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Donaldson's Troublesome Legacy: Whether to Afford Targets of SEC Investigations Notice of Third-Party Subpoenas

Brian T. Corbett

COMMENTS

DONALDSON'S TROUBLESOME LEGACY: WHETHER TO AFFORD TARGETS OF SEC INVESTIGATIONS NOTICE OF THIRD-PARTY SUBPOENAS

The Securities and Exchange Commission (SEC) is the agency charged with principal responsibility for the administration and enforcement of the federal securities laws.[1] Its establishment was a reaction to the widespread fraudulent selling of securities during the post-World War I decade, which eventually helped trigger the stock market crash of 1929.[2] Congress felt that if a government agency could ensure "full and fair disclosure" of all material facts concerning securities offered for public sale, it could prevent the countless tragedies spurred by the crash of 1929 from reoccurring.[3] As a result, the SEC has been given broad enforcement authority by the stat-

1. The SEC is directed by five Commissioners (the Commission), no more than three of whom may belong to the same political party. Members of the Commission are appointed to a five-year term by the President, with the advice and consent of the Senate. 15 U.S.C. § 78d (1982).

The Commission is assisted by a staff of professionals made up of attorneys, accountants, and securities analysts. Staff members are assigned to the four major divisions within the SEC:

(a) Division of Corporation Finance—responsible for ensuring adherence to standards of financial reporting and disclosure by companies under the jurisdiction of the various securities laws administered by the SEC. Corporation Finance reviews registration statements, prospectuses, periodic reports, and proxy statements in order to determine whether there has been full and fair disclosure.

(b) Division of Investment Management—responsible for investigations and inspections arising under the Investment Company Act of 1940, 15 U.S.C. § 80a (1982), and the Investment Advisers Act of 1940, 15 U.S.C. § 80b (1982). *See infra* notes 43-51 and accompanying text.

(c) Division of Market Regulation—responsible for conducting an ongoing surveillance of the trading markets. This division plays a large role in the regulation of national securities exchanges and of brokers and dealers registered under the Investment Advisers Act of 1940.

(d) Division of Enforcement—responsible for conducting all enforcement investigations pursuant to federal securities laws.

2. 77 CONG. REC. 2910, 2911-14 (1933).

3. 77 CONG. REC. 2910, 2912-14 (1933).

utes under its jurisdiction.[4]

Throughout most of its fifty-year history,[5] the SEC consistently has been the subject of praise by both Congress and commentators for fairly and responsibly wielding its substantial regulatory powers in the public interest.[6] Recently, however, there have been serious criticisms leveled at the SEC, claiming that its enforcement process reflects a pattern of overzealousness, and insensitivity to individual liberties and fundamental concepts of fairness.[7] These critics can take some solace in the United States Court of Appeals for the Ninth Circuit's recent decision in *Jerry T. O'Brien, Inc. v. SEC*.[8] The *O'Brien* court held that the SEC, for the first time since its inception, must notify a target, or potential target, whenever it issues a subpoena in connection with an investigation of the target.[9] Shortly thereafter, however, the same issue of notice to targets came before the Southern District of New York in *PepsiCo v. SEC*.[10] The court concluded that a mandatory notice requirement would be devastating to SEC investigations, and criticized the Ninth Circuit as being short-sighted.[11]

The notice controversy can be attributed to the nature of SEC investigative subpoenas, and the limitations on the ability of investigative targets to challenge their enforcement when issued to third parties.[12] In *Donaldson v.*

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4. *See infra* notes 19-59 and accompanying text.

5. The SEC was created by the Securities Exchange Act of 1934, 15 U.S.C. § 78d (1982).

6. *See* H.R. REP. NO. 1321, 96th Cong., 2d Sess. 4 (1980); *"Report Card" on Federal Agencies*, U.S. NEWS & WORLD REP., Nov. 15, 1976, at 91.

7. Freedman & Sporkin, *The Securities and Exchange Commission's Enforcement Program: A Debate on the Enforcement Process*, 38 WASH. & LEE L. REV. 781 (1981); *see* Lowenfels, *Securities and Exchange Commission Investigations: The Need for Reform*, 45 ST. JOHN'S L. REV. 575, 579-81 (1971).

8. 704 F.2d 1065 (9th Cir. 1983), *cert. granted*, 104 S.Ct. 697 (1984).

9. *Id.* at 1069. The term "target" is not defined by SEC statute, rule, or practice. For purposes of this Comment, a "target" is an individual or entity that has been formally or informally identified as the subject of an SEC investigation. A "potential target" is an individual or entity recognized as a possible subject, or in some cases, a temporary subject. For example, the Commission may investigate unusually active trading in a particular stock prior to an important press release by the issuing company. Anyone who traded in the period prior to the release is a "potential target" of an insider trading investigation. In most instances, the vast majority of traders will eventually be excluded as "potential targets" as the investigation proceeds.

10. 563 F. Supp. 828 (S.D.N.Y. 1983).

11. *Id.* at 832.

12. A formal investigation by the SEC almost inevitably requires the issuing of subpoenas to nontargeted third parties. Often these parties have no interest in challenging the subpoena, and simply comply as a matter of course. The target of the investigation, the individual with the most to lose if the third party complies, has no standing to assert a challenge. *See infra* note 136 and accompanying text. The target's only recourse is to persuade the third party to challenge the subpoena, and then attempt to intervene in the sub-

United States,[13] the United States Supreme Court held that the subject of an investigation might be able to intervene in a subpoena enforcement proceeding if he could show a "significantly protectable interest."[14] The Court intimated, however, that even if such an interest were at stake, in certain instances it is best to consider that interest after the investigation is completed.[15]

The issues of intervention and notice are intimately related. The *O'Brien* court recognized that, as a practical matter, before a target can attempt to intervene he must be notified that a subpoena has been issued.[16] On the other hand, the *PepsiCo* court suggested that an SEC investigation is one of those instances when protectable interests should be asserted after the investigation has been completed and, therefore, there is no need for a notice requirement.[17]

This Comment will address the notice issue in terms of the SEC's ultimate objective of ensuring both investor protection and an individual's recognized right to be investigated according to certain standards of fairness. It will review various pertinent securities statutes, and the procedures utilized to enforce them. Moreover it will discuss the various interests which courts have recognized as bases for viable challenges to subpoena enforcement, and an investigative target's right to intervene in a third-party enforcement proceeding to assert those challenges. Finally, this Comment will analyze the conflicting views which the courts have taken on the notice issue, with emphasis on the advantages, disadvantages, and policy considerations involved. It will conclude that the SEC's established practice of denying targets notice of third-party subpoenas should be preserved.

I. The Securities Laws and How They Are Enforced: An Overview

A. Statutory Schemes and Purposes

Each of the statutes enforced by the SEC includes within its jurisdiction numerous and varied individuals and entities taking an active role in the securities industry. These congressionally enacted schemes were designed to ensure the protection of investors, and secure the integrity of the

poena enforcement proceeding by asserting his own challenge. *See infra* notes 136-54 and accompanying text.

13. 400 U.S. 517 (1971) (Internal Revenue Service investigation of taxpayer's returns).

14. *Id.* at 531; *see infra* notes 141-54.

15. 400 U.S. at 531 (citing United States v. Blue, 384 U.S. 251 (1966)).

16. 704 F.2d at 1069.

17. 563 F. Supp. at 831.

financial markets.[18] A discussion of these schemes and their purposes, as well as the SEC's enforcement authority, is essential to the present inquiry since the interests furthered by the securities laws ultimately will be balanced against the individual rights to be protected by affording targets of investigation notice of third-party subpoenas.

The Securities Act of 1933[19] and the Securities Exchange Act of 1934[20] were direct responses to the unethical practices of many individuals and corporations selling securities at that time.[21] In order to protect investors from those practices, the 1933 Act requires that prospective purchasers be apprised of all relevant material information concerning companies offering securities for public sale through the vehicle of interstate commerce.[22] This is accomplished by requiring issuing companies both to register with the SEC,[23] and send potential purchasers a copy of an approved prospectus.[24] The 1933 Act also contains antifraud provisions which impose personal liability upon specified individuals for false and misleading statements contained in either a registration statement[25] or prospectus.[26]

While the 1933 Act is designed to regulate the initial distribution of securities, the 1934 Act focuses on the trading of securities in secondary markets through brokers and exchanges.[27] It extends the requirements of registration and disclosure to any company attempting to trade its securities over a national exchange,[28] thereby enabling prospective investors to make an informed decision. The 1934 Act also protects investors in other ways. Section 14(a), for example, makes it unlawful for any person to solicit a proxy or consent in violation of any rules or regulations established by the SEC.[29] The Act also continues the antifraud theme of the 1933 Act

18. 77 CONG. REC. 937 (1933) (Message from the President to the Senate—Regulation of Securities Issues, Mar. 29, 1933).

19. 15 U.S.C. § 77a-77aa (1982).

20. *Id.* § 78a-78kk.

21. *See supra* note 18.

22. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

23. 15 U.S.C. § 77e(c) (1982). The SEC ensures only that the registration statement is complete and accurate; it has no authority to evaluate the security's investment potential.

24. *Id.* § 77e(b)(2).

25. *Id.* § 77k.

26. *Id.* § 77*l*.

27. The legislation was prompted partly as a response to an investigation by the Senate Committee on Banking and Currency, which revealed a myriad of unfair methods of speculation being used by large operators to the detriment of the investing public. The Committee Report recognized that the security and prosperity of the entire country, and not just individual investors, were intimately connected with the operation of the securities markets. S. REP. NO. 792, 73rd Cong., 2d Sess. 3 (1932) (accompanying S. 3420, Apr. 20, 1932).

28. 15 U.S.C. § 78*l* (1982).

29. *Id.* § 78n(a).

by prohibiting wash transactions,[30] matched orders,[31] and other manipulative and deceptive devices.[32]

The Public Utility Holding Company Act of 1935[33] grew out of an investigation of the utility industry that revealed the existence of corrupt practices on a national level.[34] The regulatory scheme of the Act is aimed toward the protection of both utility consumers and investors.[35] This scheme makes it unlawful for electric and gas holding companies to engage in interstate commerce without registering with the SEC.[36] Once registered, the holding company is subject to an examination of its structure by the SEC, which may then take the steps necessary for simplifying or eliminating existing complexities, and equitably distributing voting power among shareholders.[37] The Act's ultimate goal is to create simplified structures confined to a limited region, enabling efficient operation and effective local regulation.[38]

In 1939, Congress promulgated the Trust Indenture Act,[39] designed to provide for independent trustees under indentures to protect the rights and interests of individuals holding securities under those indentures.[40] Under the 1939 Act, a trust indenture, under which bonds, debentures and other debt securities are offered for public sale, must be approved by the SEC.[41] Additionally, the SEC assures that the appointed trustee will have the re-

30. A "wash transaction" occurs when there is an apparent sale of stock which actually involved no change in beneficial ownership. Such transactions have the effect of creating a misleading appearance of active trading in the stock. *Id.* § 78i(a)(1).

31. A "matched order" occurs when an individual enters an order for the purchase or sale of a security with the knowledge that a corresponding order for purchase or sale of substantially the same size at approximately the same price has been or will be entered. *Id.* § 78i(a)(2).

32. *Id.* § 78j(b).

33. *Id.* § 79a.

34. In its investigation, Congress discovered that electric and gas utility companies had formed into top-heavy holding company structures which were grossly inefficient, and managed by individuals more concerned with maneuvering for financial power than with providing a service to consumers. L. LOSS, SECURITIES REGULATION, 132-33 (2d ed. 1961).

Many of the abuses which existed are recited in the Act, including the issuance of securities upon the basis of paper profits from intercompany transactions; subjecting subsidiaries of the holding companies to excessive charges for services, construction work and equipment; and floating securities for the purpose of purchasing operating utility companies, rather than building or improving additional properties. 15 U.S.C. § 79a(b) (1982).

35. 15 U.S.C. § 79a(b) (1982).

36. *Id.* § 79d.

37. *Id.* § 79k(a).

38. *Id.* § 79a(b)(5).

39. *Id.* § 77aaa-77bbbb.

40. *Id.* § 77bbb.

41. *Id.* § 77ggg.

sources and intent necessary to safeguard the interests of investors.[42]

The Investment Company Act of 1940,[43] like the Public Utility Holding Company Act of 1935,[44] was enacted to address the problems of a particular industry that could not adequately be met by the 1933 and 1934 Acts.[45] It requires all investment companies using the mails or other vehicles of interstate commerce to file a registration statement with the SEC.[46] Each company must disclose its financial condition and investment policies to provide investors with access to complete information.[47]

The Investment Advisors Act of 1940,[48] passed contemporaneously with the Investment Company Act,[49] requires persons or firms in the business of providing advice concerning securities investments to register with the SEC.[50] In their registration statements, investment advisors must disclose all relevant and material information regarding their backgrounds and business affairs,[51] in order to provide accurate and current information for potential investors.

In 1970, Congress passed the Securities Investor Protection Act[52] as an amendment to the 1934 Act.[53] The Act created the Securities Investor Protection Corporation (SIPC), a body comprised of brokers and dealers registered with the SEC, along with members of the national securities exchanges.[54] Each member of the non-profit SIPC must pay a fee which then goes into a fund used to satisfy claims by investors for losses traceable to the conduct or financial condition of a broker or dealer.[55] The SIPC is required to file financial statements and annual reports with the SEC,[56]

In order to ensure the proper enforcement of the above statutes, Congress provided the SEC with broad investigatory powers.[57] The SEC has the authority to use its own discretion in determining who and when to

42. *Id.* § 77bbb.
43. *Id.* § 80a-1-64.
44. *See supra* notes 33-38 and accompanying text.
45. L. Loss, *supra* note 34, at 144.
46. 15 U.S.C. § 80a-8 (1982).
47. *Id.*
48. *Id.* § 80b-1-21.
49. *See supra* notes 43-47 and accompanying text.
50. 15 U.S.C. § 80-b-3 (1982).
51. *Id.* § 80-b-3(c)(1).
52. *Id.* §§ 78aaa-111. The Act was in response to the substantial losses suffered by investors due to the failure and financial difficulties of brokers and dealers. *See* Securities Investor Protection Corp. v. Barbour, 421 U.S. 412 (1975).
53. *See supra* notes 27-32 and accompanying text.
54. 15 U.S.C. § 78ccc(a)(2) (1982).
55. *Id.* § 78ddd.
56. *Id.* § 78ggg(c).
57. Section 21(a) of the Securities Exchange Act provides in part:

investigate. Most of the Acts also extend to the SEC the power to sue for injunctions when violative conduct is uncovered[58] and, where appropriate, to transmit evidence to the Attorney General for the purpose of criminal proceedings.[59]

B. The Enforcement Process at a Glance

Maintaining investor confidence is one of the SEC's primary objectives, and achievement of that end is tied to the effectiveness of its enforcement program.[60] The enforcement process is usually initiated by a lead coming from one of many possible sources. One such source is investors who often claim that they have been victims of securities violations.[61] The SEC staff, while reviewing registration statements, periodic reports, and other documents, often discover indications of violations. The SEC also operates a market surveillance program, and has the authority to conduct on-site inspections of regulated entities such as broker-dealer firms.[62] In addition, leads are obtained from newspaper and other articles, as well as from investigations into related matters.

In view of its limited resources, the SEC must attempt to pursue those cases which will have maximal impact. There are at least three factors

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> The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of this chapter, the rules or regulations thereunder. . . . The Commission is authorized in its discretion, to publish information concerning any such violations, and to investigate any facts, conditions, practices, or matters which it may deem necessary or proper to aid in the enforcement of such provisions, in the prescribing of rules and regulations under this chapter, or in securing information to serve as a basis for recommending further legislation . . . .

15 U.S.C. § 78u(a) (1982). The investigatory provisions of the other Acts resemble that of the 1934 Act in breadth and tone. *See* 15 U.S.C. §§ 77(t), 79(r), 80a-41, 80b-9, 78ggg(c)(1) (1982).

58. *Id.* §§ 77t(b), 78u(d), 79r(f), 80a-41(e), 80b-9(e).

59. *See, e.g.*, *id.* § 78u(d).

60. Enforcement is the largest activity at the SEC, accounting for approximately one-third of the total budget. In 1982 the SEC brought 251 new enforcement cases, a 31% increase over 1981 despite budgetary constraints and personnel reductions. J. Shad, Speech Before the Securities Regulation Institute (Jan. 21, 1983), *reprinted in* THE SEC SPEAKS IN 1983 21-23 (1983).

61. *See, e.g.*, SEC v. Howatt, 525 F.2d 226 (1st Cir. 1975) (investigation initiated by a written complaint from a broker whose clients had been victims of questionable securities practices).

62. The Commission maintains a comprehensive program of oversight of the exchanges and over-the-counter markets that includes surveillance; analysis and review of trading in all markets; review and analysis of publications and filings; support for investigative matters; and maintaining legal actions which result from market surveillance activities. E. HERLIHY & T. FERRIGNO, AN OVERVIEW OF VARIOUS CONSIDERATIONS IN SEC INVESTIGATIONS AND ENFORCEMENT ACTIONS, AN OUTLINE 11 (1980).

taken into consideration when the SEC assesses enforcement priorities. First, the SEC considers whether an alleged violation involves an institution or individual playing a strategic role in the securities industry.[63] For example, the SEC believes that if it can successfully induce broker-dealers, banks and other professionals to perform properly, many violative activities can be prevented. Second, the SEC generally directs its programs at abuses which recently have proliferated, and therefore have been earmarked as high enforcement priorities.[64] Third, individual cases involving large sums of investors' dollars will draw the SEC's attention regardless of the nature of the violations involved.[65]

Once priorities are established, the investigation begins. The SEC has described the nature of its investigations as completely nonadversarial.[66] They are similar to the activities of a grand jury in that their purpose is solely one of fact-finding. Therefore the SEC's discretion in determining who and when to investigate is not constrained by challenges based upon forecasts of the probable result of the investigation.[67]

Generally, formal investigations are preceded by informal or preliminary inquiries. These inquiries are not conducted pursuant to subpoena power[68] and, therefore, the SEC staff relies on the voluntary cooperation of individuals with relevant information. The goal of the preliminary investigation is to determine whether it is likely that a violation of the securities laws has occurred.[69] If such a likelihood exists, or if additional leverage is required in order to conduct a proper inquiry, the staff will seek a formal order of investigation from the Commission.[70] This request is usually made in the form of a memorandum stipulating the alleged violations, the relevant facts and circumstances, and the need for the formal investigation. If the Commission agrees with the staff's recommendation, it will issue the formal order. The formal order serves two important functions: first, it draws the general boundaries of the investigation; and second, it entrusts the staff with the power to issue subpoenas and administer

63. E. HERLIHY & T. FERRIGNO, *supra* note 62, at 2.

64. *Id.* at 3.

65. *Id.*

66. *In re* White, Weld & Co., 1 S.E.C. 574, 575 (1936).

67. Wooley v. United States, 97 F.2d 258 (9th Cir. 1938). The *Rules Relating to Investigations*, 17 C.F.R. §§ 203.1-203.8 (1983), support the theory that the investigation is nonadversarial, in that they provide few procedural protections for individuals being investigated.

68. 17 C.F.R. § 202.5 (1983).

69. *Id.*

70. A formal finding by the staff of a likelihood of a violation is not a prerequisite to issuance of a formal order. The SEC may also investigate facts and practices in order to prescribe rules and regulations and recommend legislation. *See* 15 U.S.C. § 78u(a) (1982).

oaths.[71] The order may also name the subjects of the investigation, if known. The SEC, however, is not required to inform identified subjects that they are being investigated.[72] As a practical matter, subjects will usually become apprised of that fact as the investigation proceeds and subpoenas are issued.

Unless the Commission orders otherwise, an investigation is nonpublic, and all reports prepared pursuant to the investigation are for internal use only.[73] Confidentiality is critical since the mere existence of an inquiry tends to undermine the reputation of the investigated company within the investment community.[74] Nevertheless, at the conclusion of a deposition or production of documents a subpoenaed third party will necessarily leave with full knowledge of who the particular target is, and the SEC's allegations against it.[75] In an attempt to protect the reputation of the investigated party, the SEC has adopted the Wells Committee's[76] suggestion that all formal orders and letters accompanying subpoenas contain a statement that the existence of an investigation does not necessarily mean that a violation has occurred.[77] The practical purpose of the statement is prophylactic; it is designed to dissuade the subpoenaed party from making hasty judgments concerning the culpability of the subject of the investigation.

Once the staff has exhausted its avenues of investigation, and has determined that there is sufficient evidence to prove its allegations, it will recommend to the Commission that formal enforcement proceedings be brought.[78] The SEC is given the authority to seek either temporary or

71. E. HERLIHY & T. FERRIGNO, *supra* note 62, at 27.

72. *See* 17 C.F.R. § 202.5(a) (1983).

73. *Id.* § 202.5(a).

74. The SEC has been severely criticized for allowing adverse publicity to reach the business community before there has been any determination that the law has been violated. *See supra* note 7 and accompanying text.

75. *See* Lacy, *Adverse Publicity and SEC Enforcement Procedure*, 46 FORDHAM L. REV. 435, 438-39 (1977). Witnesses called to testify in connection with the investigation are often the sources of the damaging information. Frequently, they are competitors or former employees having no interest in maintaining the nonpublic posture of the investigation.

76. In 1972, the Commission appointed the Advisory Committee on Enforcement Policies and Practices for the purpose of evaluating and reviewing the SEC's overall enforcement program, and making recommendations aimed at achieving fair and effective procedures. The Committee consisted of John A. Wells, Manuel F. Cohen and Ralph H. Demmler. REPORT OF THE SECURITIES AND EXCHANGE COMMISSION'S ADVISORY COMMITTEE ON ENFORCEMENT POLICIES AND PRACTICES 1-3 (1972) [hereinafter cited as WELLS COMM. REP.].

77. *See* Merrifield, *Investigations by the Securities and Exchange Commission*, 32 BUS. LAW. 1583, 1594 (1977).

78. The Wells Committee also suggested that when an investigation has reached the point where the staff is going to the Commission to seek enforcement proceedings, prospective defendants should be notified of the charges against them, and afforded an opportunity

permanent injunctive relief under the various statutes which it administers.[79] In order to be successful in obtaining either type of relief before the Commission, the staff need only show that it is warranted by the public interest.[80] Once in federal district court, the SEC must prove a reasonable likelihood that the alleged violations will recur.[81] Therefore, proving past violations is insufficient; the SEC must prove a reasonable likelihood of future violations.

Although the injunction is the only remedy authorized by most of the securities laws, and because it is ineffective against "one time only" offenders, the SEC has been able to secure various forms of ancillary relief in recent years.[82] These new sanctions have enabled the SEC to protect investors more effectively, and to assure future compliance with the securities laws.[83] The forms of ancillary relief utilized by the SEC have included disgorgement of proceeds received in connection with a public offering,[84]

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to submit a written statement presenting their side of the facts and arguments. WELLS COMM. REP., *supra* note 76, at 34. In some instances, a defendant might reveal facts justifying the alleged unlawful conduct, or the staff may be persuaded to drop one or more of the serious charges which would otherwise reach the ears of the business community. Letter from A. Mathews to the SEC Advisory Committee on Enforcement Policies and Practices (May 23, 1972), *reprinted in* Mathews, *A.L.I. Proposed Federal Securities Code: Part XV—Administration and Enforcement*, 30 VAND. L. REV. 465, 485-86 n.124 (1977). Despite these advantages, the Commission refused to formally adopt the "Wells Submission" procedure. Instead these advantages would be attained on a "strictly informal basis in accordance with procedures which are now generally in effect." *Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations, Securities Act Release No.* 5310 (Sept. 27, 1972) [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,010 (SEC 1972).

In practice, the staff decides whether to afford a prospective defendant notice and an opportunity to present its case to the Commission. Although the staff has been criticized in the past for exercising its discretion inconsistently and arbitrarily, the staff will now, upon request, usually grant a prospective defendant the opportunity to make a Wells submission.

79. *See* 15 U.S.C. §§ 77t(b), 78u(d), 79r(f), 80b-9(e) (1982).

80. *See, e.g., id.* § 78u(d).

81. Chris-Craft Indus. v. Piper Aircraft Corp., 480 F.2d 341, 405 (2d Cir.), *cert. denied*, 414 U.S. 924 (1973) (in order for the SEC to obtain injunctive relief, there must be a showing that the person charged is engaged, or intends to engage, in conduct constituting a violation).

82. *See* Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779, 1779-82 (1976); Hazen, *Administrative Enforcement of the Securities and Exchange Commission's Use of Injunctive and Other Enforcement Methods*, 31 HASTINGS L.J. 427, 444-51 (1979).

83. Authority for these remedies has been founded on the equitable powers of federal courts in adjusting their remedies in order to grant the necessary relief where federally secured rights are invaded. SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1103 (2d Cir. 1972) (ancillary relief which included appointment of a trustee to receive defrauded lands and distribute them to defrauded investors; a temporary freeze on the accused's assets; and requiring disgorgement of proceeds, was a proper exercise of the district court's equity powers).

84. *See id.*

impoundment of assets in order to satisfy likely future judgments against a defendant,[85] and appointment of a receiver to preserve and protect property that was the subject of pending litigation.[86]

The effectiveness of these and other types of ancillary relief, as well as that of the SEC enforcement process generally, depends to a large extent on the ability of the staff to exercise its subpoena authority pursuant to the formal order of investigation. The subpoena is the staff's principal tool for gathering information,[87] which in turn provides leverage for the SEC in dealing with prospective defendants.

There are two general requirements which govern the form of an SEC subpoena. First, the number of documents sought through a subpoena duces tecum must not be unnecessarily burdensome.[88] Second, the information sought must be relevant to the purpose of the investigation as described in the formal order.[89] These two requirements, though logically distinguishable, are often meshed by courts to form a standard of reasonableness.[90] The staff need not make any showing of probable cause that a violation has occurred,[91] nor must it show that the subject of the investigation is within the jurisdiction of the securities laws.[92] The absence of such restrictions on the issuance of a subpoena reflects its critical importance to the SEC as a tool for regulating the securities industry.

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85. *See* International Controls Corp. v. Vesco, 490 F.2d 1334 (2d Cir.), *cert. denied*, 417 U.S. 932 (1974) (enjoining the dispostion of a large share of defendant's stock held to be within the district court judge's discretion where the stock would be a critical asset should the plaintiff prevail on the merits).

86. *See* SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3, 42 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970) (because the defendant corporation's management team worked so closely together, a wholly disinterested officer of the court was chosen to administer the corporation and prosecute certain of the members of the management team).

87. The subpoena may take two forms: ad testificandum, which requires the subject of the subpoena to appear for a deposition, or duces tecum, which requires the production of stipulated categories of documents. *See generally* Merrifield, *supra* note 77, at 1604-05.

88. *See* SEC v. Blackfoot Bituminous, Inc., 622 F.2d 512, 515 (10th Cir. 1980) (a subpoenaed party challenging enforcement on grounds that the subpoena is unnecessarily burdensome carries the burden of proving that allegation).

89. *See* SEC v. Howatt, 525 F.2d 226, 229 (1st Cir. 1975) (information sought via a subpoena found to be relevant where the subpoenaed party offered no meaningful evidence of abuse by the staff).

90. *See, e.g.*, United States v. Morton Salt Co., 338 U.S. 632, 652-53 (1950) (quoting Oklahoma Press Pub. Co. v. Walling, 327 U.S. 186, 208 (1946)).

91. *See* SEC v. Brigadoon Scotch Distrib. Co., 480 F.2d 1047, 1053-54 (2d Cir. 1973), *cert. denied*, 415 U.S. 915 (1974) ("official curiosity" held sufficient for enforcement of an SEC subpoena).

92. *See* SEC v. Wall Street Transcript Corp., 422 F.2d 1371, 1375 (2d Cir.), *cert. denied*, 398 U.S. 958 (1970) (the initial determination of whether a particular person or entity is covered by the securities laws lies within the discretion of the Commission).

II. CHALLENGING SUBPOENA ENFORCEMENT

Although both Congress and the courts have given the staff much discretion in the issuance of subpoenas, there is one significant constraint on its information gathering power. SEC subpoenas, like administrative subpoenas generally, are not self-executing;[93] therefore, a witness has a right to refuse compliance with the subpoena without threat of contempt proceedings. The SEC must then petition the appropriate federal district court for an order compelling the witness to comply.[94]

Whether compliance should be ordered is the issue addressed at the subpoena enforcement proceeding. The witness usually challenges the subpoena on one or more grounds, ranging from procedural flaws in its issuance, to the violation of a constitutional right if it is enforced. Although in most instances the court orders the witness to comply, the subpoena enforcement proceeding does safeguard against abuse of individual rights by an overly zealous staff.

The challenges recognized by the courts have developed within the context of subpoenas issued to individuals who are also the targets of investigation. Difficulties arise, however, when a subpoenaed third party attempts to challenge subpoena enforcement by asserting rights that only the investigative target has standing to raise,[95] and when a target attempts to challenge a subpoena issued to a third party. The latter situation compels a confrontation with the issues of notice and intervention. Initially, however, the development of substantive and procedural challenges to subpoena enforcement must be reviewed.

A. Challenges Available to Subpoenaed Targets and Subpoenaed Third Parties

A subpoenaed party may challenge an SEC subpoena on any appropriate ground,[96] but those who have based their challenges on either a flaw in subpoena form or a lack of jurisdiction of the SEC have not had much success. In *SEC v. Brigadoon Scotch Distributing Co.*,[97] the United States Court of Appeals for the Second Circuit held that the SEC did not have to show that the subject of the investigation was within its regulatory authority before a subpoena could issue. Furthermore, the court stated that rais-

93. Reisman v. Caplin, 375 U.S. 440, 445 (1964).

94. 15 U.S.C. § 77v(b) (1982).

95. *See, e.g.*, Sierra Club v. Morton, 405 U.S. 727, 734-35 (1972) (party seeking review of agency action must in fact be among those injured by the action).

96. Reisman v. Caplin, 375 U.S. at 446.

97. 480 F.2d 1047, 1052-53 (2d Cir. 1973), *cert. denied*, 415 U.S. 915 (1974).

ing jurisdictional issues was improper at the subpoena enforcement stage since the SEC must have free reign to investigate whether, in fact, the activities in question are within its regulatory authority.[98] The court made clear that the proper time for adjudicating such issues is at the trial stage.[99]

Challenges to the form of a subpoena, i.e., that it is burdensome, or that it seeks irrelevant documents, are usually dismissed by courts without elaboration.[100] This is because the formal order of investigation is written in general terms, rendering most documents in the possession of the party relevant. In addition, a subpoena that seeks production of a veritable mountain of documents will not be considered burdensome as long as each of the documents is relevant to the investigation.[101] As a result, the reasonableness of a SEC subpoena is usually sustained.

A subpoenaed target or third party may also mount a challenge claiming that the SEC, in issuing the subpoena, failed to fulfill the requirements established in *United States v. Powell*.[102] In *Powell*, a case arising in the Internal Revenue Service (IRS) context, the United States Supreme Court enunciated the showing that the IRS must make for one of its subpoenas to be procedurally sound. Powell, the subject of the investigation, refused to comply with the subpoena contending that the IRS had to prove a reasonable basis for believing a fraud had been committed.[103] The Court disagreed, stating that the IRS did not have to meet any standard of probable cause in order to enforce a subpoena. Instead, the Court held that the IRS must show that: (1) the investigation is being conducted pursuant to a legitimate, congressionally authorized purpose; (2) the particular inquiry is relevant to that purpose; (3) the information is not already in the Commissioner's possession; and (4) the administrative steps required by the Internal Revenue Code have been followed.[104]

Elaborating on its authority to question the motivation for an IRS investigation, the *Powell* Court invoked the equitable power courts have to prevent abuse of their process. The Court concluded that such an abuse

98. 480 F.2d at 1053.

99. The Court emphasized the need for the Commission to investigate without undue interference or delay. *Id.*

100. *See, e.g.*, SEC v. ESM Gov't. Sec., Inc., 645 F.2d 310, 311 n.1 (5th Cir. 1981) (where contention that subpoena exceeded scope of SEC investigation was rejected by the lower court and not appealed, the contention is treated as abandoned).

101. *See* SEC v. Arthur Young & Co., 584 F.2d 1018, 1024 (D.C. Cir. 1978), *cert. denied*, 439 U.S. 1071 (1979) (subpoena requiring production of documents which, when stacked, would extend 275 lineal feet, and cost the subpoenaed party over $100,000, determined not to be unduly burdensome).

102. 379 U.S. 48 (1964).

103. *Id.* at 49.

104. *Id.* at 57-58.

results when a court enforces a summons issued pursuant to an unauthorized purpose or an investigation conducted in bad faith.[105]

Although *Powell* represents the definitive statement with regard to the appropriate issues for review in an IRS subpoena enforcement proceeding, it is unclear whether review in the SEC context is as extensive. In *SEC v. Blackfoot Bituminous, Inc.,* the United States Court of Appeals for the Tenth Circuit inferred that the third procedural requirement which must be met by the IRS, showing that the information sought is not already in its possession, may not be applicable to the SEC.[106] The court placed the burden on the challenging party to identify the items allegedly in the staff's possession.[107] Since the challenging party failed to do so, the SEC was apparently under no obligation to fulfill this *Powell* requirement.

The remaining *Powell* requirements, however, have consistently been applied to SEC investigative subpoenas.[108] In fact, challenges to subpoena enforcement charging an improper purpose for either the entire investigation or the issuance of a particular subpoena, though largely unsuccessful, are somewhat common. Technically, the formal order of investigation is issued pursuant to an authorized purpose, such as, investigating possible violations of stipulated provisions of the securities acts. The staff, as a practical matter, would never state that it is issuing a subpoena to harass or pressure an individual, even if that is its intention. Likewise, an investigated party will, in an attempt to delay the inquiry, allege that the SEC has ulterior motives for its investigation that are not authorized by statute.

In general, the burden lies with the target to prove that the investigation is not being conducted pursuant to the stipulated legitimate purpose.[109] A number of circuits, however, have allowed a subpoenaed party an evidentiary hearing to inquire further into the motives of the agency that issued

105. *Id.* at 58.

106. 622 F.2d 512, 515 (10th Cir. 1980).

107. *Id.* at 515.

108. Another notable difference in the showings required of the IRS and SEC lies in the administrative steps mandated by the agencies' respective governing statutes. An SEC formal order of investigation is the only administrative requirement necessary for issuance of an investigative subpoena. 17 C.F.R. § 203.1 (1983). The steps required for issuance of an IRS subpoena, however, are more numerous and complex. For example, § 7609(b) of the Internal Revenue Code, 26 U.S.C. § 7609(b) (1982), the provision in dispute in *Powell*, requires the taxpayer to be notified in writing as to why a second inspection of relevant books of account is necessary. In addition, there are restrictions concerning the time and place for review of documents, *Id.* § 7605(a), and requirements for notifying targets of investigation when certain third parties are issued subpoenas. *Id.* § 7609.

109. *See* United States v. Morton Salt Co., 338 U.S. 632 (1950); Oklahoma Press Publishing Co. v. Walling, 327 U.S. 186 (1946).

the subpoena or summons. The Courts have required that the individual initially muster some evidence to support its improper purpose allegation.[110] The purpose of the evidentiary hearing is to identify those rare cases in which bald allegations of improper purpose can be substantiated.[111] After such a hearing, the court has the discretion to order additional discovery procedures to ferret out any improper motivations. If such motivations exist, the court will deny enforcement of the subpoena.[112]

Ayers v. SEC[113] involved such a scenario. Ayers sought to stay an SEC investigation which had numerous subpoenas outstanding. He alleged that the SEC's purpose in issuing the subpoenas was to harass Ayers and his associates, because they had successfully defeated an injunctive action the SEC had brought against them in another matter. The Montana District Court granted Ayers' motion to stay. The court held that he had raised sufficient doubts concerning SEC motives to merit a limited evidentiary hearing to decide whether discovery was warranted to determine the SEC's purposes.[114] *Ayers* stands for the proposition that courts, given the proper circumstances, will not simply defer to the discretion of the agency, but will inquire into its motives.

A related problem that has continually burdened courts is the existence of parallel civil and criminal proceedings. In general, when there is an imminent or pending criminal charge against an individual also the subject of a civil investigation arising out of the same circumstances, there is an inherent danger that the fruits of civil discovery will be used to further the criminal investigation. As a result, subpoenaed parties who are targets of investigation have alleged, as a challenge to enforcement, that issuance was made solely for the unauthorized purpose of fueling a parallel criminal proceeding.[115] A series of United States Supreme Court cases culmi-

110. *See* United States v. Cortese, 614 F.2d 914, 921 n.12 (3d Cir. 1980) (in order for a taxpayer to demonstrate the improper investigative motives, he must be afforded basic discovery tailored to the inquiry); United States v. Church of Scientology, 520 F.2d 818, 824 (9th Cir. 1975) (a subpoenaed party must show some evidence of improper motive before discovery will be ordered; an evidentiary hearing consisting of an examination of the agent who issued the summons would be the proper method for determining whether to proceed with discovery); United States v. Salter, 432 F.2d 697, 700 (1st Cir. 1970) (where, after an evidentiary hearing, there remains a substantial question in the court's mind regarding the government's purpose, it may then grant discovery).

111. United States v. Church of Scientology, 520 F.2d at 825. The form of the proposed evidentiary hearing consisted of an examination of the staff member who issued the subpoena by the subpoenaed party. The court, after observing the examination, determines whether discovery is in order. *Salter*, 432 F.2d at 700.

112. United States v. Powell, 379 U.S. at 58.

113. 482 F. Supp. 747 (D.D.C. Mont. 1980).

114. *Id.* at 753.

115. *See, e.g.*, United States v. LaSalle Nat'l Bank, 437 U.S. 298 (1978); Donaldson v.

nating in *United States v. LaSalle National Bank*,[116] discussed the enforceability of IRS civil investigative subpoenas in light of an existing criminal investigation.[117] The *LaSalle* Court held that the mere potential for criminal prosecution was insufficient to defeat enforcement of a civil subpoena. Such subpoenas would be denied enforcement only if they were issued subsequent to the IRS's referral of the case to the Justice Department for criminal prosecution.[118]

Whether *LaSalle* applies to parallel investigations into possible violations of the securities laws was the issue addressed in *SEC. v. Dresser Industries, Inc.*[119] That issue arose in the context of the SEC's campaign against the improper use of corporate funds to influence government officials in the United States and foreign countries.[120] As part of its campaign, the SEC instituted a "Voluntary Disclosure Program" to encourage corporations to pursue investigations of their past conduct and make appropriate disclosures, with only a remote chance of enduring an enforcement action.[121] Dresser participated in this program, but after filing three Form 8-K's,[122] was requested to release to the SEC the documents forming

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United States, 400 U.S. 517 (1971); United States v. Kordel, 397 U.S. 1 (1969); SEC v. Dresser Indus., 628 F.2d 1368 (D.C. Cir.), *cert. denied*, 449 U.S. 993 (1980).

116. 437 U.S. 298 (1978).

117. *See, e.g.*, United States v. Kordel, 397 U.S. 1 (1969). The *Kordel* Court held that parallel proceedings are not per se unconstitutional. Implicit in its analysis was the overriding importance of prompt investigation on both fronts in order to protect the public interest. The Court did state, however, that it may be unconstitutional for the government to initiate a civil investigation solely for the purpose of obtaining evidence to further a criminal investigation. *Id.* at 11-12. This latter proposition was reiterated by the Court in *Donaldson*, 400 U.S. at 533.

118. 437 U.S. at 313-17.

119. 628 F.2d 1368 (D.C. Cir.), *cert. denied*, 449 U.S. 993 (1980).

120. In *Dresser*, the court noted:

> SEC investigation revealed that many corporate officials were falsifying financial records to shield questionable foreign and domestic payments from exposure to the public and even, in many cases, to corporate directors and accountants. Since the completeness and accuracy of corporate financial reporting is the cornerstone of federal regulation of the securities markets, such falsification became a matter of grave concern to the SEC.

628 F.2d at 1371.

121. *Id.* The program consisted of four basic elements: (1) a thorough investigation by an independent committee of the corporation into questionable foreign payments by the corporation; (2) disclosure of the results of the investigation to the board of directors; (3) disclosure of the substance of the report to the SEC on Form 8-K, without including specific names, places, or dates; and (4) issuance of a policy statement by the corporation prohibiting such payments in the future. *Id.*

122. *Id.* at 1372. Form 8-K is a current report which must be filed by companies registered under the 1934 Act upon the occurrence of any of a number of events enumerated on the form, including changes in control and acquisition or disposition of assets.

the basis of the reports. When Dresser refused, the Commission ordered a formal investigation and subpoenas were issued. Concurrently, the Justice Department began a criminal investigation, and requested from the SEC its files on Dresser, including the 8-K's. Dresser sought to quash the SEC's subpoenas, claiming that transferring the files to Justice was a "referral" under *LaSalle*, and therefore the civil investigation should be stayed.[123]

The United States Court of Appeals for the District of Columbia Circuit refused to extend the *LaSalle* restrictions to the SEC investigative powers.[124] After an extensive review of the Internal Revenue Code and the various securities statutes, the *Dresser* court held that the SEC investigative power was authorized to continue during a parallel criminal investigation until the latter results in an indictment. It cited a key distinction between the respective nature of the two agencies' investigations: the IRS can postpone tax collection without serious harm to the public; the SEC, however, must investigate quickly and effectively before false or incomplete statements, or fraudulent conduct in general, infects the financial markets.[125] The court, however, did approve the application of *LaSalle* to SEC investigations to the extent that the SEC, like the IRS, must not issue a civil subpoena for the sole purpose of obtaining criminal evidence.[126]

Subpoenaed parties have also had some success in challenging enforcement based on *Powell's* prohibition of abuse of process. Such an abuse occurs when a court enforces a subpoena issued for an unauthorized purpose or pursuant to an investigation which the agency has conducted in bad faith.[127] Therefore, a subpoena issued pursuant to an investigation conducted for an authorized purpose may nevertheless be denied enforcement on abuse of process grounds if the subpoenaed party can successfully prove "bad faith" on the part of the SEC.

In *SEC v. ESM Government Securities, Inc.*,[128] the subpoenaed party challenged enforcement alleging that the SEC had engaged in fraud and deceit during its investigation. The party maintained that for a court to

123. *Id.* at 1370.

124. *Id.* at 1380.

125. *Id.* at 1379-80; *see infra* notes 194-96 and accompanying text.

126. 628 F.2d at 1387.

127. *Powell*'s "abuse of process" language reads:

> Nor does our reading of the statement mean that under no circumstances may the court inquire into the underlying reasons for the examination. It is the court's process which is invoked to enforce the administrative summons and a court may not permit its process to be abused. Such an abuse would take place if the summons had been issued for an improper purpose . . . or for any other purpose reflecting on the good faith of the particular investigation.

379 U.S at 58.

128. 645 F.2d 310 (5th Cir. 1981).

enforce a subpoena based on information obtained as a result of such conduct is an abuse of process. Like the *Powell* Court, the United States Court of Appeals for the Fifth Circuit invoked the equitable power it had over its own process to prevent abuse, oppression and injustice, and held that fraud, deceit or trickery is grounds for denying enforcement of an administrative subpoena.[129] In so doing, the court illustrated its authority to consider the staff's methods and its underlying motivation for conducting an investigation.

Other successful challenges to enforcement asserted by subpoenaed targets of investigation have been based upon the first,[130] fourth,[131] fifth,[132] and sixth[133] amendments. In general, however, courts have taken

129. *Id.* at 317.

130. *See, e.g.*, SEC v. McGoff, 647 F.2d 185 (D.C. Cir.), *cert. denied*, 452 U.S. 963 (1981), where McGoff, a newspaper publisher, challenged an SEC subpoena on grounds that the information sought could include documentation regarding editorial decisions on the sources for, or writing of, news stories. The District of Columbia Circuit modified the subpoena to permit the withholding or deletion of documents, or segregable portions of documents, relating solely to editorial policy or newsgathering. The decision represents an attempt by courts to weigh and accommodate competing, significant interests. *But see*, SEC v. Wall St. Transcript Corp., 422 F.2d 1371, 1380 (2d Cir. 1970) (the fact that a demand for disclosure may have some deterrent effect upon freedom of speech does not automatically invalidate it).

131. Since the SEC is not required to make a showing of probable cause when it issues a subpoena, an individual does not have that particular fourth amendment challenge available. Nevertheless, the fourth amendment's protection against unreasonable search and seizure does apply. Therefore, an SEC subpoena can be attacked for being overly broad, *see supra* notes 100-01 and accompanying text, or for not describing with reasonable certainty the category of documents sought. *See* Oklahoma Press Publishing Co. v. Walling, 327 U.S. at 208-09 (the fourth amendment, if applicable at all to a subpoena seeking production of corporate records, only requires that the subpoena's description of documents to be produced not be too indefinite). In these instances, however, a court is more likely to allow the staff to narrow its demand, or describe it with more certainty, than to bar enforcement completely.

Under certain circumstances, a corporation may have a fourth amendment privilege, but an officer, employee or third person may not plead it personally to suppress corporate books and records implicating them. Lagow v. United States, 159 F.2d 245, 246 (2d Cir. 1946), *cert. denied*, 311 U.S. 858 (1947).

132. The fifth amendment privilege against self-incrimination may be invoked by an individual to challenge subpoena enforcement, SEC v. Yanowitch, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,533 (D.C. Cir. 1974), but the privilege is not available to a corporation. Hale v. Henkel, 201 U.S. 43 (1906). Therefore, a subpoenaed party may not withhold corporate records on the ground that production would tend to incriminate him personally, United States v. White, 322 U.S. 694 (1944), nor on the ground that production would tend to incriminate the corporation, United States v. Fago, 319 F.2d 791 (2d Cir. 1963).

The privilege is personal, and therefore it applies solely to personal testimony or records in the subpoenaed party's possession. The latter, however, will be protected by the privilege only if they were prepared by the subpoenaed party. Fisher v. United States, 425 U.S. 391 (1975). If, for example, the SEC subpoenaed a broker's accounting records which, although

an extremely narrow view of the amendments' protections and have sided instead with the legitimate interests of society in enforcement of its laws. Common law privileges, such as attorney-client[134] and attorney work product,[135] also have been asserted successfully, but they too have been narrowly construed.

B. A Target's Ability to Challenge Enforcement of a Third Party Subpoena

The *Powell* and other challenges assume a more narrow meaning when the individual subpoenaed by the SEC is not the subject of the investigation. A witness called to testify or produce documents often has no interest in challenging the subpoena. The subject of the investigation, the individual most concerned with the information sought, has no standing to bring a challenge.[136] In order to protect its rights in such a situation, an investigative target must either attempt to restrain compliance, or persuade the subpoenaed party to challenge, and then attempt to intervene in the enforcement proceedings.

A target's ability to intervene in a third-party enforcement proceeding was recognized by the Supreme Court in *Reisman v. Caplin*,[137] a case arising within the context of an IRS investigation. In *Reisman*, two taxpayers brought an action to enjoin their accountants from complying with an IRS summons issued pursuant to an investigation into the taxpayers' tax liabil-

in his possession, were prepared by his accountant, those records will not be protected unless the broker is compelled to affirm the truth of their contents. 425 U.S. at 409.

133. Any person compelled to appear at an investigation has the right to be accompanied, represented and advised by counsel. 17 C.F.R. § 203.7 (1983); *see* SEC v. Higashi, 359 F.2d 550, 553 (9th Cir. 1966).

134. The attorney-client privilege, available as a ground for challenging SEC subpoena enforcement, is based on the premise that sound legal advice is in the public interest and such advice depends upon the attorney being fully informed by the client. Upjohn Co. v. United States, 449 U.S. 383, 389 (1981). By protecting their communications from discovery, the privilege serves to encourage full and frank communication between attorney and client. *Fisher*, 425 U.S. at 403. The privilege has traditionally been read as narrowly as possible, however, and therefore a strict standard of waiver applies; any loss of confidentiality through disclosure, even if inadvertent, destroys the privilege. Tasby v. United States, 504 F.2d 332, 336 (8th Cir. 1974), *cert. denied*, 419 U.S. 1125 (1975). The attorney-client privilege takes on additional meaning in the context of the securities laws, where complete disclosure of material information is required. *See generally* Hooker, *Lawyers' Responses to Audit Inquiries and the Attorney-Client Privilege*, 35 BUS. LAW. 1021 (1980).

135. The attorney work product privilege creates a zone of privacy in which an attorney can investigate, analyze and prepare a case. Work product includes, among other things, any materials which reflect an attorney's preparation of legal theories, strategy, or mental impressions. *See* Hickman v. Taylor, 329 U.S. 495 (1947).

136. Newfield v. Ryan, 91 F.2d 700 (5th Cir. 1937).

137. 375 U.S. 440 (1964).

ity.[138] The Supreme Court dismissed the action holding that the taxpayers had an adequate remedy at law in the form of a summons enforcement proceeding.[139] The Court clearly stated that a target could intervene in a third party summons enforcement proceeding to protect any personal interests at stake.[140]

This apparent absolute right to intervene was severely limited eight years later in *Donaldson v. United States*.[141] As part of its investigation of Donaldson's tax liability, the IRS issued subpoenas to third parties, including his employer. Donaldson secured an order temporarily restraining cooperation by the third parties, and the IRS brought an action to enforce compliance. Donaldson attempted to intervene in the enforcement proceeding as a matter of right to assert his personal objections to enforcement. Both the district court and the United States Court of Appeals for the Fifth Circuit denied intervention.[142] The Supreme Court affirmed.[143] The Court stated that an individual does not have an absolute right to intervene in a third-party enforcement proceeding merely on the basis of his status as the target of the investigation.[144] Instead, the right to intervene is *permissive*; it is conditioned upon the target's showing that a "significantly protectable interest" is at stake.[145]

According to the *Donaldson* Court, a significantly protectable interest is one which could be asserted by the target at a subsequent trial to suppress the information, regardless of how the IRS obtained it from the third party.[146] The Court cited as examples abuse of process and attorney-client privilege.[147] It stated that if a "significantly protectable interest" were involved, a subsequent trial may indeed be the proper place for it to be asserted and protected.[148] The judge must balance the opposing equities to determine whether to allow the challenge at the subpoena enforcement

138. *Id.* at 441.
139. *Id.* at 443.
140. *Id.* at 449.
141. 400 U.S. 517 (1971).
142. 418 F.2d 1213, 1218 (5th Cir. 1969).
143. 400 U.S. at 517.
144. *Id.* at 530.
145. *Id.* at 531.
146. The *Donaldson* court noted:

> The nature of the "interest" urged by the taxpayer is apparent from the fact that the material in question . . . would not be subject to suppression if the Government obtained it by other routine means . . . . This interest cannot be the kind contemplated by Rule 24(a)(2) . . . . What is obviously meant there is a significantly protectable interest.

400 U.S. at 531.
147. *Id.*
148. *Id.* at 531 (citing United States v. Blue, 384 U.S. 251 (1966)).

stage.[149]

The *Donaldson* formula has been the law with regard to intervention in third-party subpoena enforcement proceedings for over a decade. During that period, lower courts have had difficulty agreeing upon an interpretation of the decision. Despite *Donaldson*, some courts have equated the ability to intervene with due process rights,[150] traditionally inapplicable in nonadversarial settings.[151] Other courts have avoided the issue by holding that the interest asserted was not significantly protectable.[152] Still others have read *Donaldson* as vitiating the right to even permissive intervention, on the ground that an investigation should never be hampered by an individual capable of protecting his interests if and when the case reaches the trial stage.[153]

The dispute over the *Donaldson* intervention rule, though limited for the most part to IRS investigations, now has spread to the SEC enforcement process. To appreciate the issues currently plaguing the SEC, the varying interpretations of *Donaldson* must be analyzed, with emphasis on their respective implications for the closely related problem of notice to targets of SEC investigations.[154]

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149. 400 U.S. at 530.

150. *See* Callahan v. First Pa. Bank, 422 F. Supp. 1098 (E.D. Pa. 1976) (a taxpayer must be afforded a hearing to determine whether intervention will be allowed); United States v. First Nat'l Bank, 399 F. Supp. 379 (D. Md. 1975) (taxpayer has a due process right to a hearing whenever the government seeks his records in connection with an investigation).

151. *See* Hannah v. Larche, 363 U.S. 420, 442 (1960) (nonadjudicatory fact-finding investigations do not trigger the full panopoly of due process protections).

152. *See, e.g.*, United States v. Miller, 425 U.S. 435 (1976) (taxpayer had no protectable fourth amendment interest in bank records since they are the bank's business records); United States v. Luther, 481 F.2d 429 (9th Cir. 1973) (target had no fifth amendment interest in records which did not belong to him); United States v. Price Waterhouse & Co., 76-1 U.S. Tax Cases (CCH) ¶ 9295 (W.D. Pa. 1975) (target had no protectable interest in audit-related records, since it had already voluntarily turned over some of those documents).

153. *See* United States v. Nemetz, 450 F.2d 924, 926 (3d Cir. 1971) (an order of the district court granting a taxpayer the right to intervene, though within court's discretion, was nevertheless improper); United States v. Newman, 441 F.2d 165, 172-73 (5th Cir. 1971) (permissive intervention was not available to a taxpayer whose only interest in the records was that they related to his tax liability).

154. The notice implications were given significant consideration in cases arising in the context of IRS investigations before 1976. The courts, however, tended to separate the issues of notice and intervention. At least three circuits held outright that an investigated taxpayer had no right to notice of third-party subpoenas, regardless of that individual's ability to intervene. *See* United States v. Schutterle, 586 F.2d 1201 (8th Cir. 1978); Scarafiotti v. Shea, 456 F.2d 1052 (10th Cir. 1972); Application of Cole, 342 F.2d 5 (2d Cir. 1965). Another circuit recognized the same principle in dicta. *See* United States v. Continental Bank & Trust Co., 503 F.2d 45 (10th Cir. 1974).

In response to these developments, Congress added § 7609 to the Internal Revenue Code as part of the Tax Reform Act of 1976. 26 U.S.C. § 7609 (1982). This section affords each

III. *O'BRIEN, PEPSICO* AND *WEDBUSH*: CHOOSING FROM THE *DONALDSON* ALTERNATIVES

A. Intervention and Notice

Despite the confusion over *Donaldson*, the Supreme Court did make one point clear: the target of an investigation does not have an absolute right to intervene in a third-party subpoena enforcement proceeding.[155] Rather, the ability to intervene is conditioned upon the target convincing the court that a significantly protectable interest is at stake. This is no simple task. The *Donaldson* Court provided only two examples of significantly protect-

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taxpayer a statutory right to notice whenever the IRS issues a summons to a "third-party recordkeeper" in connection with an investigation into that taxpayer's tax liability. Congress felt the new measures were necessary to prevent the unreasonable infringement by the IRS on taxpayers' civil rights, especially the right to privacy. S. REP. No. 938, 94th Cong., 2d Sess. 368, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3797.

When the IRS issues a summons to a third-party recordkeeper pursuant to an investigation into a particular taxpayer's tax liability, the taxpayer must receive notice of the summons from the IRS by registered mail within three days of service, but no later than 23 days before the day scheduled for the examination of the records. 26 U.S.C. § 7609(a)(1)(A)(B) (1982). The taxpayer then has the right to intervene in any proceeding brought to enforce the summons. 26 U.S.C. § 7609(b)(1) (1982).

Originally, the taxpayer was also afforded the right to stay compliance simply by requesting, within 14 days of receiving notice, that the recordkeeper not comply. This provision was amended in 1982, however, and now, in order to prevent compliance, the taxpayer must bring a civil action to quash the summons within 20 days of receiving notice. *Id.* § 7609(b)(2). The purpose of the change was to make it more difficult to stay compliance. S. REP. No. 530, 97th Cong., 2d Sess. 282, *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 1028. Under the former provision, the IRS had experienced significant delays in investigation in a vast number of cases, with no discernable advantages to the taxpayers. The former provision was so easy to use that taxpayers invoked it even though they had no intention of intervening. *Id.*

Congress' intent in enacting this legislation was not to expand the substantive rights of taxpayers. Rather, its purpose was to "facilitate the opportunity of the noticees to raise defenses which are already available under the law . . . ." S. REP. No. 938, 94th Cong., 2d Sess. 370-71, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3800. Nevertheless, § 7609 provides that the target can assert any challenges available to him under the law, as well as certain defenses which previously could be asserted only by the subpoenaed party. 26 U.S.C. § 7609 (1982). These include claims that the subpoena is vague or ambiguous, or that it is not relevant to a lawful investigation. *Id.* In order to discourage the use of the intervention provisions as a vehicle for delaying an IRS investigation, a section was added providing that the running of any statute of limitations on the assessment or collection of taxes, or on any related criminal prosecution, is suspended for as long as any enforcement proceeding or appeal is pending. *Id.* § 7609(e).

The list of recordkeepers found in the Act is by no means exhaustive of the possible recipients of third-party summonses. Presumably, whether a taxpayer receives notice of other third-party summonses depends on whether those third parties inform him voluntarily. Furthermore, assuming notice, the taxpayer's ability to intervene will be governed by *Donaldson* and its progeny.

155. 400 U.S. at 530; *see supra* notes 144-45 and accompanying text.

able interests, and its definition of "protectable" prevents most personal interests from attaining that status.[156]

Even if a target can overcome this first hurdle, he is not guaranteed the right to intervene. The ultimate determination is entrusted to the court's discretion. In essence, the court will balance the target's significantly protectable interest against the need, recognized by Congress, for prompt, efficient investigation of the securities laws. This "balancing of equities" was the first alternative suggested by the *Donaldson* Court.[157]

The second alternative suggested by the *Donaldson* Court requires postponing a judicial determination of the status of the target's asserted interest until the investigation is complete and enforcement proceedings are brought against the target. This alternative is based upon the premise that a significantly protectable interest, by definition, can be protected adequately at any time. Therefore, since the target's significantly protectable interest cannot be compromised, the public interest in prompt and efficient investigation mandates that the interest be protected later, if and when the matter goes to trial.

Within the context of an SEC investigation, if a court adopts the first *Donaldson* alternative without addressing the issue of notice, it has done nothing to enhance the target's rights. Many of the sources of information in an SEC investigation are individuals who have little or no interest in an investigative target's protectable interests. Often, they are vengeful former or disgruntled employees. A witness may also be a broker who has knowledge of a target's fraudulent acts which have ultimately worked to the disadvantage of his other customers. These individuals are unlikely to extend courtesy notice of their appearances to the subject of the investigation. Still another source of information may provide statistical or other general trading information to the SEC, and therefore have no particular interest in the investigation or the target. Thus, absent a requirement of formal notice, the right to permissive intervention is highly illusory.

As a practical matter, if a court is to determine the status of a target's interest in the enforcement of a subpoena, and ultimately balance that interest against the need for effective investigation, every target must be notified of third-party subpoenas. Even targets with no protectable interest at stake must be notified, so that they can have a judicial determination that their interest is, in fact, not significantly protectable. In short, granting the few individuals who possess a significantly protectable interest the right to

156. *See supra* notes 141-54 and accompanying text.

157. *See supra* notes 141-49 and accompanying text.

permissive intervention necessarily extends to all targets the right to a judicial determination of the status of their respective rights.

The second *Donaldson* alternative disposes with the notice problem because intervention is not available at the subpoena enforcement stage. Since the target can protect any significantly protectable interest at any subsequent trial, there is no justification for monitoring the investigation, or intervening in third-party subpoena enforcement proceedings. Therefore, the target has no legitimate need for notice of third-party subpoenas.

B. Conflicting Positions

The courts which have addressed the notice issue in the SEC context have adopted the conflicting positions described above. In *Jerry T. O'Brien, Inc. v. SEC*,[158] the United States Court of Appeals for the Ninth Circuit held that a target must be afforded notice of third-party subpoenas to ensure the SEC's compliance with *Powell's* requirements.[159] The case arose out of a formal investigation into possible violations of the 1934 Act, including insider trading, filing of false or misleading annual reports and proxy statements, and participating in fraudulent sales of stock.[160] Subpoenas were served upon Jerry T. O'Brien, Inc., and a number of third parties. The targets of the investigation brought an action in the Federal District Court for the Eastern District of Washington to enjoin the inquiry, alleging that it was being conducted improperly. The SEC moved to dismiss the claim, and the court agreed on the basis that the targets had an adequate remedy at law in the form of the subpoena enforcement proceedings.[161]

On appeal, the Ninth Circuit affirmed in part, and reversed in part.[162] It affirmed that part of the decision concerning the targets' remedy in connection with the subpoenas issued to them, but reversed with regard to the subpoenas issued to third parties because, without notice of the subpoenas, they had no adequate remedy at law. The *O'Brien* court recognized that a target of an SEC investigation has a right to be investigated according to the standards of fairness laid down in *Powell*.[163] Furthermore, the *Powell* prohibition of abuse of process was an interest recognized by the *Donald-*

158. 704 F.2d 1065 (9th Cir.), *cert. granted*, 104 S. Ct. 697 (1984).

159. 704 F.2d at 1069.

160. *Id.* at 1066.

161. Jerry T. O'Brien Inc. v. SEC, [1983 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,442 (E.D. Wash. 1983).

162. 704 F.2d at 1066-69.

163. *Id.* at 1069.

son Court as being significantly protectable.[164] Therefore, the *O'Brien* court reasoned that every target has an inherent right to permissive intervention. It stated that, as a practical matter, the target must have formal notice of every third-party subpoena in order to effectively exercise that right.[165]

The SEC challenged *O'Brien* in *Wedbush, Noble, Cooke, Inc. v. SEC*,[166] another case arising within the Ninth Circuit. *Wedbush* evolved from an investigation by the SEC of Webush, Noble, Cooke, Inc., a registered securities brokerage firm with offices in many western cities. The SEC was investigating possible violations of antifraud and antimanipulation provisions of the 1934 Act by Wedbush and its customers. It subpoenaed a number of third-party witnesses without notifying the targets and, as a result, Wedbush brought an action to enjoin the investigation. The Federal District Court for the Central District of California granted the preliminary injunction based on *O'Brien*'s establishment of a due process right to notice of third-party subpoenas for targets of SEC investigations.[167] Furthermore, the balance of hardships did not favor the SEC; the public interest favored the injunction. Additionally, in light of the recent *O'Brien* decision, the SEC was unlikely to prevail on the merits.[168]

On appeal, the SEC argued that its petition for rehearing in the *O'Brien* case had stayed *O'Brien's* mandate, and therefore it was not good authority in the *Wedbush* matter. The Ninth Circuit rejected this assertion, stating that although the *O'Brien* mandate had not yet issued, it was still final for stare decisis purposes.[169] The court agreed with the district court that the SEC did not have a strong likelihood of success on the merits.[170]

In *PepsiCo, Inc. v. SEC*,[171] the District Court for the Southern District of New York completely rejected the *O'Brien* court's reasoning, and held that the SEC was not required to notify targets of investigations when it issued subpoenas to third parties. The case followed an investigation into alleged accounting fraud in PepsiCo's international division, which was

164. 400 U.S. 517, 531 (1971).

165. 704 F.2d at 1069.

166. No. CV-83-3961 (July 11, 1983), *appeal pending*, No. 83-6035 (C.D. Cal.), *stay denied*, 714 F.2d 923 (9th Cir. 1983).

167. 714 F.2d at 924.

168. *Id.*

169. *Id.* at 924-25.

170. On Oct. 28, 1983, the Ninth Circuit denied the SEC's petition for a rehearing en banc of the *O'Brien* decision. On January 9, 1984, the Supreme Court granted the SEC's petition for certiorari.

171. 563 F. Supp. 828 (S.D.N.Y. 1983).

brought to the SEC's attention by PepsiCo.[172] During the investigation, PepsiCo filed a complaint seeking an injunction that would have required the SEC to give PepsiCo notice of all third-party subpoenas issued in connection with the inquiry. PepsiCo also requested a temporary restraining order barring third-party subpoenas issued without notice, until the court could evaluate the merits of the injunctive action.[173]

In denying the temporary restraining order, the court stated that a notice requirement would be abused by investigative targets, and would undermine the nation's public policies.[174] It held that the balance of hardships tilted so favorably in favor of the SEC that the litigability of the issue may be irrelevant.[175] The court also noted PepsiCo's ability to vindicate its rights later if indeed they were violated.[176] With regard to *O'Brien*, the *PepsiCo* court criticized the Ninth Circuit as being unconcerned with the implications of its decisions.[177]

The *O'Brien* court embraced the first *Donaldson* alternative and carried it out to its logical conclusion. The court recognized that every target of an SEC investigation has a right to be investigated according to the *Powell* standards, and also that third parties lack standing to assert the *Powell* interests. Furthermore, the *O'Brien* court acknowledged the status of the *Powell* rights as "significantly protectable."[178] Therefore, every target has a right to permissive intervention: an opportunity to have the court weigh the target's *Powell* rights against the public interest in prompt, efficient investigation into possible violations of the securities laws. The court ultimately recognized that, given the nature of SEC investigations, absent a requirement of formal notice, the target's right to permissive intervention would be unassertable.[179]

The *O'Brien* court analyzed the notice issue in terms of its interpretation of *Donaldson*. Requiring the SEC to notify investigative targets every time it issues a subpoena to a third party was a means to assure the target's right to permissive intervention. The district court in *Wedbush*, however, took the *O'Brien* decision beyond its "practicality" reasoning. Citing *O'Brien*, it held that targets have a due process right to notice of third-party subpoenas.[180] *O'Brien*, however, contains no reference to due process. Indeed,

172. *Id.* at 829.
173. *Id.* at 830.
174. *Id.* at 832.
175. *Id.* at 831-32.
176. *Id.* at 831.
177. *Id.*
178. *O'Brien*, 704 F.2d at 1068.
179. *Id.* at 1069.
180. *Wedbush*, 714 F.2d at 924 (preliminary discussion of decision below).

the Supreme Court has stated on a number of occasions that the full panoply of due process rights has no place in administrative investigations.[181]

Nevertheless, it is clear that *O'Brien* and *Wedbush* share an overriding concern for individual rights. Both decisions allow the target of an SEC investigation to ensure compliance with the *Powell* requirements and to protect any relevant constitutional or common law privileges in a timely fashion. Furthermore, the decisions assure that a target will be informed of the nature and scope of the potential charges at an early stage.[182] These are the ultimate benefits of the first *Donaldson* alternative, and the mandatory notice requirement that necessarily accompanies it.

The major flaw in the Ninth Circuit's reasoning is that it fails to consider the drawbacks which accompany a notice requirement in the SEC context.[183] *O'Brien* and *Wedbush* are pervaded by the notion that, regardless of how substantial those drawbacks might be, they are nevertheless subordinate to the target's individual rights. An additional flaw is the court's failure to recognize the overwhelming precedent established by other circuits with regard to notice of IRS summonses.[184]

The *PepsiCo* court, in concluding that notice should not be required, relied heavily on both the drawbacks associated with notice, and on the wealth of precedent contrary to PepsiCo's position and the *O'Brien* decision.[185] According to the court, the problems which accompany a notice requirement fall into two categories: the probability of procedural maneuvering and other tactics which targets can employ in order to frustrate and stall an investigation, and the many uncertainties which would be generated, including the problem of identifying exactly the targets of a particular investigation.[186]

The *PepsiCo* court's conclusion that notice should not be required follows logically from the second *Donaldson* intervention alternative. The court, however, did not address notice in terms of *Donaldson*. Rather, it attempted to divorce the intervention issue from the notice issue, apparently reading *Donaldson* as contrary to its ultimate holding.[187] Nevertheless, the court unwittingly applied the analysis suggested by the second *Donaldson* alternative when it discussed whether irreparable harm to

181. *See, e.g.*, Hannah v. Larche, 363 U.S. 420, 442 (1960).

182. *See supra* note 72 and accompanying text.

183. The *O'Brien* court stated that notice should be dispensed with only where there are "special circumstances involving a serious threat to the integrity of the investigation." 704 F.2d at 1069.

184. *See supra* note 154 and accompanying text.

185. 563 F. Supp. at 831-32.

186. *Id.* at 832.

187. *Id.* at 831.

PepsiCo would result in the absence of notice. The *PepsiCo* court reasoned that if an attorney-client or work product privilege were violated by enforcement of the subpoena, PepsiCo could vindicate its rights later in the enforcement process.[188] This is essentially the logic of the second *Donaldson* alternative.

C. Policy Considerations

The negative ramifications which stem from a mandatory notice requirement, along with the ability of a target to protect any legitimate significantly protectable interest at a subsequent trial, command that intervention be disallowed at the subpoena enforcement stage, and that notice be forsaken in favor of prompt, efficient investigation. As the *PepsiCo* court noted, a mandatory notice requirement would inject substantial uncertainties into the federal law enforcement process,[189] many of which could not be resolved without extensive litigation. For instance, at what point does an individual attain "target" status? Since much of the SEC's focus at the initial stages of an investigation is on a particular transaction, and not on an individual, potential targets include anyone associated with, or with an interest in, that transaction.[190] The task of notifying all potential targets of third-party subpoenas, and then litigating their various interests in a subpoena enforcement proceeding, would be a monumental one to say the least. Additionally, a problem would arise if another target were identified in the middle or toward the conclusion of an investigation. Will retroactive notice be sufficient to preserve that target's rights under *Powell*? If not, can the new target move to exclude any evidence against him which was obtained prior to his becoming a target?

The *PepsiCo* court also recognized the probability of abuse inherent in a mandatory notice requirement.[191] Notifying targets of third-party subpoenas will expose SEC investigations to procedural maneuvering and other tactics designed to obstruct justice, including destruction or alteration of records, avoidance of service, transfer or dissipation of assets, and intimidation of witnesses.[192] These and other similar activities are likely to occur within the context of any law enforcement investigation where the

188. *Id.*

189. Opposition of the Securities and Exchange Commission at 32-33, PepsiCo, Inc. v. SEC, 563 F. Supp. 828 (S.D.N.Y. 1983).

190. *Id.* at 32.

191. 563 F. Supp. at 832.

192. *See* NLRB v. Robbins Tire & Rubber Co., 437 U.S. 214, 239-42 (1978) (witness statements in pending unfair labor practice proceedings are exempt from FOIA disclosure in order to avoid interference with enforcement proceedings in the form of coercion or intimidation of witnesses); United States v. Eisenberg, 711 F.2d 959, 961 (11th Cir. 1983) (secrecy

subjects of investigation are continually apprised of the government's next move. The possibility of SEC investigations being thwarted or delayed is an even more compelling problem in light of budget and enforcement staff cuts at the SEC.[193]

The prospect of delay is especially inimical to SEC as opposed to other agency investigations.[194] All of the securities laws under the SEC's jurisdiction have as their goals investor protection and preservation of market integrity.[195] Many violations of these laws result in an immediate undermining of the SEC's goals. For example, a materially misleading statement in a prospectus has the potential to trigger significant investments of capital in the issuing company's stock. When an individual trades on inside information, he reaps a benefit not at the expense of the government, but at the expense of other investors. When an individual manipulates the price of a stock upward and then sells, he is doing so to the detriment of his buyer. The implications of these fraudulent acts have an immediate effect on the investors involved. The adverse consequences are not felt over time; rather, the defrauded investors are immediately left with a significant loss of capital and devalued stock.

The benefits of prompt, efficient investigation by the SEC into such violations are two-fold. First, the staff can prevent the damage which would otherwise result from securities fraud. Second, timely and effective enforcement will discourage similar activities in the future. Ultimately, both sophisticated and unsophisticated investors are protected from the fraudulent schemes of companies and other investors. Individuals who would otherwise refrain from investing in securities may be more willing to speculate, and the economy as a whole will benefit from enhanced efficiency of capital formation.[196]

There are two disadvantages in dispensing with the mandatory notice requirement. The first is borne exclusively by the target: the inability to monitor and impede an investigation into his own wrongdoing. Second,

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requirement associated with grand jury proceedings encourages reluctant witnesses to testify without fear of reprisals from those against whom testimony is given).

193. J. Shad, Address before the Securities Regulation Institute (Jan. 21, 1983), *reprinted in* THE SEC SPEAKS IN 1983 21, 24 (1983).

194. *See* SEC v. Dresser Indus., Inc., 628 F.2d 1368 (D.C. Cir.), *cert. denied*, 449 U.S. 993 (1980) (Supreme Court's dictum in United States v. LaSalle Nat'l Bank, 437 U.S. 298 (1978), that an IRS civil investigation must cease when the case is referred to the Justice Department for a parallel criminal investigation, does not apply to SEC investigations, partly because of the immediacy inherent in an investigation into possible violations of the securities laws).

195. *See supra* notes 19-59 and accompanying text.

196. R. KARMEL, REGULATION BY PROSECUTION 295-300 (1982).

targets of investigation will be unable to assure SEC compliance with their *Powell* rights, or safeguard other assertable interests through the vehicle of the subpoena enforcement proceeding. This is not to say, however, that they will never be able to protect their interests. Under the second *Donaldson* alternative, those interests can and should be protected at a subsequent trial,[197] thereby preserving the integrity of the investigation. Presumably, there would be some sort of exclusionary mechanism applied to evidence obtained by the SEC through some forbidden practice, or through an abuse of the court's process.[198]

The application of an exclusionary rule to evidence obtained through staff abuse of the second *Donaldson* alternative would inevitably be accompanied by the problems traditionally associated with exclusionary rules.[199] For example, if the staff obtains information subject to the target's attorney-client privilege, it is clear that such evidence could be excluded at the target's trial. But what of evidence obtained as a result of information subject to the attorney-client privilege, but which does not enjoy the privilege itself? Would it also be excludable?

Given the presumption of regularity that attaches to administrative action,[200] in addition to the investigatory freedom which the SEC staff would enjoy under the second *Donaldson* alternative, any exclusionary principle would have to be applied strictly by courts. Such an application would be necessary in order to achieve some degree of fairness to investigative targets. Furthermore, a strictly applied exclusionary rule would motivate the staff to stay within the bounds of its already broad investigatory powers.

The possibility of harm traceable to investigations with no legitimate purpose and which are never brought to trial, thereby denying the target of a remedy, is remote. In most instances, the purpose would be harassment

197. *Donaldson*, 400 U.S. at 531.

198. *See supra* notes 127-29 and accompanying text.

199. The exclusionary rule has been justified by the Supreme Court on two grounds. The first is the need to deter law enforcement officers from using illegal and unconstitutional procedures in the search for evidence. United States v. Calandra, 414 U.S. 338, 347-48 (1975); Elkins v. United States, 364 U.S. 206, 217 (1960). The second reason for invoking the exclusionary rule is to maintain the integrity of the judicial process. Olmstead v. United States, 277 U.S. 438, 483-85 (1928) (Brandeis, J., dissenting); Weeks v. United States, 232 U.S. 383, 392-93 (1914). Both goals would be furthered in the SEC enforcement setting if the rule were applied strictly. *See generally* Comment, *The Due Process Exclusionary Rule: A Fifth Amendment Due Process Approach to the Regulation of Government Misconduct*, 17 U.S.F.L. REV. 277 (1983).

200. *See* Hannah v. Larche, 363 U.S. at 442-44.

or duress[201] and, therefore, the target would have full knowledge of the investigation, and could bring suit to enjoin it.

Public interest in prompt, efficient investigation into possible violations of the securities laws is overwhelming. Nevertheless, respect for the rights of individuals has been, and continues to be, the bulwark of American society. When there is a conflict between public and individual interests, it should be resolved through a balancing and compromise which will result in the fewest restrictions on the operation of each interest.[202]

If the Ninth Circuit's notice requirement were to become the law in all circuits, the individual rights of targets would be safeguarded at an early stage, and the enforcement staff would be prevented from abusing its investigative authority. On the other hand, targets would be given the ability to impede and deter investigations into their own wrongdoing, greatly reducing the power of the SEC to enforce the securities laws. In turn, investors would be much more vulnerable to fraud, and the integrity of the financial markets would be reduced. Such an undermining could ultimately affect the ability of publicly held corporations to raise funds through stock offerings. That, in turn, would have far reaching ramifications for the nation's economy.

Alternatively, rejection of the notice requirement would preserve the integrity of the financial markets by protecting investors through powerful enforcement authority. Furthermore, the identity of third-party witnesses could be kept confidential, and courts would not need to grapple with the problem of defining a "target" in SEC investigations. On the other hand, investigative targets would be unable to challenge a subpoena until trial. This could lead to staff abuse of investigative authority, resulting in a great disadvantage to the target. With the strict application of an exclusionary rule, however, such abuse could be minimized.

Given the equities and interests involved, requiring the SEC to give real and potential targets notice of third-party subpoenas will not achieve the least restrictive end.[203] Rather, this end will be achieved by dispensing with a notice requirement, and allowing targets to assert their significantly protectable interests only after the investigation has been concluded. A strict exclusionary rule may then be applied to evidence obtained through a violation of those interests.

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201. *See, e.g.*, Ayers v. SEC, 482 F. Supp. 747 (D.D.C. Mont. 1980); *see also supra* notes 113-14 and accompanying text.

202. *See, e.g., Donaldson*, 400 U.S. at 517; *PepsiCo*, 563 F. Supp. at 828.

203. *O'Brien* has had a devastating effect on the SEC's west coast investigations. According to the Wall Street Journal, the SEC has chosen to freeze its West Coast investigations, rather than afford notice to targets. Wall St. J., Sept. 22, 1983, at 33, col. 4.

IV. CONCLUSION

Donaldson provides two possible approaches in deciding the issue of whether to allow a target of investigation to intervene in a third-party subpoena enforcement proceeding. First, the court can evaluate the target's asserted interest in order to determine whether it is significantly protectable. If it is, the court can then balance that interest with the SEC's need for prompt investigation, finally deciding whether intervention should be allowed. As the *O'Brien* court held, for this approach to have any meaning, the target must have notice of third-party subpoenas. The second *Donaldson* approach disallows intervention at the early stages of investigation since the target's interests can be adequately protected at a subsequent trial, if and when it occurs. Since there is no right to even permissive intervention, there is no need for targets to be notified of third-party subpoenas.

The devastating effects which mandatory notice would have on SEC investigations require adoption of the second *Donaldson* alternative. The SEC is charged with the responsibility of protecting investors and preserving the integrity of the financial markets. These interests are severely and irretrievably undermined by unchecked fraud in the trading of securities. Therefore, it is imperative that the SEC be able to investigate promptly and efficiently, unburdened by procedural challenges and other less wholesome tactics which a notice requirement would encourage. The result will be effective enforcement of the securities laws, and preservation of the legitimate rights of investigated parties.

Brian T. Corbett