. These steps would conceal, rather than correct, statutory violations. Thus, "the prerequisite of a warrant could easily frustrate inspection." Biswell, 406 U.S. at 316. Cf. Marshall v. Barlow's Inc., 436 U.S. at 316 (where advance notice served to encourage employers to comply with OSHA). In view of the ease with which violations may be camouflaged, unannounced inspections are crucial to maintaining the financial and operational integrity of broker-dealers.

The alternative -- obtaining a warrant -- would be tremendously burdensome to the agency and would seriously impair its investor protection program. The Commission performs approximately 900 broker-dealer examinations each year (Kwalwasser Declaration ¶ 3,6). The volume of paperwork required to obtain warrants would severely drain scarce resources in a period of budget cuts and reductions-in-force (id. at ¶¶ 8-9). 83/ Diversion of staff resources to obtain

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83/ Moreover, the Commission's compliance examiners have many responsibilities in addition to conducting broker-dealer examinations (Kwalwasser Declaration ¶ 7).

warrants could force the Commission to reduce the number and scope of examinations at a time when the securities markets are expanding significantly in number and complexity (id. at ¶ 7). Moreover, it is probable that, having obtained a warrant and commenced an examination, the examiner would require additional records for which the Commission would have to seek still another warrant to complete the examination (Kwalwasser Declaration ¶ 9). This time-consuming and burdensome process could be used as a tactic by recalcitrant broker-dealers to impede and delay Commission examinations.

II. PLAINTIFFS CONSENTED TO THE EXAMINATION THEY NOW CHALLENGE.

A fourth amendment challenge to a search must be rejected when circumstances "show that permission to search was obtained from a third party who possessed common authority over or other sufficient relationship to the premises or effects sought to be inspected." United States v. Matlock, 415 U.S. 164, 171 (1974) (footnote omitted). "Common authority" includes mutual use or joint access such that "it is reasonable to" believe that the person giving consent is authorized to do so. United States v. Sells, 496 F.2d 912, 914 (7th Cir. 1974), quoting United States v. Matlock, 415 U.S. at 171 n.7.

In their complaint, plaintiffs in effect concede that Mr. Mahoney, the Commission's compliance examiner, reasonably inferred that Ms. McElveen consented to the examination. Ms. McElveen was responsible for Mr. Hill's bookkeeping and certain duties for the broker-dealer, including receiving visitors at its offices (Complaint ¶¶ 10,12). She obtained permission from Mr. Hill's accountant to show the brokerage firm's books and records to Mr. Mahoney (id. at ¶ 13), which she then did (id. at ¶ 14). 84/ Ms. McElveen obviously had access to the relevant books and records and, at the very least, she had implied permission to consent to the examination. United States v. Buettner-Janusch, 646 F.2d at 765. See United States v. Gradowski, 502 F.2d 563, 564 (2d Cir. 1974) (per curiam).

Thus, the facts alleged in plaintiffs' complaint provide sufficient basis to conclude that Mr. Mahoney could reasonably believe that the bookkeeper had the authority to consent to the examination and did so voluntarily. See United States v.

84/ Although the complaint does not expressly state that Ms. McElveen gave permission to Mr. Mahoney, her consent may be inferred from her conduct in providing and photocopying the records. E.g., United States v. Buettner-Janusch, 646 F.2d 759, 764 (2d Cir. 1981).

Moreover, the complaint does not allege facts that establish coercion. As the complaint recognizes, after Mr. Mahoney appropriately showed the bookkeeper his credentials, she was free to deny him access until she had satisfied herself, by contacting Hill or his accountant, that permission should be granted.

Sledge, 650 F.2d 1075, 1078 (9th Cir. 1981); United States v. Block, 590 F.2d 535, 539-40 (4th Cir. 1978); United States v. Sells, 496 F.2d 912, 914 (7th Cir. 1974). See generally United Staes v. Harrison, 679 F.2d 942, 947 (D.C. Cir. 1982). Accordingly, the complaint should be dismissed for failure to state a claim upon which relief can be granted. Fed. R. Civ. P. 12(b)(6).

Alternatively, summary judgment should be entered on the Commission's behalf because the undisputed facts show that Mr. Mahoney reasonably concluded that Ms. McElveen had been authorized to grant him access to the records. In any event, Mr. Hill ratified her action the following day and thereafter by providing additional records and by not objecting to the examination.

As Mr. Mahoney's declaration establishes, he had every reason to believe that the bookkeeper could consent to the examination. After he told her that he was from the Securities and Exchange Commission and was there to examine the brokerage books and records, Ms. McElveen said that she kept the books (a statement confirmed throughout the day as she demonstrated familiarity with the records' location and general substance) (Mahoney Declaration ¶¶ 9-10). In response to Mr. Mahoney's request that Ms. McElveen contact Mr Hill, she left to make a telephone call and returned shortly thereafter stating that

she had obtained permission for Mr. Mahoney to begin the examination (id. ¶ 9-10). Later she told Mr. Mahoney that Mr. Hill would be in the office the following day (id. ¶ 12), thus confirming Mr. Mahoney's understanding that she had been in touch with the firm's principal. 85/

On June 27, Mr. Hill neither withdrew the permission nor in any way restricted Mr. Mahoney's additional examination (id. ¶ 13). Indeed, Mr. Hill personally provided additional information and made available copies of other broker-dealer documents (id. ¶ 13-14). 86/ Thereafter, neither Mr. Hill nor his counsel complained to Mr. Mahoney or his superior for over eleven months (Harper Affidavit ¶¶ 2-4; Mahoney Declaration ¶ 15). The Commission and its compliance examiner were entitled to rely on Mr. Hill's consent -- apparent from all objective appearances -- to the examination. Mr. Hill's

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85/ The following day, June 27, 1980, Mr. Hill greeted Mr. Mahoney as if he had been expecting the examiner to return (id. ¶ 13). This added further support to Mr. Mahoney's conclusion, reasonable under the circumstances, that Mr. Hill and the bookkeeper had conferred about the examination.

86/ In paragraph 16 of their complaint, plaintiffs make a generalized allegation that personal papers of Mr. Hill were taken on June 26, 1980. The only specifically described documents are "offering documents of A.T. Bliss & Co., Inc." copies of which, as Mr. Mahoney states, were in fact given to him by Mr. Hill on June 27, 1980 (Mahoney Declaration ¶ 13). Such documents are not, however private, since they are required by law to be kept. See 17 C.F.R. 240. 17a-4.

claimed subjective intention to the contrary -- not disclosed until after he learned that the Commission was investigating his firm -- must be rejected. United States v. Sledge, 650 F.2d at 1078.

Moreover, almost two years ago (in May, 1981), at plaintiffs' request, the Commission provided their counsel with a list and copies of all documents obtained by Mr. Mahoney on the first day of the examination (Harper Affidavit ¶ 5 and attachment thereto). Plaintiffs did not challenge the accuracy of the list until the filing of this action (id. ¶ 6). At this point, they must be deemed to have waived objections to the examination that took place three years ago. Cf. In re Grand Jury Investigation of Ocean Transportation, 604 F.2d 672, 675 (D.C. Cir. 1979) (attorney-client privilege held waived where demand not made for several years for return of documents that had been given to the government, allegedly by mistake).

III. CLAIMS FOR INJUNCTIVE RELIEF AGAINST USE OF DOCUMENTS REGISTRANT PROVIDED DURING THE EXAMINATION SHOULD BE DISMISSED FOR LACK OF JURISDICTION.

Plaintiffs seek to enjoin the Commission's use of documents Registrant produced during the first day (June 26, 1980) of the Commission's examination in any future enforcement proceeding (Third Prayer for Relief). They also seek return of the documents (Fifth Prayer for Relief) and

an order enjoining the Commission from forwarding them to other government agencies (Fourth Prayer for Relief). Even assuming, arguendo, that the purposes of the exclusionary rule were furthered by the suppression of evidence in civil cases, 87/ plaintiffs' claims are not justiciable at this time.

A. Plaintiffs' Claims Are Not Ripe For Judicial Review.

Claims not ripe for judicial review do not present a case or controversy as required by Article III, Section 2, of the Constitution. Absent a case or controversy, a district court lacks subject matter jurisdiction. In Abbott Laboratories v. Gardner, 387 U.S. 136 (1967), the Supreme Court identified the tests courts must apply to determine whether a controversy arising in an ongoing agency proceeding is ripe. These are (1) "the fitness of the issues for judicial decision," and (2) the potential "hardship to the parties of withholding court consideration." Id. at 149. 88/

87/ See, e.g., United States v. Janis, 428 U.S. 433, 447 (1976); Todd Shipyards Corp. v. Secretary of Labor, 586 F.2d 683, 689 (9th Cir. 1978) (questioning application of exclusionary rule to evidence obtained in warrantless OSHA search prior to Supreme Court decision in Marshall v. Barlow's, Inc., 436 U.S. 307).

88/ See Webb v. Department of Health and Human Services, 696 F.2d 101, 106 (D.C. Cir. 1982); Diamond Shamrock Corporation v. Costle, 580 F.2d 670, 672 (D.C. Cir. 1978).

The doctrine's purpose is to prevent courts from "entangling" themselves in agency action "until an administrative decision has been formalized and its effects felt in a concrete way by the challenging parties." Abbott Laboratories Gardner, 387 U.S. at 148-49; Citizens for a Better Environment v. Costle, 617 F.2d 851, 853 (D.C. Cir. 1980).

Plaintiffs' attempt to enjoin use of the documents is not fit for judicial resolution at this time. There has been no "final" agency determination to use the documents in any proceeding against plaintiffs or to forward them to another agency. See FTC v. SOCAL, 449 U.S. 232, 239-43 (1980); Hooker Chemical Co., Ruco Div. v. United States, 642 F.2d 48, 53 (3d Cir. 1981). Only after plaintiffs' charges are raised in the context of an administrative or judicial proceeding can a "final" determination be made on their admissibility. 89/

Plaintiffs also do not satisfy the second test of Abbott Laboratories. They do not allege that the production of their documents, without later use, has a "direct" or "immediate" impact upon their economic interest. The provision of documents to the Commission cannot result in sanctions against the plaintiffs; only if the Commission institutes and prevails in an enforcement action can the possibility arise that plaintiffs' economic interests will be directly and immediately affected. See FTC v. Socal, 449 U.S. at 242, 244; Hannah v. Larche, 363 U.S. 420, 442-43 (1960). "In the absence of hardship, only a minimum showing of counter-vailing judicial or administrative interest is needed, if any, to tip the balance against review." Diamond Shamrock v. Costle, 580 F.2d 670, 674 (D.C. Cir. 1978).

89/ A decision on admissibility would be subject to review at such time as an enforcement action were instituted and an adverse decision on the merits rendered against plaintiffs. See Section 21, Exchange Act, 15 U.S.C. 78t.

B. Even If The Court Had Equitable Jurisdiction, It Should Not Exercise It Because Plaintiffs Have An Adequate Remedy At Law.

Even if the court had equitable jurisdiction to suppress evidence or return property in an action in which the evidence is not sought to be introduced, the Court should exercise its discretion to deny such relief, as have the other courts that have considered such requests. Marshall v. Central Mine Equipment Co., 608 F.2d 719, 721 (8th Cir. 1979). 90/ Courts have denied such relief when the plaintiff has not "clearly demonstrate[d] that his constitutional rights [could not] be adequately adjudicated in the pending or anticipated enforcement proceeding against him." Marshall v. Central Mine Equipment Co., 608 F.2d at 721, quoting In re Worksite Inspection of Quality Products, 592 F.2d 611, 615 (1st Cir. 1979). Thus, in Marshall, the court declined to suppress the fruits of an administrative search in an ancillary proceeding. The court held that plaintiff had an adequate remedy at law as it could assert its fourth amendment challenge should the agency institute an enforcement proceeding. Id. at 721-722. The court noted that if the agency brought no proceedings, the movant would suffer no irreparable harm. Id at 722. See FTC v. Socal, 449 U.S. at 242, 244; Hannah v. Larche, 363 U.S. at 442-43.

90/ In re Worksite Inspection of Quality Products, 592 F.2d 611, 614-15 (1st Cir. 1979); Hunsucker v. Phinney, 497 F.2d 29, 34 (5th Cir. 1974). See Smith v. Katzenbach, 351 F.2d 810, 814-17 (D.C. Cir. 1965).

In this case, plaintiffs will have an opportunity to argue the admissibility of evidence they produced to the Commission should the agency bring an enforcement action against them. See Hunsucker v. Phinney, 497 F2d 29, 34 (5th Cir. 1974). Absent such a proceeding, plaintiffs suffer no legal harm. 91/

CONCLUSION

The Colonnade-Biswell doctrine authorizes warrantless inspections of broker-dealer books and records, as provided in Section 17(b) of the Exchange Act. The Court should, therefore, enter summary judgment for the Commission on plaintiffs' fourth amendment challenge to the Act and to the Commission's administration of the examination program mandated by the Congress. The fourth amendment claims arising from the particular examination of plaintiffs' brokerage records in June 1980 should be dismissed for failure to state a claim since the complaint establishes that plaintiffs consented to the examination. Alternatively, the Court should grant the Commission summary judgment on these claims since the undisputed record establishes that the Commission's examiner reasonably believed that plaintiffs' agent consented to the

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91/ Moreover, as noted, the Commission has provided them with copies of all the documents at issue (Harper Declaration ¶ 5 and attachment thereto).

examination and plaintiffs then ratified that consent. The remaining claims for injunctive relief, seeking to suppress evidence should be dismissed as premature since no action has been lodged against plaintiffs.

Respectfully submitted,

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