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No. 98-17324

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

JOAN C. HOWARD,

Plaintiff-Appellant,

v.

EVEREX SYSTEMS, INC.,

Defendant,

and

STEVEN L.W. HUI; MICHAEL C.Y. WONG; WONG'S INTERNATIONAL (HOLDINGS) LIMITED; GATCOMBE CORP. N.V.,

Defendants-Appellees.

On Appeal from the United States District Court
for the Northern District of California

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission, the agency principally responsible for the administration and enforcement of the federal securities laws, submits this brief, amicus curiae, to address an important question concerning liability in private lawsuits, and possibly certain Commission actions, brought under the antifraud provisions of Section 10(b) of the Securities and Exchange Act of 1934 ("Exchange Act") and Commission Rule 10b-5:

> When an official of a corporate issuer signs a Commission filing containing material misrepresentations, does his lack of involvement in preparing the filing preclude his being a primary violator of Section 10(b) and Rule 10b-5 and relegate him to being merely an aider and abettor, who is not liable in a private Rule 10b-5 damages action?

In the Commission's view, such a corporate official, assuming that he acts with the requisite scienter (i.e., either knowingly or recklessly), is a primary violator. 1/

This question arises because the Supreme Court, in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994), ruled that private actions cannot be brought against persons who aid and abet violations of Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, but only against "primary violators." The Supreme Court expressly stated in Central Bank, however, that any person, even a "secondary actor," could be a primary violator if he "makes" a misrepresentation. 511 U.S. at 191. This brief addresses what the Supreme Court meant by its use of the word "make" in Central Bank.

The Commission has an interest in the resolution of this issue because private actions under the federal securities laws serve an important role: they can provide compensation for investors who have been harmed by securities law violations; and, as the Supreme Court has repeatedly recognized, they "provide 'a

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1/ The Commission does not address the separate question, also raised in this appeal, as to whether the evidence was sufficient to establish scienter -- an issue that turns on the particular facts of this case.

most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985), quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964). See also Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975). Congress, in adopting the Private Securities Litigation Reform Act of 1995, affirmed that "[p]rivate securities litigation is an indispensable tool with which defrauded investors can recover their losses" and that private lawsuits "promote public and global confidence in our capital markets and help to deter wrongdoing and guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs." Conference Report on Securities Litigation Reform, H.R. Rep. No. 369, 104th Congress, 1st Sess., at p. 31 (1995). 2/

2/ The Commission has a further interest in this case, beyond its implications for private actions. Because Central Bank was a private action, the Supreme Court did not explicitly address the Commission's authority to bring actions against aiders and abettors. After Central Bank, Congress reaffirmed the Commission's authority to bring such actions in the Litigation Reform Act. Exchange Act Section 20(e), 15 U.S.C. 78t(e). Nonetheless, a decision in this case could affect the Commission's litigating authority in certain areas.

First, the provision in the Litigation Reform Act that reaffirmed the Commission's authority to sue aiders and abettors requires a showing that the defendant provided assistance knowingly, thus raising a question about whether the scienter element in a securities fraud action brought by the Commission against an aider and abettor can be satisfied by the reckless conduct that is sufficient to make a defendant liable as a primary violator. Second, resolution of the issue in this case could have a bearing upon the Commission's authority to proceed against violators of the antifraud provisions in Section 17(a) of the Securities Act

(continued...)

STATEMENT OF THE CASE

1. The Facts

Defendant Steven L.W. Hui is the founder of Everex Systems, Inc., a computer company. ER 6, p. 5. 3/ As Chairman and Chief Executive Officer of Everex, Hui signed Forms 10-Q filed with the Commission for three consecutive quarters in 1991 and 1992. ER 65, 83, 98. 4/ All three 10-Q's contained the representation that the information in the 10-Qs, although unaudited, included all adjustments "necessary for the fair presentation of the financial position, results of operations, and cash flow" of the company. ER 65, p. 6; ER 83, p. 6; ER 98, p. 6. Plaintiff alleges that this representation was materially false and misleading in that inventory, net income, and earnings per share as set forth in the 10-Qs were "artifically and improperly inflated." ER 3, pp. 29-30.

2/(...continued)
of 1933, 15 U.S.C. 77q(a). The Supreme Court's rejection of aiding and abetting liability under Section 10(b) of the Exchange Act could be applied to Section 17(a) as well. The Litigation Reform Act, however, does not give the Commission authority to proceed against aiders and abettors of violations of the Securities Act.

3/ "ER" refers to Plaintiff-Appellant's Excerpts of Record.

4/ Hui claims that, although he was Chairman and Chief Executive Officer when he signed the 10-Qs, he did not have the power within the company to control their preparation. Joint Pretrial Statement, p. 19. Hui contends that he had relinquished his management authority over the company's operations previously, when another person replaced him as president and assumed operational control of the company. Id.

2. The District Court Decision

After a jury trial, the district court ordered a directed verdict for Hui. Although it is not entirely clear from the court's oral opinion, the court appears to have relied upon two grounds in making this determination: first, that no reasonable jury could conclude from the evidence that any misrepresentations in the filings were made by Hui; and second, that no reasonable jury could conclude from the evidence that Hui had scienter. 5/

The district court stated, apparently with regard to its first reason for ordering a directed verdict (the conclusion that Hui did not "make" a false statement), that "[T]here [was] no evidence that Mr. Hui had anything to do with the preparation of [the] financial statements or the creation of the actual numbers .... [Others] prepared the statements and presented them to him .... [H]e signed the statements that were presented to him and did so without making any corrections." Id. The district court rejected plaintiff's contention that Hui had reviewed the financial statements with the Chief Financial Officer, stating that "the evidence is that there were no meetings by Mr. Hui with [the Chief Financial Officer] before the numbers were presented

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5/ Under Section 10(b) of the Exchange Act and Rule 10b-5, a defendant must act with scienter in order to be liable -- that is, he must engage in deceptive conduct either knowingly or recklessly. Recklessness in this context means an extreme departure from the standards of ordinary care that presents a danger of misleading buyers or sellers that is either known to the defendant or so obvious that he must have been aware of it. See Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc), cert. denied, 499 U.S. 976 (1991).

to a board of directors meeting." Id. The district court stated that Hui's "scrutiny of the numbers was superficial at best" and noted that he did not have the power to make changes in the financial statements presented to him by the Chief Financial Officer unless the board approved those changes. Id. 6/

With regard to its second reason for ordering a directed verdict (the conclusion that no reasonable jury could find from the evidence that Hui had scienter), the court stated that "there's no evidence that he, Mr. Hui, knew or thought that any of the numbers were wrong." Id. The district court stated that the scienter requirement is satisfied only if "the danger [of misrepresentation] is so obvious that defendant must have been aware of it." Id. In the court's view, the plaintiff had not presented any evidence from which a reasonable jury could conclude that Hui must have been aware of the misrepresentations.

ARGUMENT

A CORPORATE OFFICIAL WHO SIGNS A COMMISSION FILING CONTAINING MATERIAL MISREPRESENTATIONS, ASSUMING HE ACTS WITH SCIENTER, IS A PRIMARY VIOLATOR OF THE FEDERAL SECURITIES LAWS.

The district court, in ruling that the misrepresentations were not "made" by Hui, misinterpreted the distinction between primary violators and aiders and abettors. Section 10(b) states that it is unlawful for any person "[t]o use or employ ... any manipulative or deceptive device or contrivance." In Central

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6/ Although the district court did not mention Central Bank in its oral ruling, it appears to have been responding to the parties' citation and discussion of the Central Bank distinction between primary violators and aiders and abettors.

Bank, the Supreme Court recognized a distinction between, on the one hand, persons who "commit" or "engage in" "manipulative or deceptive acts" or "make" misrepresentations and thus are primary violators, and, on the other hand, persons who give assistance, but do not themselves commit manipulative or deceptive acts, and thus are only aiders and abettors. 511 U.S. at 177-78, 191. A corporate official who, acting with scienter (see n. 5 supra), signs a Commission filing containing misrepresentations is not merely giving aid to someone else who commits a deceptive act; he himself commits a deceptive act.

It does not make any difference whether the corporate official was involved in preparing the document he signed, so long as he had scienter when he signed the document. See In Re JWP Inc. Sec. Lit., 928 F. Supp. 1239, 1255-56 (S.D.N.Y. 1996) (under Central Bank, director who signs Form 10-K that contains allegedly false or misleading statements can be liable as primary violator for those statements); F.N. Wolf & Co., Inc. v. Estate of James W. Neal, Fed. Sec. L. Rep. (CCH) 95,805 at p. 98,876 (S.D.N.Y. 1991) ("director signing a document filed with the SEC...'makes or causes to be made' the statements contained therein") (construing Section 18 of the Exchange Act, 15 U.S.C. 78r(a)). When the public sees a corporate official's signature on a document, it understands that the official is thereby stating that he believes that the statements in the document are true. If in fact statements in the document are not true, and the corporate official has

culpably misled the public. Under Central Bank, a person who misleads the public in that fashion is a primary violator. 7/

Precedent in this Court is consistent with the view that when an official signs a Commission filing, the official thereby attests to the document's accuracy and completeness. In a number of cases arising in contexts other than the securities laws, this Court has held that the act of signing a document signifies that the signer believes that the statements in the document are true. See, e.g. United States v. Gomez-Gutierrez, 140 F.3d 1287, 1288-89 (9th Cir.), cert. denied, 119 S.Ct. 206 (1998) ("the affixing of a signature is not a mere formality, but rather signifies that the signer has read the document and attests to its accuracy"); United States v. Cain, 130 F.3d 381, 383 (9th Cir. 1997), cert. denied, 118 S.Ct. 1333 (1998) (an attorney's signature on proposed jury instructions "represented to the court that he had read the instructions, that he had studied them, and that, to the best of his knowledge, they represented the current state of the law").

Accurate and complete disclosure is central to the federal securities laws. See Central Bank, 511 U.S. at 171 ("Together, the Acts embrace a fundamental purpose...to substitute a philosophy of full disclosure for the philosophy of caveat

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7/ A corporate employee who issues a document not in an executive capacity but in a purely ministerial capacity, such as a public relations employee who issues a press release, would not be a primary violator. This is because such a person is understood not to be saying that the statements in the document are true but only that the information in the document comes from the corporation.

emptor.") (internal quotation omitted)). In 1934, when Congress enacted the Exchange Act and required the filing of "adequate and honest reports to securities holders by registered corporations," Congress stressed "the vital importance of true and accurate reporting as an essential cog in the proper functioning of the public exchanges." H.R. Rep. No. 73-1383, at 11 (1934). At that time, the reporting requirements applied to securities traded on exchanges, but not to companies whose securities were traded in the over-the-counter market. In 1964, when the Exchange Act was amended to extend the reporting requirements to such companies, Congress again stressed the importance of full and honest reporting to the proper functioning of the securities markets:

> The lack of the basic investor protection of disclosure in the over-the-counter market has made informed investment judgment difficult; it has created grave difficulties for brokers and dealers who try to fulfill their responsibilities to provide sound investment advice to the public; it has deprived investors of important bulwarks against fraud; and it has made it impossible for the over-the-counter market to enjoy a sustained expression of public confidence.

S. Rep. No. 379, at 10 (1963). 8/

8/ The importance of complete and accurate information to the proper functioning of the securities markets is reflected in the "fraud on the market" theory, adopted by the Supreme Court in Basic Inc. v. Levinson, 485 U.S. 224, 244 (1987) ("'In an open and developed market, the dissemination of material misrepresentations or withholding of material information typically affects the price of the stock, and purchasers generally rely on the price of the stock as a reflection of its value'") (quoting Peil v. Speiser, 806 F.2d 1154, 1161 (3d Cir. 1986)). See also Shaw v. Digital Equipment Corp., 82 F.3d 1194, 1207 (1st Cir. 1996) ("The disclosure of accurate firm-specific information enables investors to compare the prospects of investing in one firm versus another, and enables capital to flow to its most valuable uses.").

The Commission has long taken the position, and courts have held, that the requirement that issuers file current and annual reports with the Commission "necessarily embodies the requirement that such reports be true and correct." Great Sweet Grass Oils, Ltd., 37 S.E.C. 683, 684 n.1 (1957), aff'd, 256 F.2d 893 (D.C. Cir. 1958); SEC v. IMC Int'l, Inc., 384 F. Supp. 889, 893 (N.D. Tex.) ("The reporting provisions of the Exchange Act are clear and unequivocal, and they are satisfied only by the filing of complete, accurate, and timely reports.") aff'd, 505 F.2d 733 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975).

Corporate officials play an important role in assuring that reports required to be filed with the Commission are complete and accurate. In order to stress their important role, the Commission in 1980 amended the instructions to the annual report on Form 10-K, which formerly was signed only by the issuer, to require that the 10-K also be "signed on behalf of the issuer by the registrant's principal executive officer or officers, its principal financial officer, its controller or principal accounting officer, and by at least the majority of the board of directors or persons performing similar functions." Securities Exchange Act Rel. No. 16496, at p. 28 (Jan. 15, 1980), 1980 SEC LEXIS 2254. 9/ The Commission has emphasized the need for

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9/ The Commission stated at the time that although the change "constitutes a significant expansion of the existing signature requirements, it does not believe that this expansion will have substantial legal effect. In the Commission's view the persons who would be required to sign the revised form are presently legally responsible for the (continued...)

corporate officials to "take steps to assure the accuracy and completeness of the statements" in corporate filings. In the Matter of W.R. Grace & Co., Securities Exchange Act Rel. No. 39157, at p. 3 (Sept. 30, 1997), 1997 SEC LEXIS 2038; In the Matter of The Cooper Cos., Inc.. Securities Exchange Act Rel. No. 35082, at p. 4 (Dec. 12, 1994), 1994 SEC LEXIS 3975.

If the district court's view on primary liability were accepted, a corporate official who signs a document for public dissemination could disclaim legal responsibility (at least in private actions) on the ground that he was not involved in preparing the document, even if he had scienter, i.e., either knew or was reckless in not knowing that the document contained misrepresentations. Such a result is inconsistent with the responsibility of corporate officials to assure that documents filed with the Commission are true and accurate and is not warranted by Central Bank. When a corporate official signs a

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9/(...continued)
information content of the existing form." Exchange Act Rel. No. 16496, at p. 28.

The Commission recently issued a proposal for amendments to the rules governing the corporate filings that are required by the Securities Act of 1933, 15 U.S.C. 77a et seq., and the Exchange Act. Release No. 34-40632A, 68 S.E.C. Dkt. 1571, 1641-1642 (Nov. 3, 1998). This proposal, among other things, would require persons who sign those filings to make certifications that, to their knowledge, the filings contain no material misstatements or omissions. The requirement for certifications, if adopted, would make explicit what the Commission already believes to be implicit when a corporate official signs a filing with the Commission, namely, that the corporate official thereby states that he believes that the statements in the filing are true.

document containing statements about his company, he should be liable as a primary violator if he knows or is reckless in not knowing that the statements are false or misleading.

CONCLUSION

For the foregoing reasons, the Court should hold that an official of a corporate issuer who, acting with scienter, signs a Commission filing containing material misrepresentations, is a primary violator of Section 10(b) and Rule 10b-5.

Respectfully submitted,

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June 1999