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No.01-147

IN THE
SUPREME COURT OF THE UNITED STATES

SECURITIES AND EXCHANGE COMMISSION,

Petitioner,

v.

CHARLES ZANDFORD,

Respondent.

On Writ of Certiorari To The United States
Court of Appeals For the Fourth Circuit

BRIEF *AMICI CURIAE* OF AARP, NATIONAL
ASSOCIATION OF SECURITIES AND
COMMERCIAL LAW ATTORNEYS, AND
CONSUMER FEDERATION OF AMERICA
IN SUPPORT OF PETITIONER

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BRIEF *AMICI CURIAE* OF AARP, NATIONAL
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IN SUPPORT OF PETITIONER

INTEREST OF *AMICI CURIAE*^{1/}

AARP is a non-profit, non-partisan organization with more than 35 million members, dedicated to addressing the needs and interests of Americans aged 50 and older. As the largest membership organization representing the interests of older Americans, AARP is very concerned about fraudulent

^{1/} The parties' consents have been filed with the Clerk of the Court. *Amici curiae* state that no counsel for any party authored this brief in whole or in part and that no party other than these *amici curiae*, their members or counsel made a monetary contribution to the preparation or submission of this brief.

practices in the securities industry. Older people are frequent targets of fraud because they often have significant assets and are looking for investment opportunities that will supplement the Social Security and pension benefits they will receive during retirement. As a result, AARP has made the need to combat securities fraud a high priority, with a particular focus on stockbroker practices that are inconsistent with an investor's best interests. AARP has been very involved in commenting on legislative and regulatory proposals that address such practices, has filed *amicus curiae* briefs in cases involving interpretation of the federal securities laws, e.g., *Kauthar Sdn Bhd v. Sternberg*, No. 98-799 (U.S. Supreme Court Dec. 17, 1998) (in support of petition for writ of *certiorari*); *Newton, et al. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., et al.*, No. 96-5045 (3d Cir. July 17, 1997) (in support of petition for rehearing with suggestion for rehearing *en banc*), and has opposed efforts to limit federal statutory remedies that allow defrauded investors to obtain financial redress. In addition, AARP has undertaken efforts to combat investors' low financial literacy and to educate them about how to choose financial professionals who will act in their best financial interest. For example, in 1998 AARP commissioned a survey of people 50 and older to determine investor awareness of broker compensation practices. The survey revealed that investors do not have a basic understanding of the conflicts of interest that may arise because of such practices, such as sales contests and higher commissions for the sale of proprietary products. AARP, *Investor Awareness of Broker Compensation Practices: Findings From An AARP Survey 3-4* (Apr. 1998) (on file with AARP); *see also* AARP, *Investor Understanding of Broker Account Statements: Findings From a Survey 5-6*, available at <http://research.aarp.org/consume/broker.pdf> (Oct. 2000) (revealing that experienced investors with full-service brokerage accounts do not understand much of the information on typical account statements, including basic terms such as "equity," or fundamental transactions, such as the number of shares reinvested in a particular fund).

The National Association of Securities and Commercial Law Attorneys ("NASCAT") is an association of law firms

and attorneys who litigate antitrust, commercial, consumer, securities fraud, and shareholder derivative cases in federal and state courts throughout the country. NASCAT and its members are devoted to representing victims of corporate abuse, fraudulent schemes, and so-called "white-collar" criminal activity in cases that have the potential for advancing the state of the law, educating the public, modifying corporate behavior, and/or improving access to justice and compensation for the wrongs inflicted upon victims. NASCAT advocates principled interpretation and application of federal and state securities laws to protect investors from manipulative, deceptive, and fraudulent practices and to ensure that the nation's securities markets operate fairly and efficiently. NASCAT's members frequently represent victims of securities fraud in cases brought under federal and state securities laws and thus have an interest in the effective private enforcement of these laws.

The Consumer Federation of America ("CFA") is a non-profit association organized in 1968 to advance the interests of consumers through advocacy and education. CFA's membership is comprised of 285 national, state, and local consumer groups throughout the United States which, in turn, represent more than 50 million consumers. Recognizing the growing participation of American consumers in our nation's financial markets, CFA has made protecting the interests of individual investors a priority. The guiding principles behind CFA's work on these issues is that investors deserve effective protection from fraud, fair dealing from financial professionals, and full and timely disclosure of information relevant to their interests. In keeping with these concerns, CFA has supported federal and state legislative and regulatory initiatives on a broad array of investor protection issues, including financial planner regulation, penny stock fraud, rights to redress for victims of securities fraud (both in court and through arbitration), industry compensation practices, and plain language disclosures.

The interest of *amici* in this case stems from their positions among the leading consumer organizations in this country involved in matters that concern protecting investors

from fraud and the substantial interests at stake for their members and the consumers they serve. *Amici* submit this brief to apprise the Court of the unprecedented degree to which Americans are investing in the securities markets and their relatively low level of understanding of how the markets operate, and to more fully explain the effect the Fourth Circuit's erroneous interpretation of the "in connection with" requirement will have in undermining securities law enforcement and the protections currently afforded investors and the national securities markets by the anti-fraud provisions of § 10(b) of the Securities Exchange Act of 1934 ("the Exchange Act"), 15 U.S.C. § 78j(b) (2001), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (2001), promulgated by the Securities and Exchange Commission ("SEC").

SUMMARY OF ARGUMENT

The Fourth Circuit erred in holding that "Zandford's fraudulent actions were not sufficiently connected with a securities transaction" to support an SEC enforcement action under the federal securities laws. *SEC v. Zandford*, 238 F.3d 559, 561 (4th Cir. 2001), *cert. granted*, 2001 U.S. LEXIS 10303 (Nov. 8, 2001). Not only did the lower court misread the plain language of the Exchange Act and Rule 10b-5, it also misapplied this Court's precedent. The importance of the Court correcting the Fourth Circuit's error cannot be overstated.

In recent years, Americans have entered our nation's securities markets in record numbers, many for the first time. This is due, in large part, to the recognition that individuals have to plan and provide for their retirement security, with less reliance on Social Security and traditional employer-sponsored defined benefit pension plans. Yet, many investors are ill-equipped to navigate the complexities of the markets and thus rely on the advice of a range of professionals, including stockbrokers and financial planners. In placing their trust in others they are, in many instances, unwittingly placing their financial security in jeopardy. When the worst happens, and their trust is abused through fraud, individual investors need access to the full range of legal enforcement

mechanisms and remedies – federal and state, public and private, civil and criminal – that Congress and state legislatures have enacted for their protection.

Unless the Court reverses the Fourth Circuit and upholds the standard intended by Congress and advanced by Petitioner America's individual investors and their financial futures will remain at the mercy of unscrupulous practitioners. At the same time, the SEC's civil enforcement authority and the ability of individual investors to seek redress will be severely circumscribed. The result will be the severe dilution of two powerful weapons in the full arsenal of legal protections intended to benefit investors.

ARGUMENT

I. INTRODUCTION

A. **Individuals Are Investing in the Securities Markets in Unprecedented Numbers, Often For the First Time**

Demographic factors have led to considerable changes in participation in this country's securities markets. In the past, wealthy individuals and corporations were the primary investors in the stock market. That is no longer true, due to the combined effect of the baby boom generation's entry into adulthood, changes in retirement regulations and strategies, and a stock market that, for the most part, has been producing incredibly high returns. The nation has entered a period in which Social Security provides proportionately less of needed retirement income, and traditional employer-sponsored defined benefit pension coverage has decreased. In addition, Americans have departed, in unprecedented numbers, from their historic practice of placing primary reliance on federally-insured products, such as savings accounts and certificates of deposit, for their retirement needs.

A recent Investment Company Institute (ICI)^{2/} survey of the mutual fund industry showed that the combined assets of the nation's mutual funds totaled \$6.616 trillion in October 2001. Investment Company Institute, Mutual Funds Facts & Figures, Current Statistical Releases, Trends in Mutual Fund Investing, *available at* http://www.ici.org/facts_figures/trends_1001.html (Nov. 29, 2001). The ICI also indicates that as of May 2001, an estimated 93 million individuals in 54.8 million American households, or 52% of all U.S. households, owned mutual funds. Mutual fund ownership among U.S. households increased steadily during the 1990s and, in 2000, one out of three individuals in the country owned mutual funds. Investment Company Institute, About Mutual Fund Shareholders, Demographic Information, Frequently Asked Questions About Mutual Fund Shareholders (Nov. 2001) [hereinafter Frequently Asked Questions] *available at* http://www.ici.org/aboutshareholders/shareholders_faqs.html.

The increased number of individuals making mutual fund purchases is due, in large part, to the significant trend toward replacing defined benefit pension plans with defined contribution plans. The ICI reported that 62% of fund shareholders own funds through defined contribution retirement plans. *Id.*; *see also* Office of Investor Education and Assistance, SEC, The Facts on Saving and Investing 6 (Apr. 1999) [hereinafter SEC, The Facts on Saving and Investing]. This increased reliance on defined contribution plans places significant responsibility on individuals to make appropriate investment choices so they will have adequate retirement income. When mutual fund assets typically represent 40% of household assets, ICI, Frequently Asked Questions, *supra*, investors face a heightened risk if they incur losses due to bad advice, abusive practices, or fraud. The potential for fraud and other abuses becomes even greater

^{2/} The Investment Company Institute is the national association of the American investment company industry. Founded in 1940, its membership includes 8,710 mutual funds, 481 closed-end funds, and 7 sponsors of unit investment trusts.

as large numbers of first-time investors enter the securities markets and, due to their relative lack of sophistication and high financial illiteracy, rely on a range of professionals, including stockbrokers and financial planners, to advise them in the purchase or sale of securities.

B. Individual Investors Have Extremely Low Levels of “Financial Literacy” Leading Them to Rely Heavily on Financial Professionals

The complexity of the marketplace and the relative lack of sophistication of a majority of individual investors combine to hinder their ability to make wise investment decisions. “America faces a financial literacy crisis. At a time when more Americans than ever before are investing in our securities markets through the purchase and sale of stocks, bonds, and mutual funds, numerous studies show they lack the financial basics.” SEC, *The Facts on Saving and Investing*, *supra*, at 2.

Then-SEC Chairman Levitt stated that

[t]ens of millions of Americans lack the basic saving and investing information they need to prepare for retirement or to meet other financial goals. . . . While 63 percent know the difference between a halfback and a quarterback, only 12 percent know the difference between a load and a no-load mutual fund.

Arthur Levitt, *Expanding the Promise of Opportunity and Security Through Savings and Investing*, Remarks Before the Consumer Federation of America, *available at* <http://www.sec.gov/news/speech/speecharchive/1998/spch229.htm> (Dec. 3, 1998).

Several recent studies conducted by government agencies, financial services corporations, and non-profit organizations have produced remarkable findings that bear out Chairman Levitt’s concerns. The studies took different approaches but

reached the same conclusion: individual investors lack even the most rudimentary knowledge needed to make informed investment decisions. Investors do not know the basics of how investments work, and they do not even know what they are doing with their own money. For example, a May 1996 study conducted by the National Association of Securities Dealers (NASD) found that while 78% of Americans can name a character on a television sitcom, a mere 14% know the difference between growth and income stocks. Press Release, National Association of Securities Dealers, Inc., NASD Launches Major Public Disclosure, Investor Education Initiative (Feb. 19, 1997) (on file with AARP); see also Ruth Simon, *We Put Investors to the Test -- and, Boy, Did They Ever Flunk*, Money, Mar. 1998, at 37 (reporting on results of MONEY/Vanguard Mutual Fund Literacy Test on which mutual fund investors scored an average of just 51 out of 100); Towers Perrin, *Preparing For Retirement: A Survey of 1,000 Working Americans* 9 (Feb. 1995) (one-third of those who participate in a 401(k) or other retirement savings plan think there is no risk associated with bonds, and 14% think there is no risk associated with an investment in a "mutual fund" or a "balanced" fund) (reports on file with AARP).

Unfortunately, these findings have not improved with time. The Securities Investor Protection Corporation and the National Association of Investors Corporation recently reported that 85% of American investors do not know enough to pass a "survival" quiz designed to assess their knowledge of what to do in times of market downturns and other financial difficulties. For example, almost two in three investors do not know the first step to take when they suspect they are dealing with a problem broker, and fewer than one in five knows there is no insurance for stock market losses. Press Release, Securities Investor Protection Corporation & National Association of Investors Corporation, *Survey: More Than 4 Out of 5 U.S. Investors Fail Quiz of Basic "Survival" Knowledge*, available at <http://216.181.142.217/sipc/release0.html> (Aug. 1, 2001).

The only conclusion to be drawn from this sampling of findings is that individual investors do not know the ABCs of investing. Lacking this basic knowledge of how the securities markets operate, and being unaware of the fundamental features of their own investments, individual investors rely in large measure on third parties, such as brokers, for advice on the purchase and sale of securities. More than 80% of new mutual fund purchases were made through intermediaries such as brokers, banks, financial planners, insurance agents, and employers,^{3/} and 37% of shareholders purchase funds primarily through full-service brokers, insurance agents, financial planners, or bank representatives. ICI, Frequently Asked Questions, *supra*. In spite of this, almost four-fifths (79%) of investors feel it is difficult to know how to choose a good professional investment advisor. SEC, The Facts on Saving and Investing, *supra*, at 24. And, the vast majority of investors (88%) who have received advice from a financial professional have never looked into the disciplinary history of their broker or financial planner. Press Release, Investor Protection Trust, National Association of Securities Dealers, North American Securities Administrators Association, Survey: Financial Illiteracy, Bad Habits Dangerous Mix For Investors, *available at* <http://www.investorprotection.org/nr1.htm> (May 14, 1996). Individual investors' lack of knowledge about the securities markets, their own investments, and how to choose trustworthy financial professionals place these investors at great risk of being defrauded by unscrupulous practitioners.

^{3/}Nearly half (48%) of mutual fund shareholders identified an employer-sponsored retirement plan as their primary method for purchasing mutual funds, and 57% bought their first fund through these plans. ICI, Frequently Asked Questions, *supra*.

II. THE PREVALENCE OF SECURITIES FRAUD REQUIRES THAT THE SEC & INVESTORS HAVE A FULL RANGE OF STRONG, FLEXIBLE ENFORCEMENT TOOLS.

A. Securities Fraud Continues to Plague Investors

“We are living in a time when the stock market is more a part of the American consciousness than ever before.” SEC Chairman Arthur Levitt, Remarks to National Press Club, Plain Talk About On-line Investing (May 4, 1999).^{4/} Thus, protection against fraud is more important than ever. State regulators estimate that securities fraud costs Americans billions of dollars each year. Press Release, North American Securities Administrators Association, “Top 10 Investment Scams” List Released by State Securities Regulators, available at http://www.nasaa.org/nasaa/scripts/prel_display.asp?rcid=156 (Apr. 23, 2001). The excesses of the 1980s, which gave rise to spectacular failures of financial firms,^{5/}

^{4/} The stock market has been characterized by one commentator as a kind of magic. “Investors pay enormous amounts of money for completely intangible rights whose value depends entirely on the quality of the information that investors receive and the honesty of other people about whom investors know almost nothing. This magic does not appear in unregulated markets.” Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 Bus. Law. 1565, 1565 (Aug. 2000).

^{5/} The highest-flying investment banking firm of the 1980s, Drexel Burnham Lambert pled guilty to federal felony securities fraud charges and paid \$650 million in fines and sanctions. *SEC v. Drexel Burnham Lambert, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,474 (S.D.N.Y. June 20, 1989) (reflecting entry of consent decree).

junk bonds,^{6/} and the collapse of the thrift industry,^{7/} threatened a loss of investor confidence in the financial markets with a corresponding negative impact on the ability of business to raise capital. Such apprehensions, however, gave way to the exuberance of the 1990s and the charging bull market that marked the turn of this century. New and enthusiastic investors entered the financial markets^{8/} and, as could be expected, those so inclined found new and enthusiastic ways to give honesty the slip and defraud investors.

As Chairman Levitt also observed:

With this vast expansion in our markets and in public participation in those markets, we would expect to see an increase in the incidence of fraud. We have particularly seen

⁶ The most notorious "financier" of the 1980s, Michael Milken, the "junk bond king," was indicted on 98 counts of RICO and criminal securities fraud, pled guilty to six counts and was sentenced to ten years in prison. *SEC v. Milken*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,200 (S.D.N.Y. Apr. 24, 1990) (reflecting settlement of civil enforcement action and guilty plea).

⁷ President George H. Bush told the nation that "unconscionable risk-taking, fraud, and outright criminality [were] factors' that led to the savings and loan crisis." Maureen Dowd, *Bush Savings Plan Calls for Sharing the Cost Broadly*, N.Y. Times, Feb. 7, 1989, at A1.

⁸ For example, as of 1999, 25% of all individual trades were conducted on line. In 1994 not one person traded over the Internet. Many new Internet investors are inexperienced in any form of investing. Arthur Levitt, Remarks to National Press Club, Plain Talk About On-line Investing (May 4, 1999).

an increase in abuses in the market for micro cap securities, which . . . provides opportunity for fraudsters to prey on innocent investors.

Fraud In The Micro-Capital Markets, Including Penny Stock Fraud: Hearing Before the Permanent Subcomm. on Investigations of the Senate Comm. on Governmental Affairs, 105th Cong. 114 (1997) (testimony of Arthur Levitt).

The Subcommittee Chair made a similar observation:

We conduct these hearings against the backdrop of a booming stock market and a new generation of unseasoned investors. Hidden beneath the rising tide of the market, micro-cap fraud represents a pernicious undercurrent that potentially affects thousands of American families. Many of these families are, for the first time, investing their hard-earned money to save for skyrocketing tuition costs, unforeseen medical expenses, and lengthier retirements. While we have the safest and most successful capital markets in the world, the irony is that public confidence in our markets actually creates opportunities for con artists to exploit the unwary.

Id. at 55 (opening statement of Sen. Susan M. Collins).

Fraud is by no means limited to the micro-cap market, and the Senate hearing excerpts merely illustrate the problems faced by investors in many market sectors. For example, major brokerage houses peddled high risk limited partnerships, touting their suitability for conservative and older investors. *See, e.g., Coming to Terms, CSFB Agrees to Pay \$100 Million to Settle Twin IPO Investigations*, Wall St. J., Dec. 11, 2001, at A1 (SEC announcing Credit Suisse First Boston will pay \$100 million to resolve federal investigation into alleged abuses in distribution of its IPOs); *see also In re Prudential Sec. Inc. Ltd. P'ship Litig.*, 163 F.R.D. 200 (S.D.N.Y. 1995) (describing \$110 million settlement with an

