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Are Targets of SEC Investigations Entitled to Notice of Subpoenas Issued to Third Parties?

by Carole B. Silver

Securities and Exchange Commission

v.

Jerry T. O'Brien, Inc.

(Docket No. 83-751)

Argued April 17, 1984

ISSUE

The Securities and Exchange Commission (SEC) has the duty of investigating possible violations of the federal securities laws and has the power to issue subpoenas to solicit evidence for use in its investigations. The Commission usually conducts its investigations without directly informing the suspect, or target, of the inquiry and without informing the target of any subpoenas issued to third parties during the investigation. In some instances, the SEC begins an investigation by focusing on suspicious activities rather than individuals, and can identify the suspect only after the investigation has revealed the surrounding facts and circumstances.

The target of an investigation has an interest, of course, in discovering not only that the investigation exists, but also the identities of those from whom the SEC attempts to solicit evidence. If the target knows of the persons to whom the SEC has issued subpoenas, then the target can attempt to discover what information will be disclosed to the SEC. The target might also be able to convince the subject of the subpoena to refuse to cooperate with the Commission. Since an SEC subpoena is not self-executing, if the subject of the subpoena refuses to cooperate, the SEC would have to bring an action in federal district court to seek enforcement. Thus, if the target successfully dissuades the subject of the subpoena from cooperating with the Commission, the SEC would have to take formal action to obtain the subpoenaed evidence.

In contrast to the interests of the target of an SEC investigation, the SEC is concerned with conducting efficient inquiries. SEC investigations are fact-finding ventures, intended to give rise to sufficient evidence to permit the Commission to determine whether a civil or criminal action for violation of the securities laws should be initiated. The Commission, therefore, has an interest

in avoiding lengthy delays and controversy at the investigatory stage of the proceedings. Requiring that notice be given to the target of an investigation each time the SEC issues a subpoena to a third party obviously would impose an administrative burden on the Commission and foster controversy and litigation among the Commission, the target and the subject of the subpoena.

In *O'Brien*, the Court is called upon to strike a balance between the interests of the target of an SEC investigation and those of the SEC by deciding whether the SEC must give notice to targets of its investigations of the subpoenas it issues to third parties.

FACTS

In September of 1980, the SEC initiated its investigation of possible violations of various provisions of the federal securities laws by H. F. Magnuson & Co., an accounting firm; Harry F. Magnuson, the owner of H. F. Magnuson & Co.; Pennaluna & Co., Inc., a private investment company; Benjamin A. Harrison, the owner of Pennaluna and other persons who were unnamed. All of the subjects of the investigation were located in or around the areas of Spokane, Washington and Wallace, Idaho. In furtherance of its investigation, the Commission issued a subpoena soliciting evidence from Pennaluna and Jerry T. O'Brien, Inc., a securities broker-dealer firm of which Magnuson was a customer. Jerry T. O'Brien was the principal stockholder of Jerry T. O'Brien, Inc. and Harrison was an employee of the firm. H. F. Magnuson & Co. served as the accountant for Pennaluna and Jerry T. O'Brien, Inc.

O'Brien complied with the SEC's subpoena. Pennaluna refused to cooperate and instead forced the SEC to seek judicial enforcement of the subpoena. At the same time these subpoenas were issued, O'Brien's lawyer learned that O'Brien was among the "other unnamed persons" who were targets of the investigation.

Shortly after O'Brien learned that he and his company were targets of the SEC's investigation, he and Harrison and their two corporations brought suit in the United States District Court for the Eastern District of Washington to enjoin the SEC's investigation and to restrain Magnuson from complying with several outstanding subpoenas. The action alleged that the investigation was being conducted improperly and was beyond the scope of the investigators' authority. Magnuson filed a crossclaim in which he too sought to enjoin the investigation. The district court dismissed the claims

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for injunctive relief. It reasoned that an injunction was unnecessary because O'Brien, Harrison and Magnuson could raise the issues regarding the propriety of the SEC's investigation if and when the SEC sought to enforce the subpoenas by an action before the district court.

On appeal, the Ninth Circuit Court of Appeals affirmed the dismissal of all of the claims but one. The court of appeals held that the target of an SEC investigation was indeed entitled to notice of subpoenas issued by the SEC to third parties, unless such notice would present a "serious threat to the integrity of the investigation." The court's decision was based on its finding that the target of an SEC investigation is entitled to have the investigation conducted in accordance with the standards established in *United States v. Powell*, (379 U.S. 48 (1964))

In *Powell*, the Supreme Court held that the SEC does not have the right to enforce its subpoenas unless it shows that: 1) it has a legitimate purpose for the investigation, 2) the inquiry is relevant to that purpose, 3) it does not already possess the information that it is trying to solicit, and 4) it has adhered to the administrative steps required by law. The Ninth Circuit decided that where subpoenas are issued to a third party, no one except the target would challenge the SEC to ensure compliance with *Powell*. The court was concerned that the subject of the subpoena would most likely lack sufficient interest or motivation to challenge enforcement. Notice to the target of third party subpoenas, therefore, would be necessary to guarantee the target's right to compliance with *Powell*. If notice were provided, the target could petition the district court to intervene in the investigation and restrain compliance by the third party with the subpoena. Without notice the target would be unable to protect itself and the third party would lack sufficient motivation to challenge the SEC.

BACKGROUND AND SIGNIFICANCE

O'Brien is important because of its potential impact on the nature of SEC investigations as well as the possibility that its holding could be applied to dozens of other federal agencies. Many federal agencies besides the SEC have the same authority to issue subpoenas in connection with agency investigations, and the subpoenas are routinely issued without notice to the target of the investigation. Similarly, most state securities administrators are empowered to conduct investigations and issue subpoenas without notifying the target of the investigation. Therefore, whatever the decision rendered by the Court in *O'Brien*, it is likely to have an impact far beyond the halls of the SEC. Furthermore, a decision for O'Brien and the other targets of the investigation could significantly change the nature of SEC investigations. Historically, such investigations have been relatively unimpeded by litigation or other significant delays introduced by anyone outside of the Commission. The SEC has

considered its investigations preliminary fact-finding proceedings rather than prosecutions which would give rise to the attendant rights of discovery and confrontation. If the Supreme Court affirms the decision of the Ninth Circuit, SEC investigations could become characterized by frequent litigation challenging the agency's attempts to solicit evidence and otherwise conduct its inquiry. Commission investigations, thus, would become more adversary in nature than they have been to date.

To affirm the Ninth Circuit's decision, the Court would have to hold that the target of an SEC investigation is entitled to require the SEC to comply with the *Powell* standards for each subpoena it issues in the course of its investigation. Such a holding would be an expansion of *Powell*, where the Court held only that the SEC was required to comply with *Powell* before a district court would enforce a subpoena issued to the target of the investigation. An affirmation of the Ninth Circuit's holding in *O'Brien* would expand *Powell* in two ways. First, *Powell* involved a subpoena directed to the target of the investigation. *O'Brien* applies the *Powell* standards to subpoenas issued to third parties. Second, *Powell* involved an action by the SEC to enforce the subpoena. In contrast, the Ninth Circuit's decision permits the target to seek to intervene in the proceedings before an enforcement action is initiated, thus allowing an attempt to restrain even voluntary compliance with the subpoena.

While affirmance of the Ninth Circuit's decision would extend the holding of *Powell*, it might be justified as a recognition of the existence of the practical consequences of an SEC investigation. An investigation, alone, has no legal consequence for the target; the SEC must proceed with a civil action or refer the matter to the Justice Department for criminal prosecution in order for liability to attach to the target of the investigation. But the investigation may have a significant impact on the target regardless of ultimate liability. Even an investigation which yields no evidence of wrongdoing may affect the market value of the target's securities as well as its reputation. Thus, the target may need some way to protect itself during an SEC investigation, and the right to notice of third-party subpoenas is one form of such protection. It would provide the target with knowledge of the existence of the investigation as well as a good indication of the direction of the SEC's inquiry. Notice would permit the target to seek to intervene in enforcing a subpoena, or prior to enforcement, to protect its rights under *Powell* and to protect itself from unwarranted publicity regarding the investigation.

ARGUMENTS

For the SEC

1. Neither the Constitution, the Securities Act of 1933 nor the Securities Exchange Act of 1934 require the SEC to provide targets of its investigations with notice of subpoenas issued to other persons.
2. *United States v. Powell* does not confer a procedural right to notice upon targets of agency investigations.

3. The Ninth Circuit decision will create serious law enforcement problems. Notice of third-party subpoenas will permit the target of an investigation the opportunity to destroy evidence and persuade the subject of a subpoena to refuse to cooperate with the SEC. Moreover, the target of an investigation cannot always be identified at the beginning of the inquiry, so it would be impossible in some instances for the SEC to give notice.

For Jerry T. O'Brien, Inc., Jerry T. O'Brien, Pennaluna & Co., Inc., Benjamin A. Harrison, H. F. Magnuson & Co. and Harry F. Magnuson

1. The Ninth Circuit decision is consistent with *United States v. Powell*, the Securities Act and the Securities Exchange Act. The statutory scheme requires the

SEC to seek judicial enforcement of its subpoenas, and *United States v. Powell* held that enforcement was conditioned upon the SEC's showing its satisfaction of the *Powell* standards.

2. Notice is required to ensure that the SEC complies with *United States v. Powell* in issuing subpoenas during its investigations.

AMICUS BRIEFS

In Support of the SEC

The North American Securities Administration Association, Inc.

In Support of Jerry T. O'Brien, et al.

Wedbush, Noble, Cooke, Inc., a broker-dealer firm that is currently the subject of an SEC investigation.

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