UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, – against – BEAR, STEARNS & CO. INC., Defendant.	Civil Action No. 03 Civ. 2937 (WHP) **PLAINTIFF SECURITIES AND EXCHANGE COMMISSION'S MEMORANDUM IN RESPONSE TO JUNE 2, 2003 ORDER**
SECURITIES AND EXCHANGE COMMISSION, Plaintiff, – against – JACK BENJAMIN GRUBMAN, Defendant.	Civil Action No. 03 Civ. 2938 (WHP)
SECURITIES AND EXCHANGE COMMISSION, Plaintiff, – against – J.P. MORGAN SECURITIES INC., Defendant.	Civil Action No. 03 Civ. 2939 (WHP)

- x

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

– against –

LEHMAN BROTHERS, INC.,

Defendant.

Civil Action No.

03 Civ. 2940 (WHP)

- x

- x

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

– against –

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED,

Defendant.

Civil Action No.

03 Civ. 2941 (WHP)

- x

- x

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

– against –

U.S. BANCORP PIPER JAFFRAY, INC.,

Defendant.

Civil Action No.

03 Civ. 2942 (WHP)

- x

- x

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

– against –

UBS WARBURG LLC,

Defendant.

Civil Action No.

03 Civ. 2943 (WHP)

- x

- x

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

– against –

GOLDMAN, SACHS & CO.,

Defendant.

Civil Action No.

03 Civ. 2944 (WHP)

- x

- x

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

– against –

CITIGROUP GLOBAL MARKETS, INC., F/K/A SALOMON SMITH BARNEY INC.,

Defendant.

Civil Action No.

03 Civ. 2945 (WHP)

- x

SECURITIES AND EXCHANGE COMMISSION,	:	
	:	Civil Action No.
Plaintiff,	:	
	:	03 Civ. 2946 (WHP)
– against –	:	
CREDIT SUISSE FIRST BOSTON LLC, F/K/A CREDIT SUISSE FIRST BOSTON CORPORATION,	:	
Defendant.	:	

SECURITIES AND EXCHANGE COMMISSION,	:	
	:	Civil Action No.
Plaintiff,	:	
	:	03 Civ. 2947 (WHP)
– against –	:	
HENRY McKELVEY BLODGET,	:	
Defendant.	:	

SECURITIES AND EXCHANGE COMMISSION,	:	
	:	Civil Action No.
Plaintiff,	:	
	:	03 Civ. 2948 (WHP)
– against –	:	
MORGAN STANLEY & CO. INCORPORATED,	:	
Defendant.	:	

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Plaintiff Securities and Exchange Commission ("SEC" or "Commission") submits this Memorandum in response to the issues raised in the Court's June 2, 2003 Order ("Order"). In its Order, the Court directed the parties to address the following matters:

(1) whether the proposed Final Judgments in the above-captioned actions (the "Final Judgments") may properly be termed "final";

(2) the consequences, if any, if one or more states were to reject the "State Settlement Offer" as described in the Final Judgments, and the time frame for consideration by the states of the State Settlement Offer;

(3) the relationship between the states' acceptance of the State Settlement Offer and the treatment of the "Federal Payments" as described in the Final Judgments as penalty and disgorgement, and the tax ramifications thereof; and

(4) who the intended beneficiaries of the Distribution Funds described in the Final Judgments are, whether any categories of injured investors are excluded from receipt of proceeds from the Distribution Funds and, if so, the rationale for such exclusions.

Following a description of the Final Judgments and a discussion of the preliminary matters raised at pp. 5-7 of the Order, the SEC will address these issues in turn. As shown herein, the Final Judgments are fair, reasonable, and adequate, and should accordingly be entered.

DESCRIPTION OF THE FINAL JUDGMENTS

On April 28, 2003, the Commission filed the above-captioned actions against ten Wall Street investment firms and two individuals. These actions are part of the global settlement

among numerous securities regulators and all the defendants.[1] All told, there are potentially 67 parties to the global settlement. Along with the Complaints, the Commission filed Final Judgments against each of the defendants and each defendant's consent to entry against it of the Final Judgment as filed by the Commission.

Under the Final Judgments, 11 of the defendants have agreed to pay a total of $399 million – the "Federal Payments" – into ten separate registry fund accounts within ten business days of the Court's entry of the Final Judgments.[2] These registry fund accounts are termed "Distribution Fund Accounts." In addition, seven of the defendants[3] will pay a total of $52.5 million – the "Federal Investor Education Payments" – in five equal annual installments, with the first installment to be made into a separate registry fund account for each such defendant within 90 days after entry of the Final Judgments.[4] These registry fund accounts are termed "Investor Education Fund Accounts." Subsequent Federal Investor Education Payments will be made by means to be specified in a Court-approved Investor Education Plan to be prepared by a Court-appointed Investor Education Fund Administrator or in a further order of the Court.

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[1] The securities regulators are the SEC, two self-regulatory organizations ("SROs") – NASD Inc. and the New York Stock Exchange Inc. – and the securities regulators of the 50 states, the District of Columbia, and Puerto Rico.

[2] Merrill Lynch previously paid $100 million to settle actions brought by the Office of the New York Attorney General and other state securities regulators, and is not making payments into a Distribution Fund in the above-captioned action against it. Jack Grubman's $7.5 million payment is to be made to the Distribution Fund established in the *Citigroup Global Markets* action.

[3] These seven defendants are Bear Stearns, Citigroup Global Markets, Goldman Sachs, J.P. Morgan Securities Inc., Lehman Brothers, Merrill Lynch, and UBS Warburg. The Final Judgments against these defendants will be referred to hereinafter, where appropriate, as the "Investor Education Final Judgments."

[4] These payments are a portion of the total payment of $80 million that these defendants have agreed to make for investor education. The remaining $27.5 million will be paid to state securities regulators pursuant to these defendants' separate settlement agreements with them.

Under Section II.A of the Final Judgments,[5] each defendant is required to pay a specified "total amount" that includes a penalty, disgorgement, an amount to be used for the procurement of independent research, and (where applicable) investor education. In each case, the amount of the penalty equals the amount of the disgorgement. Under Section II.B, one-half of the total penalty-plus-disgorgement amount is the above-mentioned "Federal Payment" made in connection with the resolution of this action and related proceedings instituted by the SROs, and one-half is the amount that the defendant has offered to pay in connection with the resolution of related actions brought by the state securities regulators. The defendants' offers to the state securities regulators are termed the "State Settlement Offers" under Section II.B of the Final Judgments. Section II.B also provides that, by making the Federal Payment, each "Defendant relinquishes all legal and equitable right, title, and interest in such funds, and no part of the funds shall be returned to Defendant." An identical provision appears in Section IX.A.2 of the Investor Education Final Judgments regarding the Federal Investor Education Payments.

Under Sections II.C of the Final Judgments and IX.A.1 of the Investor Education Final Judgments, a "Defendant's obligation to make the" Federal Payment and/or the Federal Investor Education Payment "is not contingent or dependent in any way or part on Defendant's payments to state securities regulators pursuant to the State Settlement Offer." Thus, if any state or any number of states decides not to accept a defendant's State Settlement Offer, "the total amount of the" Federal Payment and/or Federal Investor Education Payment "shall not be affected, and shall

[5] Unless otherwise specified or necessary, references to section numbers of the Final Judgments will be to the Final Judgments against the investment banking firms other than Merrill Lynch. As mentioned, Merrill Lynch previously settled with the state securities regulators and is not paying money into a Distribution Fund. Because of that previous settlement, there is no "State Settlement Offer" in these actions with regard to Merrill Lynch or its former employee, Henry Blodget. There is also no State Settlement Offer with regard to Jack Grubman.

remain at" the amount specified in Sections II.B and IX.A.2 of the applicable Final Judgment(s). Final Judgments § II.C; Investor Education Final Judgments § IX.A.1.

As mentioned, and subject to the provisos discussed in footnote 2 above, the Clerk of the Court will deposit the Federal Payments into ten separate Distribution Fund Accounts. Under Section III.B of the Final Judgments, the Distribution Fund Accounts, together with interest and income earned thereon, will be used to pay "Eligible Distribution Fund Recipients" as described in Section V of the Final Judgments. Section III.C contains certain restrictions on the uses of the Distribution Funds. The provisions concerning Eligible Distribution Fund Recipients and restrictions on use of the Distribution Funds are described in greater detail in the final section of this Memorandum.

DISCUSSION OF PRELIMINARY MATTERS RAISED IN THE COURT'S ORDER

At pp. 5-7 of the Order, the Court raises three preliminary matters. *First*, in light of the fact that "an affiliate of defendant J.P. Morgan Securities Inc. manages CRIS accounts for the United States Courts and derives certain fees for those activities," the Court "suggests the establishment of accounts at the [Federal Reserve Bank of New York] pursuant to § 15 of the Federal Reserve Act in place of the CRIS accounts contemplated by the consent judgments." Order at 5-6. The SEC agrees with this suggestion.

Second, the Court "suggests that the SEC petition the Director of the Administrative Office of the United States Courts ['AOUSC'] under 28 U.S.C. § 1914 to aggregate" the defendants' deposits into the Distribution Funds and the Investor Education Funds "for purposes of calculating the statutory commission" that are to be paid from those Funds to the Clerk of the Court. *Id*. at 6. The effect of such an aggregation would be to reduce the percentage of the income earned on the Funds to be paid to the Clerk from ten percent (for all but the Citigroup /

Grubman Distribution Fund, for which the fee would be eight percent) to two percent for all Funds. For the reasons stated in the Court's Order, the SEC agrees with this suggestion as well, and has already submitted its request to the AOUSC.

Third, the Court "declines to approve any decree indemnifying or holding harmless any Administrator, agent, attorney or other person acting on his behalf, from criminal liability." *Id*. at 7. The SEC does not object to a decision here not to indemnify or hold harmless any Administrator, agent, attorney, or other person acting on his behalf, from criminal liability.

RESPONSES TO THE COURT'S QUESTIONS

I. The Finality of the Final Judgments

The Court asks whether the Final Judgments are properly termed "final," stating that "the plans to return moneys to investors, educate the investing public and fund independent research are seemingly inchoate" and that the Final Judgments "defer the formulation of specifics to unnamed 'Administrators' or, in the case of independent research, to unnamed 'Independent Consultants.'" Order at 7. The designation of the Final Judgments as final, notwithstanding the above facts, is both proper and consistent with established judicial precedent in SEC and other cases, including numerous cases filed in this District. That the parties are asking the Court to retain jurisdiction over these actions in order to oversee the *implementation* of the Final Judgments does not make the Final Judgments any less "final."

A "final" judgment is "one which ends the litigation on the merits and leaves nothing for the court to do but execute the judgment." *Catlin v. United States*, 324 U.S. 229, 233 (1945). *See also, e.g., Ginett v. Computer Task Group, Inc.*, 962 F.2d 1085, 1092 (2d Cir. 1992). Thus, the central question for purposes of determining finality is whether the litigation *on the merits* has concluded. As *Catlin*, *Ginett*, and a host of other cases to the same effect make clear, the fact

that tasks may remain as to implementation of the judgment does not mean that the judgment is not final. *See In re Martin-Trigona*, 763 F.2d 135, 138 (2d Cir. 1985) (under *Forgay v. Conrad*, 47 U.S. 201 (1848), "an order is treated as final if it directs the immediate delivery of property" even if tangential or ministerial tasks remain in implementing the order).

In line with these settled principles, courts in SEC cases have routinely approved and entered consent "Final Judgments" that (1) call for the appointment of unnamed fund administrators, independent consultants, receivers, and the like; (2) contemplate the creation of future distribution plans by such as-yet-unknown administrators for the distribution of funds to as-yet-unknown recipients; (3) contain injunctive relief provisions requiring affirmative conduct that is not set forth in final terms in the judgment; and/or (4) contain other "seemingly inchoate" terms. Perhaps the closest example is the consent "Final Judgment" that Judge Pollack approved and entered in *SEC v. Drexel Burnham Lambert, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 94,474 (S.D.N.Y. 1989). That judgment provided for the appointment of an as-yet-unnamed Special Claims Master, to be recommended by the Commission and approved by the Court, to formulate and implement a plan of distribution for a to-be-created $350 million Civil Disgorgement Fund. *Id*. at p. 93,032. The *Drexel* final judgment also created an Independent Consultant to "make recommendations for improved or additional policies, procedures and practices, in addition to those specifically required pursuant to this FINAL JUDGMENT"; those additional policies and procedures were designed, among other things, to ensure Drexel's compliance with securities laws and SRO rules, and Drexel was, as a general matter, required to "adopt, implement, and maintain all such policies and procedures" even though they were unknown at the time the Final Judgment was entered. *Id*. at pp. 93,038-40. And, the *Drexel* Final Judgment called for as-yet-

unimplemented personnel and structural changes, in particular the appointment of as-yet-unknown senior executives, in the company. *Id*. at pp. 93,033-34.[6]

These principles are not limited to SEC cases, but apply to other enforcement actions as well. For example, in antitrust cases, the courts routinely enter final judgments in enforcement actions brought by the Antitrust Division of the Department of Justice, even where those judgments defer the specifics of implementation to a future time. Most commonly, in merger cases, the Antitrust Division often enters into consent final judgments that condition approval of mergers on the defendant's agreement to divest assets or operations to an as-yet-unknown buyer and that call for an as-yet-unknown trustee to control those assets or operations if a buyer is not found within a specified time period. *E.g.*, Final Judgments entered in *United States v. Ætna Inc.*, 1999 WL 1419046 (N.D. Tex. 1999); *United States v. AT&T Corp.*, 1999 WL 1211462 (D.D.C. 1999); *United States v. Pearson*, 1999 WL 1705507 (D.D.C. 1999). Similarly, in the monopolization area, defendants in enforcement actions are subjected to final judgments requiring them to deal with their competitors on unspecified terms and at unspecified prices. *E.g.*, *United States v. Otter Tail Power Co.*, 1971 WL 584 (D. Minn. 1971), *aff'd in relevant part and vacated in part on other grounds*, 410 U.S. 366 (1973).

In the instant cases, the litigation on the merits between the SEC and the defendants has concluded. Each defendant has consented to the entry of judgment against it and to the imposition of various forms of injunctive relief, both negative (the prohibitions against violating

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[6] Final judgments requiring defendants to pay into the court registry to be distributed pursuant to as-yet-uncreated plans of distribution to be developed and/or administered by as-yet-unnamed fund administrators, claims masters, and the like are common in SEC cases. Beside *Drexel*, several cases discussed elsewhere in this Memorandum are illustrative. *See also* the Final Judgments entered in *SEC v. One or More Unknown Purchasers of Call Options and Common Stock of USCS Int'l, Inc.*, No. 98 Civ. 6327 (LBS) (S.D.N.Y. Jan. 25, 1999); *SEC v. Cantor*, No. 94 Civ. 8079 (JGK) (S.D.N.Y. Jan. 27, 1997); *SEC v. Felsher*, No. 94 Civ. 4150 (LLS) (S.D.N.Y. Dec. 10, 1995, Feb. 6, 1996, & Apr. 1, 1996); *SEC v. Salomon Inc.*, No. 92 Civ. 3691 (RPP) (S.D.N.Y. May 20, 1992).

the federal securities laws and SRO rules) and positive (e.g., the provisions regarding independent research).[7] Moreover, even though the Final Judgments call for the appointment of Distribution Fund and Investor Education Fund Administrators whose identities have yet to be determined, the defendants are required to pay sums certain at specifically identified times to the Distribution Funds and Investor Education Funds, and the provisions regarding both such Funds expressly state that, by making the required payments, "Defendant relinquishes all legal and equitable right, title, and interest in such funds, and no part of the funds shall be returned to Defendant." Final Judgments § II.B; Investor Education Final Judgments § IX.A.2.

In short, nothing remains to be litigated between the SEC and the defendants. The only remaining tasks – e.g., those relating to fund distribution, independent research, and investor education – involve *implementing* the judgments, not resolving contested matters. Under these circumstances, the Final Judgments are indeed final and should be entered so as, among other things, to subject the defendants to judicial sanctions, including contempt, for any violation of the injunctive relief and other provisions therein. *See SEC v. Randolph*, 736 F.2d 525, 528 (9th Cir. 1984) ("A consent decree is a judgment, has the force of res judicata, and it may be enforced by judicial sanctions, including, as in this case, citations for contempt.").

II. Acceptance or Non-Acceptance of the State Settlement Offer by the States

The Court has raised questions concerning the timing and consequences of acceptance or non-acceptance of the State Settlement Offer by individual states. As to timing, the Court has

[7] Defendants' consents are on a "no admit, no deny" basis. In compliance with their duty not to deny the Complaint's obligations, in ¶ 18 of their Consents (filed with the Court and incorporated by reference in its Final Judgments), the defendants have agreed, among other things, "not to take any action or to make or permit to be made any public statement denying, directly or indirectly, any allegation in the Complaint or creating the impression that the Complaint is without factual basis," with the proviso that this obligation does not affect their "(i) testimonial obligations; or (ii) right to take legal or factual positions in defense of litigation or in defense of other legal proceedings in which the Commission is not a party."

asked whether "there [is] any time frame for acceptance by the states of the 'State Settlement Offer.'" Order at 7. As to consequences, the Court has observed that the Final Judgments "contemplate future, but not necessarily assured, acceptance by the fifty states, the District of Columbia and Puerto Rico" and then asked: "If one or more States reject the 'State Settlement Offer' or challenge one or more of the consent judgments, what follows therefrom?" *Id*.

The Court is correct that the Final Judgments "contemplate future, but not necessarily assured, acceptance by the fifty states, the District of Columbia and Puerto Rico." The SEC is informed by Christine A. Bruenn, President of the North American Securities Administrators Association ("NASAA") and Maine Securities Administrator, that at present 11 states have reached final settlements with the defendants, 13 others have accepted the defendants' State Settlement Offers, and no state has rejected any of them. Ms. Bruenn has further informed the SEC that approximately half the remaining states have either prepared final settlement documents or will complete that process in the very near future, and that the other half have expressed their intent to complete the settlement process and are preparing the necessary paperwork. Ms. Bruenn has informed the SEC that NASAA's goal is for all states to finalize the settlements within 90 days after entry of the Final Judgments. Ms. Bruenn is not aware of any state that intends to opt out of the global settlement.

Ms. Bruenn has also reported to the SEC on one source of delay in finalizing some of the settlements. According to Ms. Bruenn, all defendants have ceased making any further payments to any state in respect of the State Settlement Offers until this Court enters the Final Judgments in these actions. The defendants have informed us that, subject to resolving any issues raised by a state's documentation, they are committed to making the required payments promptly upon entry of the Final Judgments.

The rejection by any state or any number of states of the State Settlement Offer would have no impact on the finality, validity, implementation, or other aspects of the Final Judgments. As an initial matter, while a state may reject one or more of the State Settlement Offers, no state has the power to "challenge one or more of the consent judgments." *Id*. To the contrary, Section X of the Investor Education Final Judgments and Section IX of the other Final Judgments state that, "notwithstanding any rule or provision of law, nothing herein, including in the Addenda hereto, shall be deemed to confer standing or right of intervention upon any persons other than the Commission, Defendant, and the Distribution Fund Administrator." Moreover, as mentioned, Sections II.C and IX.A.2 of the applicable Final Judgments state that a "Defendant's obligation to make" the Federal Payment and/or the Federal Investor Education Payment "is not contingent or dependent in any way or part on Defendant's payments to state securities regulators pursuant to the State Settlement Offer." Those obligations are also not contingent or dependent in any way or part on the acceptance of the State Settlement Offer by any state or any number of states. Nor would the rejection of a State Settlement Offer by any state or any number of states affect in any way the pertinent defendant's obligation to make the Federal Payment and/or the Federal Investor Education Payment in the time, amount, and manner specified in the Final Judgment. Similarly, the rejection or non-acceptance of the State Settlement Offers by any state or any number of states would have absolutely no impact on the injunctive relief or other provisions of the Final Judgments.

A state's rejection of a State Settlement Offer would affect the applicable defendant(s), which would have a lower total payment (though not a lower Federal Payment) by virtue of not having to pay the pro rata share of the total penalty, disgorgement, and investor education

amounts that would have gone to that state had it accepted the State Settlement Offer. However, such defendant(s) would also be subject to a possible separate enforcement action by such state.

III. Penalty/Disgorgement Allocation of Federal Payment and Tax Consequences Thereof

The Order states that the Final Judgments "require the 'Federal Payments' to be designated as a penalty and disgorgement in equal proportions" and then asks whether that allocation would be affected by the states' acceptance (or presumably a state's rejection) of the State Settlement Offers. Order at 8. The Order also asks about the tax ramifications of the penalty/disgorgement allocation. *Id*.

The Final Judgments do not require that the Federal Payments be designated as a penalty and disgorgement in equal proportions. Rather, they provide that the total amount of penalties and disgorgement paid to all regulators combined shall be equally divided between penalties and disgorgement. Thus, Section II.C of the Final Judgments states:

> The total amount of penalties paid ... in the Federal Payment ... and ... pursuant to that portion of the State Settlement Offer that is accepted by the state securities regulators ... shall at all times equal the total amount of disgorgement paid ... in the Federal Payment ... and ... pursuant to that portion of the State Settlement Offer that is accepted by state securities regulators ....

How much of the Federal Payments is to be characterized as a penalty and how much is to be characterized as disgorgement will depend on how each state that accepts the State Settlement Offer treats the payment made to it. In this regard, the SEC understands that each state will treat its respective payments according to its law and that the states' laws are not uniform. The SEC further understands that, under the laws of some states, payments made pursuant to the State Settlement Offers may be characterized *only* as a penalty. As set forth in Section II.C of the Final Judgments, to the extent that amounts paid to state securities regulators are deemed a penalty, the amount of the Federal Payment that is considered a penalty shall be

adjusted to achieve equality between the total amount of penalty and the total amount of disgorgement.[8]

For tax purposes, therefore, 50 percent of each defendant's total penalty-plus-disgorgement payment is a penalty and 50 percent is disgorgement. Each defendant, in Paragraph 6 of its Consent (which was filed with the Court and is incorporated by reference in and is therefore a part of the Final Judgment), agreed as follows:

> Defendant agrees that it shall not seek or accept, directly or indirectly, reimbursement or indemnification, including but not limited to payment made pursuant to any insurance policy, with regard to any penalty amounts that Defendant shall pay pursuant to Section II of the Final Judgment, regardless of whether such penalty amounts or any part thereof are added to the Distribution Fund Account or otherwise used for the benefit of investors. Defendant further agrees that it shall not claim, assert, or apply for a tax deduction or tax credit with regard to any federal, state, or local tax for any penalty amounts that Defendant shall pay pursuant to Section II of the Final Judgment, regardless of whether such penalty amounts or any part thereof are added to the Distribution Fund Account or otherwise used for the benefit of investors.

The "penalty amounts that Defendant shall pay pursuant to Section II of the Final Judgment" include both the penalty paid in the Federal Payment and the penalty paid pursuant to the State Settlement Offer. *See* Final Judgments § II.A. Accordingly, there shall be no tax credit or deduction at any level for any penalty paid by any defendant pursuant to the global settlement.

The Consents and Final Judgments do not contain any provisions stipulating the tax treatment of disgorgement, independent research, or investor education payments. The tax treatment of payments other than penalties will presumably be in accordance with the tax laws of the pertinent jurisdiction. In that regard, in Paragraph 6 of its Consent, each defendant has stated its understanding and acknowledgment that the provisions of the Consent and Final Judgment

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[8] While the respective percentages of the Federal Payments that are characterized as a penalty and disgorgement are not known at this point, that circumstance does not render the Final Judgments non-final, since the litigation on the merits has concluded and all that is left to do is to implement the Final Judgments.

> are not intended to imply that the Commission would agree that [non-penalty amounts] the Defendant shall pay pursuant to the Final Judgment may be reimbursed or indemnified (whether pursuant to an insurance policy or otherwise) under applicable law or may be the basis for any tax deduction or tax credit with regard to any federal, state, or local tax.

IV. Beneficiaries of and Exclusions from the Distribution Funds

The Final Judgments call for the creation of Distribution Funds. There will be a separate Distribution Fund for each defendant (other than Merrill Lynch). Pursuant to Section IV.A of the Final Judgments, the Court will appoint a Distribution Fund Administrator, whom the Commission shall recommend. Subject to the Court's approval, there will be one Distribution Fund Administrator. The primary responsibilities of the Distribution Fund Administrator will be to create and administer Distribution Fund Plans and to distribute the Distribution Funds to Eligible Distribution Fund Recipients in accordance with certain requirements and guidelines set forth in the Final Judgments. The overarching objectives of the Distribution Fund Plans are to provide for "the equitable, cost-effective distribution of funds to Eligible Distribution Fund Recipients" and to attempt "to ensure an equitable (though not necessarily equal) distribution of funds and that those who are allocated funds receive meaningful payments from the Distribution Fund[s]." Final Judgments §§ V.A, V.B.

Before discussing the specific provisions of the Final Judgments that address recipients of payments and exclusions from the Distribution Funds, the SEC first sets forth the following general points concerning the Distribution Funds and the rationale underlying the Final Judgments' provisions regarding them.

First, the Commission recognizes that the Final Judgments – like final judgments in all cases involving the distribution of large amounts of money to large numbers of people affected by the conduct of multiple defendants over a period of years – do not precisely identify the

intended beneficiaries of the Distribution Funds. Of necessity, and consistent with the agency's primary mission and expertise, the SEC's investigation focused on the defendants' conduct rather than identifying those affected by that conduct or, more specifically, those who should receive payments from distribution funds created pursuant to a government enforcement action. As with past final judgments in similar cases, therefore, the Commission believes it appropriate to entrust a Distribution Fund Administrator to identify in the first instance – subject to review by the Commission and approval by the Court – those who should receive payments from the Distribution Funds, in accordance with the Final Judgments' above-stated general objectives, requirements, and guidelines.

Second, under Section V.B of the Final Judgments,

> [t]he Distribution Fund Plan need not provide that funds be allocated (i) with respect to purchases of equity securities of *each* company identified in the Complaint or (ii) to *all* purchasers of equity securities of a company identified in the Complaint. The Distribution Fund Plan also may recognize that purchasers of equity securities of companies referenced in connection with one kind (or some kinds) of conduct by Defendant should receive all of the Distribution Fund available for distribution to Eligible Distribution Fund Recipients or a greater proportion than should purchasers of equity securities of companies referenced in connection with another kind (or other kinds) of conduct by Defendant.

(Emphasis in original). Again, the Commission believes it appropriate to allow the Distribution Fund Administrator to make these determinations in the first instance, subject to Commission review and Court approval.

In short, the Commission recognizes that it is possible that not everyone who was conceivably affected by the defendants' conduct would receive a payment from the Distribution Funds. The Commission nevertheless believes that the provisions of the Final Judgments regarding the Distribution Funds and the Distribution Fund Plans are fair, reasonable, adequate,

and in the public interest.[9] The Distribution Funds are not the exclusive source of funds potentially available to injured investors. Section V.A of the Final Judgments expressly states that "[a]n Eligible Distribution Fund Recipient is not precluded from pursuing, to the extent otherwise available, any other remedy or recourse against Defendant." Such other remedies and recourse include the many private actions that have already been filed, the many more private actions that assuredly will be filed in the future, and arbitration claims.

Relatedly, since the Distribution Funds here are not required to be used to fully or partially fund settlements in private actions, the Distribution Fund Administrator has the flexibility to craft Distribution Fund Plans that would provide funds to injured investors who will not or likely would not receive funds in private actions or in arbitration.[10] Thus, the Distribution Funds here could be supplements to, not replacements for, other potential remedies.

Given the size of the Distribution Funds compared to the losses suffered by investors as measured from the top of the market, it is necessary to balance between, at one extreme, including all investors who may have been harmed by defendants' conduct and, at the other extreme, paying those who receive payments from the Distribution Funds 100% of their losses.

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[9] In recognition of, among other things, the difficulty of the task, courts give the Commission significant discretion in formulating distribution plans. More generally,"[u]nless a consent decree is unfair, inadequate, or unreasonable, it ought to be approved." *Randolph*, 736 F.2d at 529 (reversing district court's rejection of proffered SEC consent judgment). *See also Weinberger v. Kendrick*, 698 F.2d 61, 73 (2d Cir. 1982) (Friendly, J.) ("fair, reasonable and adequate"), *cert. denied*, 464 U.S. 818 (1983). In applying this standard, "the district court must justify any departure from" the principle "that settlements are favored and ordinarily should be approved." *Donovan v. Robbins*, 752 F.2d 1170, 1177 (7th Cir. 1985). This "presumption in favor of approving the settlement" (*id.*) is especially forceful where, as here, "the plaintiff ... is a department of the United States government" because, in this situation, the court "need not fear that the pecuniary interests of the plaintiff and defendant will tempt them to agree to a settlement unfair to unrepresented persons, but can safely assume that the interests of all affected have been considered." *United States v. City of Miami*, 614 F.2d 1322, 1332 (5th Cir. 1980), *modified on other grounds*, 664 F.2d 435 (5th Cir. 1981) (*en banc*). Thus, approval of a consent judgment in a government enforcement action may not be conditioned on what a court considers "to be in the public's *best* interest"; rather a court should give deference "to the agency's decision that the decree is appropriate." *Randolph*, 736 F.2d at 529 (emphasis in original).

[10] For example, private plaintiffs are generally required to show reliance and causation. The Final Judgments do not require the Distribution Fund Administrator to formulate plans that call for the distribution of monies only to those who can establish reliance and causation.

The Final Judgments strike that balance by instructing the Distribution Fund Administrator to formulate Distribution Fund Plans that attempt to provide equitable (though not necessarily equal) and meaningful payments. The Commission believes that this balance is appropriate, particularly given the other remedies and recourse available to investors. "This kind of line-drawing – which inevitably leaves out some potential claimants – is, unless commanded otherwise by the terms of a consent decree, appropriately left to the experience and expertise of the SEC in the first instance." *SEC v. Wang*, 944 F.2d 80, 88 (2d Cir. 1991) (affirming district court's approval of distribution plan).

Third, quickness and ease of administration are important considerations. In the context of these cases, the Commission believes it is critical to have as efficient a process as possible and to avoid as much as possible a protracted claims process. The Final Judgments set forth what the Commission regards as an extremely aggressive schedule for the formulation of ten Distribution Fund Plans and the distribution of funds to hundreds of thousands or even more Eligible Distribution Fund Recipients: six months after entry of the Final Judgments, the Distribution Fund Administrator must present ten Distribution Fund Plans to the Commission and, nine months after Court approval of those Plans, the Distribution Fund Administrator must present Distribution Fund Reports that precisely set forth the identities of the Eligible Distribution Fund Recipients, the amount of the Distribution Fund that each Eligible Distribution Fund Recipient will receive, and the procedures for distributing the Distribution Fund to Eligible Distribution Fund Recipients.

To help enable the Distribution Fund Administrator to meet these tight deadlines, the Final Judgments are drafted to obviate an elaborate claims process.[11] As discussed in greater detail below, Section V.B of the Final Judgments states that "[t]he Distribution Fund Administrator shall formulate a Distribution Fund Plan that, to the extent practicable, allocates funds to persons who purchased the equity securities of companies referenced in the Complaint." Section V contains other requirements and guidelines for identifying Eligible Distribution Fund Recipients. Section VII.A of the Final Judgments requires the defendants to provide the documents, records, and other information and assistance necessary for the Distribution Fund Administrator to identify Eligible Distribution Fund Recipients in accordance with those requirements and guidelines. Thus, the Commission believes that the Distribution Fund Administrator may be able to formulate Distribution Fund Plans based on documents and information already in the defendants' possession, without needing to require investors to provide any or at least significant additional information. The Commission believes that this approach will enable the Distribution Fund Administrator to identify the investors who suffered losses and to get proceeds from the Distribution Funds to those investors as quickly as possible.

Fourth, while the Final Judgments set forth various requirements and guidelines for identifying Eligible Distribution Fund Recipients, they also give the Distribution Fund Administrator the flexibility to identify different or additional Eligible Distribution Fund Recipients if, after studying the circumstances in connection with preparing Distribution Fund Plans, he determines that such action is appropriate. Thus, Section V.B of the Final Judgments makes clear that the Distribution Fund Plans shall "*to the extent practicable* allocate[] funds to

[11] At the same time, the Final Judgments do not preclude a claims process if the Distribution Fund Administrator believes that such a process is appropriate.

persons who purchased the equity securities of companies referenced in the Complaint[s]" against the defendants. (Emphasis added). And, under Section V.E of the Final Judgments:

> If monies remain in the Distribution Fund after all distributions pursuant to the Distribution Fund Plan have been made, then such remaining monies shall be paid in accordance with a plan of residual distribution to be proposed by the Distribution Fund Administrator after consultation with Commission staff and, in his sole discretion, Defendant, and approved by the Court.

A. Beneficiaries

The intended beneficiaries of the Distribution Funds are the "Eligible Distribution Fund Recipients" as described in Section V of the Final Judgments. Section V.B. of these Judgments states that, separately for each defendant, the Distribution Fund Administrator shall formulate a Distribution Fund Plan "that, to the extent practicable, allocates funds to persons who purchased the equity securities of companies referenced in the Complaint" against that defendant. Under Section 3(a)(11) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78c(a)(11), the term "equity security" includes "any stock or similar security; or any security future on any such security; or any security convertible ... into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right." Under Section 3(a)(10) of the Exchange Act, 15 U.S.C. § 78c(a)(10), the term "security" includes, among other things, stock and options.

Under Section V.C of the Final Judgments, there are two additional requirements for identifying Eligible Distribution Fund Recipients. *First*, the person *must* have purchased the equity securities in question through Defendant during the relevant period identified in the Complaint. *Second*, the person *must* have suffered a net loss on his equity securities purchases in question. The Final Judgments also state that the Distribution Fund Administrator may consider (1) whether the person was a retail or institutional customer; and (2) the proximity in time

between the person's purchase of a company's equity securities and the applicable defendant's publication of pertinent research regarding that company.[12]

The Distribution Fund Administrator is responsible in the first instance for determining, consistent with these requirements and guidelines, the "intended beneficiaries" of the Distribution Funds, i.e., the Eligible Distribution Fund Recipients. That determination is subject to Commission review and, ultimately, Court approval.

The Second Circuit has upheld requirements and guidelines of the sort contained in the Final Judgments. *Wang*, 944 F.2d at 86-88 ("the SEC's decision to treat some options traders differently from stock traders was reasonable and fair"); *SEC v. Certain Unknown Purchasers of Common Stock and Call Options for Common Stock of Santa Fe Int'l Corp.*, 817 F.2d 1018, 1021 (2d. Cir. 1987) ("It was not unreasonable ... to compensate only those investors who suffered actual out-of-pocket losses."), *cert. denied*, 484 U.S. 1060 (1988). These requirements and guidelines are appropriate here. In particular, the Commission believes that, individually and collectively, these requirements and guidelines will enable the Distribution Fund Administrator to identify the investors to whom it is most appropriate to provide payments from the Distribution Funds and to distribute the proceeds of those Funds to them in the quickest, most efficient manner possible. *See Santa Fe*, 817 F.2d at 1021 (affirming district court's approval of SEC distribution plan in light of district court's belief that "the most grievously injured claimants should receive the greatest share of the fund"); *SEC v. Finacor Anstalt*, 1991 WL 173327, at *3 (S.D.N.Y. 1991) (rejecting challenge to SEC's proposed distribution plan and holding that the

[12] As a threshold matter, the purchase must have been made after the publication or receipt of such research. Assuming that threshold has been met, in general, the shorter the time period, the more likely the person suffered a loss as a result of the applicable defendant's conduct.

"equities weigh in favor of limiting payment at this time to the claimants suffering the greatest injury").

B. Exclusions

Section III.C of the Final Judgments identifies the restrictions on the uses of the Distribution Funds. Specifically, it states that the Distribution Funds shall not be used, directly or indirectly, to pay (1) the defendants; (2) with respect to investments in their own securities, securities issuers as to which securities the Distribution Fund Administrator determines that an investment therein would otherwise provide a basis for payment from the Distribution Funds;[13] (3) any person who has been convicted of a crime substantially related to, enjoined by a court or sanctioned by the Commission or any other regulatory authority for, or named as a defendant in a pending federal criminal or civil enforcement action regarding, any act or practice, or the types of acts or practices, identified in the Complaints against the defendants; (4) any judgment or award of punitive or non-compensatory damages; (5) administrative fees, costs or expenses related to the Distribution Fund Plans, other than the fees required by law to be paid to the Clerk of this Court; or (6) any amount denominated as attorneys' fees, costs, or disbursements. Once again, the Distribution Fund Administrator is responsible in the first instance for determining whether any of these restrictions applies in any particular instance, and those determinations are subject to Commission review and ultimate Court approval.

[13] For the purpose of identifying restrictions on use of the Distribution Funds, the definitions of the defendants and the securities issuers include their predecessors, successors, subsidiaries, affiliates, and present or former officers, directors, and their employees, agents, assigns, members of their immediate households, and those persons in active concert or participation with them.

Such restrictions and exclusions are commonplace in court-approved final judgments in SEC enforcement actions that create distribution funds to provide monies to injured investors.[14] They are appropriate here. The SEC does not believe that the defendants or issuers of securities as defined in the Final Judgments, or individuals convicted of a crime, the subject of an injunction or other sanction, or named as a defendant because of conduct regarding the conduct or type of conduct challenged in these actions should receive any payments from the Distribution Funds. To the extent such entities and individuals engaged in wrongful conduct, they should not be allowed to profit from it. At all events, in light of the limited amount of funds available for distribution to all investors affected by the defendants' conduct, the Commission believes it is appropriate that such limited resources be made available to those who are not affiliates of the defendants or issuers of the applicable securities.[15] The restrictions against using the Distribution Funds to pay for punitive or non-compensatory awards, attorneys' fees, costs, and disbursements, or administrative fees and expenses are appropriate to ensure that injured investors receive the maximum amount possible from the Funds.

The Court asked specifically whether "shareholders in mutual funds, investors in derivatives or purchasers of equity securities who relied on conflicted research but did not

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[14] In *SEC v. Salomon Inc.*, 1995 WL 412429 (S.D.N.Y. 1995), *vacated and remanded on other grounds*, 78 F.3d 802 (2d Cir. 1996), the court stated that such restrictions are "designed to protect the integrity of the market place and ensure public confidence in its regulation." The exclusions in *Salomon Inc.*, including the exclusion of persons named as a defendant in a pending federal criminal or civil enforcement action, were substantively identical to those contained in the Final Judgments in the instant actions. *See* 1995 WL 412429, at *1. In vacating and remanding, the Second Circuit did not as a legal or general matter question the propriety or validity of any of the exclusions. Rather, the Second Circuit held that, as a factual matter, the fund administrator had not made the necessary findings to support his determination that a former Salomon employee was precluded from recovery under an exclusion not contained in the Final Judgments in these actions (namely, an exclusion for a person's "participation in Salomon-Related Activities or such person's failure to supervise such activities"). 78 F.3d at 807-08, 804.

[15] Under the Final Judgments, a broad based pension fund plan (i.e., a plan for all employees rather than one targeted to specific individuals such as executive officers) and a pension fund plan that is subject to ERISA would not be considered an affiliate of an issuer and therefore would not be excluded from receipt of payments from the Distribution Fund Plans.

purchase the securities through any of the defendant banks" are precluded from receiving payments from the Distribution Funds. Order at 7.

A mutual fund would *not* be excluded simply because it is an institution, but will be eligible provided it "purchased the equity securities in question through Defendant during the relevant period identified in the Complaint" against that defendant (Final Judgment § V.C.1), met all the other requirements described above, and was not excluded under Section III.C of the Final Judgments. A shareholder of such a mutual fund would not be able to receive a *direct* payment from the Distribution Funds but might be able to receive a payment *indirectly* through the mutual fund if the Court-approved Distribution Fund Plan in question provides for payments to the mutual fund. As mentioned above, in identifying Eligible Distribution Fund Recipients, the Distribution Fund Administrator may consider whether the person in question was a retail or institutional customer.

As discussed above, derivatives such as options and futures fall within the Exchange Act's definition of equity securities and, accordingly, derivatives investors are not specifically excluded from receiving payments from the Distribution Fund Plans. However, the Distribution Fund Administrator could determine that stock purchasers are more appropriate recipients of payments from the Distribution Fund Plans than are derivatives investors. The research at issue in these actions concerned the fundamentals of the securities that were the subject of the research. Options and futures traders, however, often do not trade on the basis of fundamentals. Indeed, many of the defendants issued research specifically on options and other derivatives. That research was not the subject of the SEC's Complaints. Particularly in light of the limited amount of funds available for distribution, the Distribution Fund Administrator might appropriately decide to make the Distribution Funds available only to purchasers of equity

securities. *See Wang*, 944 F.2d at 87-88 ("decision to treat some options traders differently from stock traders was reasonable and fair" even though "[t]his kind of line-drawing ... inevitably leaves out some potential claimants").

Section V.C.1 of the Final Judgments precludes purchasers of equity securities who did not purchase through any of the defendants from being considered Eligible Distribution Fund Recipients under the Distribution Fund Plans. This exclusion is appropriate. The primary purpose of disgorgement is to prevent defendants from being unjustly enriched. *Id*. at 88. An investor's purchase of equity securities through a broker other than one of the defendants could have unjustly enriched a defendant only indirectly, if at all. Moreover, any injury suffered by an investor who did not purchase through one of the defendants is more remote and speculative than injury suffered by those who did purchase through one of the defendants. In short, only the customers of a defendant firm were in privity with that firm. Again, in light of the limited funds available for distribution, the Final Judgments have appropriately drawn the line. *See id.*

There is one caveat to this discussion. The Final Judgments provide for the possibility of residual plans of distribution that are not subject to the requirements and guidelines of Section V, though such plans would remain subject to the restrictions of Section III.C, of the Final Judgments. Thus, so long as any person is not excluded under Section III.C, there is at least a possibility that (s)he could receive a payment from the Distribution Funds even if (s)he was not deemed an Eligible Distribution Fund Recipient under one of the Distribution Fund Plans.

CONCLUSION

For the foregoing reasons, the Final Judgments are fair, reasonable, and adequate, and they should be entered.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that, on June 13, 2003, I caused Plaintiff Securities and Exchange Commission's Memorandum in Response to June 2, 2003 Order to be served on the following by FedEx (standard overnight delivery) or, as indicated below, by electronic mail transmission (signed copy in .pdf format) pursuant to agreement between the parties:

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