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KARMEL'S DISSENT: THE SEC'S USE AND OCCASIONAL MISUSE OF SECTION 21(A) REPORTS OF INVESTIGATION

James J. Park[*]

ABSTRACT

Section 21(a) of the Securities Exchange Act gives the SEC the option of publishing a report of its findings after conducting an investigation. Typically, the SEC issues such reports about once a year to highlight major compliance and enforcement issues. This Article examines the SEC's use of Section 21(a) investigative reports with special attention to its 1979 report in Spartek, where Commissioner Roberta Karmel filed a famous dissent. In that opinion, she argued that the report effectively sanctioned conduct over which the SEC did not have jurisdiction and that Spartek did not have sufficient notice of its regulatory obligations. While such concerns have not been at issue in most Section 21(a) reports of investigation, they were recently raised by the SEC's report in DAO, which analyzed whether a digital token was a security under the Howey test. While the SEC's conclusion was reasonable, it was a close call, and the report did little to clarify the scope of the SEC's jurisdiction over tokens. The SEC should be cautious in using reports of investigation to define its own jurisdiction and should actively seek adjudication to confirm the scope of its authority.

INTRODUCTION

A small number of investigations by the Securities and Exchange Commission (SEC) end with the filing of a report rather than a complaint or administrative order. Section 21(a) of the Securities Exchange Act of 1934 authorizes the SEC "to publish information" relating to any securities law violations that it discovers.[1] When the SEC issues a report pursuant to this authority, it typically recites its factual findings and discusses how the described conduct violated the securities laws.

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1. The provision provides:

> 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 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 concerning the matters to which this chapter relates.

Securities Exchange Act of 1934, 15 U.S.C. § 21(a).

SEC reports of investigation represent the views of an expert administrative agency in the context of a particular case. They are also an opportunity to convey the agency's views about an issue of importance. The SEC has explained that it issues "reports of investigations relating to various subjects where, in the Commission's judgment, substantial issues of public concern, widespread investor impact, or other matters of significance relating to the federal securities laws were involved."[2] One commentator has observed that, "in these Section 21(a) reports, the Commission criticizes policies and decisions made by subject parties, thus directing to all concerned the areas in which the Commission desires reform."[3] Reports of investigation are thus a way for the SEC to provide the industry guidance on significant matters.

Section 21(a) reports of investigation permit the SEC to publish an opinion even when it does not bring an enforcement action. When the report is not accompanied by an administrative order that imposes a sanction, the investigated party has less of an incentive to dispute the SEC's public characterization of the facts.[4] As a result, there is a risk that the report's narrative can be one-sided. Reports may characterize contested facts as essentially established, omit counter-narratives, or overreach with respect to a legal theory.[5]

The potential for the misuse of reports of investigation was highlighted more than forty years ago by Roberta Karmel, the first woman to serve as an SEC Commissioner and one of just a handful of Commissioners that did not serve as Chair to develop a national profile.[6] In a case involving Spartek, a tile maker from Canton, Ohio, the SEC combined a Section 21(a) report of investigation with an administrative order instituting proceedings against the

2. The Commission's Practice Relating to Reports of Investigations and Statements Submitted to the Commission Pursuant to Section 21(a) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-15664, 17 SEC Docket 18 (Mar. 21, 1979). Two practitioners offered a somewhat different view, explaining that a "prime consideration underlying the decision to proceed under Section 21(a) [enforcement] is presumably whether or not another enforcement mechanism is available and, if so, whether or not the Commission would be successful in obtaining a traditional sanction." Dennis J. Block & Nancy E. Barton, *Section 21(a): A New Enforcement Tool*, 7 SEC. REG. L.J. 265, 266–67 (1979).

3. MARC I. STEINBERG & RALPH C. FERRARA, SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT § 4:16 (1985).

4. In some cases, the subject of the investigation may fear the prospect of private litigation or the reputational impact of the report and would thus have an incentive to negotiate the content of the report.

5. The SEC may give parties the opportunity to review a report. *See, e.g.*, Neal Perlman, *Section 21(a) Reports: Formalizing a Functional Release Valve at the Securities Exchange Commission*, 69 N.Y.U. ANN. SURV. AM. L. 887, 925 (2014) (noting that the SEC may "occasionally allow the opposing counsel to proofread a report").

6. For an overview of Roberta Karmel's career, see Oral History of Roberta S. Karmel (2013), https://abawtp.law.stanford.edu/exhibits/show/roberta-s-karmel.

company.[7] It did so because it only had authority to bring an administrative action for part of the misconduct it sought to sanction. The SEC thus used its power under Section 21(a) to describe its views about practices it disapproved of but did not have jurisdiction to punish. It then required the target of the investigation to adopt corporate governance measures to address the conduct that it did not have the power to sanction.

Karmel dissented in *Spartek*. She argued that SEC reports of investigation can only publicize a violation of the securities laws that the SEC has the authority to sanction.[8] They cannot be used to expand the agency's jurisdiction beyond what it was given by Congress. In exceeding its limits, the SEC risked undermining its legitimacy as a fair regulator. Karmel's dissent was part of a broader criticism she famously advanced. The SEC had developed a tendency to engage in what she called "regulation by prosecution" – using enforcement actions to expand its authority and develop law, rather than petitioning Congress to act or passing an administrative rule subject to notice and comment procedures.[9]

While the SEC has generally used Section 21(a) judiciously in the modern era, some of the criticisms highlighted by Karmel's dissent are applicable to an SEC report of investigation that was filed almost forty years after her *Spartek* dissent. In the DAO Report, the SEC took the position that digital tokens issued by an investment fund were securities subject to its jurisdiction.[10] The SEC applied the notoriously vague *Howey* test and made a close call that the tokens were securities under that test.[11] The DAO, which described itself as a Decentralized Autonomous Organization, had been designed so that the purchasers of its tokens would vote on the investments that the fund would make. Such involvement would mean that an essential element of *Howey*, that the investors rely mainly on the efforts of others to generate a return, might not be satisfied. But the SEC took the position that because the founders of the fund pre-screened the investment proposals that would be voted on, the investors significantly relied upon their efforts and thus the DAO tokens were securities.

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7. In the Matter of Spartek Inc. and John A. Cable, Exchange Act Release No. 15567, 1979 SEC Lexis 2151 (Feb. 14, 1979).

8. *Id*.

9. ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 146–59 (1982). The critique re-emerged by the end of the 1980s as the SEC became more aggressive in bringing insider trading cases under Rule 10b-5. *See* Harvey L. Pitt & Karen L. Shapiro, S*ecurities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149, 203–04 (1990); *see also* James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625, 637 (2007) ("The 'Regulation by Enforcement' critique reflects a general sense that norms are best initiated by rulemaking whereas enforcement actions should merely enact previously defined rules.").

10. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 34-81207, 117 SEC Docket 745 (July 25, 2017) [hereinafter DAO Report].

11. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946).

The DAO Report only expressed the SEC's opinion on an unadjudicated case, but the SEC later cited it as putting the industry on notice that Initial Coin Offering (ICO) tokens were securities. The DAO Report only dealt with one unique set of facts and did not shed much light on *Howey*'s application to the myriad of ICO tokens that were being developed and sold. While the SEC later provided more clarity on the issue as it brought additional cases, the DAO Report by itself was not enough to provide such notice.

Given the importance of the threshold question of whether an investment is a security, the SEC should have been more cautious in defining its own jurisdiction through the issuance of a Section 21(a) report. Courts give deference to agency interpretations of statutes,[12] but it is not prudent for an administrative agency to define its own jurisdiction without any scrutiny by an Article III judge. More importantly, the fact pattern raised in the DAO Report was not a common one and left unclear the application of *Howey* to other tokens. Just as the *Spartek* case raised questions about the SEC's legitimacy, the SEC's aggressive citation of the DAO Report was questionable.

This Article thus concludes that the SEC should refrain from using reports of investigation in closely contested cases, particularly those involving questions about its jurisdiction. Rather than unilaterally writing an advisory opinion that purportedly resolves the issue, the SEC should test its jurisdictional theories in federal court litigation. Alternatively, it could make its reports of investigation more effective by discussing a range of fact patterns that give clearer notice to the industry about the agency's position. In doing so, the SEC can better ensure the legitimacy of its enforcement efforts. The lessons of Karmel's dissent in *Spartek* are still relevant for the SEC today.

I. THE SEC'S EARLY USE OF SECTION 21(A) REPORTS OF INVESTIGATION

The SEC began its use of Section 21(a) reports of investigation fairly soon after the Exchange Act gave it the authority to do so. In 1940, it issued a notable report arising out of its investigation of McKesson & Robbins, a pharmaceuticals company that had forged inventory and receivables representing $19 million of its $87 million in reported assets.[13] The report reflected an exhaustive investigation that uncovered the details of a brazen fraud and discussed the broader concern of how the company's auditors failed to detect it.

12. *See* City of Arlington, Tex. v. FCC, 569 U.S. 290, 307 (2013) (holding that *Chevron* deference applies to agency interpretations of jurisdictional provisions in a statute).

13. In the Matter of McKesson & Robbins, Inc., Exchange Act Release No. 2707, 1940 WL 977 (Dec. 5, 1940).

In its early years, the SEC also filed Section 21(a) reports in cases involving misrepresentations in SEC filings. There were reports describing misstatements in proxy filings, periodic disclosure, and registration statements.[14] There were also reports faulting a controlling shareholder's lack of disclosure when purchasing the stock of minority shareholders.[15]

The SEC wrote one of its most interesting and innovative reports of investigation in response to the sudden collapse of the Penn Central railroad in 1970.[16] Formed just a couple of years before through the merger of the Pennsylvania and New York Central railroads, Penn Central filed for bankruptcy after its effort to raise funds through a bond offering failed.[17] The railroad had hidden the extent of the losses from its core railroad operations by selling assets to generate revenue. Retail investors were unaware of the extent of Penn Central's problems while institutional investors knew enough to exit the stock before the truth became widely known.[18]

The SEC was not the primary regulator of Penn Central. Railroads fell under the jurisdiction of the Interstate Commerce Commission, which produced an extensive report of the company's failure.[19] A congressional committee also published a five-volume report that examined Penn Central's corporate governance and the suspicious trading in its stock.[20] The SEC's effort in Penn Central can thus be understood as establishing its regulatory niche in the context of a high-profile corporate scandal.

The SEC's report articulated an ambitious shareholder wealth maximization theory of securities fraud against Penn Central and its top executives.[21] It claimed that the pressure on Penn Central to increase its earnings led the company to misrepresent its dire condition. The railroad did so through a number of tactics. First, it used the aggressive sale of its extensive property assets, which included interests in New York City

14. *See, e.g.*, Sec. & Exch. Comm'n Release Notice, Exchange Act Release No. 34-903, 1936 WL 31895 (Oct. 22, 1936) (proxy statement of Consolidated Film Industries); In the Matter of Alleghany Corp., Exchange Act Release No. 34-2423, 1940 WL 36352 (Mar. 1, 1940) (periodic filings); In the Matter of Elastic Stop Nut Corp. of Am., Exchange Act Release No. 3701 (June 12, 1945) (registration statement); In the Matter of Drayer-Hanson, Inc., Securities Act Release No. 3277 (Mar. 15, 1948) (registration statement).

15. *See, e.g.*, In the Matter of the Purchase and Retirement of Ward La France Truck Corp. Class "A" and Class "B" Stocks, Exchange Act Release No. 1786 (May 20, 1943).

16. The Financial Collapse of the Penn Cent. Co., Staff Report to the Special Committee on Investigations (1972).

17. JOSEPH R. DAUGHEN & PETER BINZEN, THE WRECK OF THE PENN CENTRAL 263 (5th ed. 1971).

18. For a fuller account of the Penn Central scandal, see JAMES J. PARK, THE VALUATION TREADMILL: HOW SECURITIES FRAUD THREATENS THE INTEGRITY OF PUBLIC COMPANIES (forthcoming 2022).

19. INTERSTATE COM. COMM'N, DOCKET NO. 35291, STATEMENTS CONCERNING PENN CENTRAL TRANSPORTATION COMPANY (1971).

20. STAFF OF H. COMM. ON BANKING AND CURRENCY, 92D CONG., THE PENN CENT. FAILURE AND THE ROLE OF FINANCIAL INSTITUTIONS (Comm. Print 1971).

21. The Financial Collapse of the Penn Cent. Co., *supra* note 16, at 33–34.

landmarks such as Madison Square Garden, to generate revenue to avoid reporting losses. Second, it issued optimistic statements and paid a healthy dividend to convey the impression that its business would improve.

Viewed today after the development of almost fifty years of doctrine on securities fraud liability, the report described many practices that would not be viewed as fraudulent under Rule 10b-5,[22] the primary anti-fraud provision that the SEC and investors assert against public companies. The conglomerate General Electric, for example, was known to routinely sell assets during the 1990s to meet its quarterly earnings projections.[23] Courts often dismiss general statements of optimism as not sufficiently misleading to support a claim under Rule 10b-5.

The SEC's broad view of securities fraud thus only reflected the agency's own view about the scope of Rule 10b-5. Its report recited factual findings that were not contested by a defendant. No federal judge evaluated the SEC's narrative to assess whether the alleged misconduct it described met the elements of a Rule 10b-5 claim. It would thus be a mistake to view the report as an uncontestable statement of the law of securities fraud.

The report did describe some transactions that would likely support Rule 10b-5 liability under modern case law. Penn Central's purported sale of a Six Flags Amusement Park to a partnership of investors seeking tax losses was questionable. Because Penn Central rather than the partnership retained most of the risk of owning the park, it was improper to treat the transaction as a sale to the investors. Penn Central's auditors defended the transaction on the ground that it only generated about $25 million in revenue and thus was not material. But the additional revenue it added permitted Penn Central to show a profit in a quarter where it had promised strong results. Without it, the railroad would have reported a loss to investors, potentially raising red flags about its financial condition.

The SEC followed its report by filing a complaint in district court against the company and its top executives under Rule 10b-5.[24] At the time, the SEC did not have the power to seek civil penalties against defendants. The only sanction it sought was an injunction that would prohibit the company from violating Rule 10b-5. The company quickly settled the case without contesting the allegations and agreed to the injunction. The SEC's securities fraud theory was also advanced by investors who sought damages through a class action and recovered about $10 million.

22. 17 C.F.R. § 240.10b-5 (2018).

23. *See, e.g.*, Jon Birger, *Glowing Numbers: Investors Know that General Electric Posts Great Earnings. How it Happens is More of a Mystery – And it Isn't Always Pretty*, MONEY MAG., Nov. 1, 2000.

24. Complaint at 1, Sec. & Exch. Comm'n v. Penn Cent. Co., 1974 WL 391, at *1 (E.D. Pa. May 2, 1974).

II. SPARTEK

By the end of the 1970s, enforcement was a major part of the SEC's regulatory toolkit. Notably, it formed a separate division of enforcement in 1972. The director of that division through most of the 1970s, Stanley Sporkin,[25] was known as an aggressive and effective enforcer who sought to extend the SEC's jurisdiction beyond securities fraud to regulate the corporate governance of large public companies.

Roberta Karmel was appointed by President Carter to the SEC and began serving as a Commissioner in 1977. She had started her legal career as an SEC enforcement attorney in the New York Regional Office in 1962.[26] She then worked in private practice from 1969 to 1977. Unlike Sporkin, who was in private practice for just one year before joining the SEC, Karmel had substantial experience advising corporate clients.[27]

Through much of the 1970s, public trust in corporations was generally low.[28] Corporate scandals such as the Penn Central disaster reinforced the perception that public company managers were not just selfless organization men. Corporate giants performed poorly in an economy with high inflation and increasing competition from foreign manufacturers. The stock market was generally depressed. There was a general sense that U.S. public companies were poorly managed and bureaucratic.[29]

Perhaps because of the perception that public companies were mismanaged, the SEC did not see its role as limited to sanctioning public companies that issued misleading disclosure. It attempted to more broadly

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25. Sporkin was Deputy Director of the Division of Enforcement from 1972 to 1974 and the Director from 1974 to 1981.

26. Prior to law school, Karmel worked for a brokerage firm. *See* KARMEL, *supra* note 9, at 23–24.

27. Karmel later discussed the influence of that experience:

> My view of the SEC began to change, in part because I was looking at the Commission from a different perspective. In representing private clients before the Commission, I found much of the staff maddening because they had such a rigid and limited view of the business world. In general, their minds were closed to any version of fact or law that did not meet their preconceived ideas.

KARMEL, *supra* note 9, at 29; *see also* Roberta S. Karmel, *From SEC Enforcement Attorney to Commissioner*, 65 MD. L. REV. 692, 700 (2006) (noting that because of her time in the private sector, "I did not think business people were a bunch of crooks but rather the same mix of good and bad men and women found in other parts of our society, including government."). Some commentators have questioned whether the revolving door between private practice and the SEC could make the agency unduly friendly to business. For some recent contributions to this debate, see James D. Cox & Randall S. Thomas, *Revolving Elites: The Unexplored Risk of Capturing the SEC*, 107 GEO. L.J. 845 (2019); Alexander I. Platt, *The Non-Revolving Door*, 46 J. CORP. L. 751 (2021).

28. *See, e.g.*, Harwell Wells, *"Corporation Law is Dead": Heroic Managerialism, Legal Change, and the Puzzle of Corporation Law at the Height of the American Century*, 15 U. PA. J. BUS. L. 305, 348–49 (2013).

29. *See, e.g.*, Robert H. Hayes & William J. Abernathy, *Managing Our Way to Economic Decline*, HARV. BUS. REV., at 67 (1980).

regulate the governance of large corporations to help ensure that they acted in the interests of shareholders. In some cases, the SEC interpreted its power to order injunctive relief broadly to require companies to adopt corporate governance reforms.

There was a serious question as to whether the SEC had authority to control corporate governance given its specific charge to enforce the securities laws. In 1977, the U.S. Supreme Court had decisively rejected an attempt by private plaintiffs to broadly read Rule 10b-5 to support a claim for breach of fiduciary duty without any allegation of a material misrepresentation.[30] Commentators also questioned the effectiveness of some of the SEC's efforts to regulate general corporate misconduct.[31]

The SEC's emphasis on corporate governance was reflected in its reports of investigation. Starting in the mid-1970s, the SEC used such reports to convey its views about the obligations of public company directors. It addressed the duty of independent directors to inform themselves,[32] the board's review of interested transactions,[33] the duty of the board to disclose information to investors,[34] and the propriety of stock sales by board directors.[35] In 1979, the SEC released at least four reports of investigation, the most Section 21(a) reports ever issued in a single year.[36]

One of those reports arose out of an SEC investigation involving Spartek, an Ohio tiling manufacturer listed on the American Stock Exchange. Spartek had a controlling shareholder who wanted to sell the company to an

30. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 475 (1977).

31. *See, e.g.*, John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1246–75 (1977).

32. Report of Investigation in the Matter of Stirling Homex Corp. Relating to Activities of the Board of Directors of Stirling Homex Corp., Exchange Act Release No. 34-11516, 7 SEC Docket 298-01 (July 2, 1975).

33. Report Pursuant to Section 21(a) of the Sec. Exch. Act of 1934 Regarding the Investigation of Gould Inc., Exchange Act Release No. 34-13612, 12 SEC Docket 773-02 (June 9, 1977).

34. Report of Investigation in the Matter of Nat'l Tel. Co., Inc., Relating to Activities of the Outside Directors of Nat'l Tel. Co., Inc., Exchange Act Release No. 34-14380, 13 SEC Docket 1393-1 (Jan. 16, 1978).

35. Report of Investigation in the Matter of Sterling Drug, Inc., Exchange Act Release No. 34-14675, 14 SEC Docket 824-1 (Apr. 18, 1978).

36. *See* Spartek, *supra* note 7, at 4 (disclosure to minority shareholders concerning company sale); Report of Investigation in the Matter of Greater Wash. Invs., Inc., Exchange Act Release No. 34-15673, 17 SEC Docket 40-02 (Mar. 22, 1979) (investment company board); Sec. & Exch. Comm'n Staff Rep. on Transactions in the Marine Protein Corp. Indus. Dev. Revenue Bonds, Exchange Act Release No. 34-15719, 17 SEC Docket 257-01 (Apr. 11, 1979) (issuance of industry revenue bonds); Sec. & Exch. Comm'n Staff Report on Proxy Solicitations in Connection with Compass Investment Group, Exchange Act Release No. 34-16343, 18 SEC Docket 927-1 (Nov. 15, 1979) (disclosure between proxy filing and annual meeting); *see also* Sec. & Exch. Comm'n, Exchange Act Release No. 34-15746, 17 SEC Docket 302-01 (Apr. 18, 1979) (issuing statement rather than report pursuant to section 21(a)). The SEC also issued a report relating to its investigation of the default of New York City on municipal bonds to Congress. *See* STAFF OF S. COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 96TH CONG., REP. IN THE MATTER OF TRANSACTIONS IN THE SECURITIES OF THE CITY OF NEW YORK (Comm. Print 1979).

acquirer.[37] Such transactions raise the concern that the board, which consists of directors appointed by the controlling shareholder, will not adequately protect the interests of the other shareholders. Minority shareholders have the right to bring a corporate derivative action against the board if they believe that the board breached its fiduciary duties to them in approving the transaction.

While a breach of fiduciary duty does not necessarily involve the issuance of a misleading statement that would trigger securities fraud liability, in *Spartek* the sale of assets required approval by the shareholders. The proxy statement that would inform the minority shareholders of the transaction allegedly omitted information about how the sale would generate certain tax benefits for the controlling shareholder.[38] As the SEC described, the document "failed to disclose certain principal reasons for the transaction, including the fact that the transaction was structured to give management certain advantages not necessarily available to other shareholders."[39] If they had known this information, the shareholders voting on the transaction might have been suspicious that the controlling shareholder was willing to accept a lower price for the company because it would capture those savings.[40]

The SEC had a solid argument that the proxy disclosure relating to the transaction was misleading, but it did not have jurisdiction to file an administrative action for such a violation. A misleading proxy statement would run afoul of Section 14 of the Securities Exchange Act. But Section 15(c)(4), which gives the SEC the authority to initiate an administrative hearing, did not cover Section 14 violations. At the time, it only permitted an action for violations of Sections 12, 13, and 15(d) of the Exchange Act, which require periodic reporting by public companies.[41] As Karmel observed, "[t]he language of the section and its legislative history indicate that its purpose was

37. Two brothers owned 39.6% of the company's stock. Spartek, *supra* note 7, at 3–4.

38. The proxy statement was never actually sent to the shareholders. The company postponed the mailing because of the SEC's investigation. *Id.* at 8. In addition, the statement allegedly failed to disclose management's belief that the company's land had substantial resources that would increase the value of the company. *Id.* at 13–14.

39. *Id.* at 21.

40. The SEC found that the company had negotiated a price of 5 to 6 percent less than what the controlling shareholder believed the company was worth. *See id.* at 12.

41. As described in *Spartek*, the section at the time provided:

> that if the Commission finds, after notice and opportunity for hearing, that any person subject to the provisions of Section 12, 13 or subsection (d) of Section 15 of the Exchange Act or any rule or regulation thereunder has failed to comply with any such provision, rule or regulation in any material respect, the Commission may publish its findings and issue an order requiring such person to comply with such provision or such rule or regulation thereunder upon such terms and conditions and within such time as the Commission may specify in such order.

Spartek, *supra* note 7, at n.1. Later, Congress amended this provision to permit administrative actions arising out of Section 14 violations.

to give the Commission authority to resolve accounting issues and to require timely and accurate filings."[42]

The SEC decided to finesse its inability to bring an administrative proceeding by instead filing a Section 21(a) report of investigation describing Spartek's alleged Section 14 violation. Simultaneously, it filed an administrative order alleging that Spartek had violated Section 13, which governs public company disclosure, by failing to file an interim disclosure about the transaction on Form 8-K.[43] Spartek filed an Offer of Settlement and agreed to various undertakings proposed by the SEC.

Even if Spartek was required to file an 8-K,[44] the SEC was mainly pursuing Spartek because of its belief that the company was not treating its minority shareholders fairly. This was evidenced by one of the remedies that Spartek agreed to in resolving the case. The SEC required the company to appoint a "special review person" to represent the interests of the minority shareholders in the transaction.[45] More invasively, it required the controlling shareholders to agree to restrictions on the voting of their shares with respect to the approval of the sale.[46] Such remedies could only be justified based on the Section 21(a) report's finding that the company had authored a misleading proxy statement, presumably to cheat the minority shareholders. But that conduct could not be the basis for an administrative order against Spartek.

Karmel dissented in *Spartek*.[47] Her main objection was that a report of investigation should not be used to justify a sanction in a case. Such reports may only describe violations of the securities laws, and the report mainly described conduct by Spartek that the SEC did not have the authority to address. The SEC could not circumvent its limited authority under Section 15(c)(4) by supplementing its case with facts from a report of investigation. Rather than exceed its statutory power, Karmel believed that the proper course of action would have been for the SEC to seek additional authority from Congress. She explained: "If the Commission does not have adequate remedies for handling cases like this under the present law, it should request further authority from the Congress. The implication of new remedies by a

42. *Id.* at 33.

43. The SEC later noted that its investigative reports had been accompanied by enforcement actions in a "a number of instances." *Id. See generally* The Commission's Practice Relating to Reports of Investigations and Statements Submitted to the Commission Pursuant to Section 21(a) of the Securities Exchange Act of 1934, *supra* note 2.

44. Karmel took the position that it was "doubtful" that the company had an obligation to file an 8-K. Spartek, *supra* note 7, at 33.

45. *Id*. at 23.

46. The controlling shareholders could only vote "the percentage of their common stock for approval of the proposed transaction [that] equal[ed] the percentage that all other common stock voted for approval of the proposal. . . ." *See* The Commission's Practice Relating to Reports of Investigations and Statements Submitted to the Commission Pursuant to Section 21(a) of the Securities Exchange Act of 1934, *supra* note 2, at 24.

47. At the time, written dissents by SEC Commissioners were unusual.

government agency is not an appropriate way to vindicate or develop the law."[48] In response, one of the Commissioners who signed on to the majority opinion expressed the expansive view that the SEC could "obtain relief in the form of restrictions and safeguards which will protect investors, even if they are not specifically described in the statute book."[49]

In Karmel's view, by acting beyond its authority, the SEC risked undermining its legitimacy. How could a regulator tasked with enforcing the rules bend them to suit the needs of an individual case? She argued that "[o]verreach by administrative agencies inevitably results in diminished respect for the processes of government and for the law."[50] Specifically, Karmel objected to the "use of such a weak jurisdictional nexus to impose sanctions," particularly relief that was "a questionable incursion into state corporation law."[51] The issue of the SEC's limited power to regulate corporate governance was an important one for Karmel. Years later, she noted, in criticizing efforts to expand federal corporate law, how the SEC had long "aspired to regulate corporate governance."[52]

In addition to legitimacy concerns, *Spartek* raised a due process issue. Companies like Spartek were not on notice that they could be sanctioned for violations of Section 14. The tile maker would not have known that going forward with the transaction could trigger an obligation to appoint a special master and the dilution of the controlling shareholder's voting rights. If it had understood the SEC's expectations, it might have avoided a scandal. The issue of notice was an important one for Karmel. She later wrote: "I believe that clarity and predictability, especially in a regulatory scheme as complex as the securities laws, is an important ingredient of respect for the law. It is important for the SEC and the courts, as well as for the Congress, to state clearly what the law is and why conduct against which action is taken is proscribed."[53]

Karmel's criticisms of legitimacy and due process were widely noted. Her dissent was covered in the *New York Times*, which observed: "Commissioners customarily act on the basis of consensus. Public disagreements about the handling [of] commission enforcement actions are rare."[54] Karmel not only dissented in *Spartek* but filed dissents in several

48. Spartek, *supra* note 7, at 39–40.

49. *Id.* at 26.

50. *Id.* at 31.

51. *Id.* at 34, n.4; *see also* KARMEL, *supra* note 9, at 197 ("As a commissioner I began to be very troubled by this use of publicity to do indirectly what the Commission had no direct authority to accomplish—sanction corporate officers and directors and effect corporate governance changes").

52. Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 80 (2005); *see also* James J. Park, *Reassessing the Distinction Between Corporate and Securities Law*, 64 UCLA L. REV. 116, 128 n.50 (2017).

53. Karmel, *supra* note 9, at 201.

54. *Tile Maker Accused on Stock Laws*, N.Y. TIMES, Feb. 15, 1979, at D3.

other reports of investigation issued by the SEC in 1979.[55] Karmel became viewed as a counterweight to what some viewed as an overaggressive SEC.

III. THE MODERN SEC REPORT OF INVESTIGATION

The decade after *Spartek* saw an SEC that largely abandoned the view that it should attempt to regulate public company governance. At least for the first half of the 1980s, the SEC continued to use reports of investigation regularly, issuing about two a year through the mid-1980s.[56] After the 1980s, the SEC has filed on average less than one Section 21(a) report a year.[57] For the most part, the SEC has moved away from using reports of investigation to address controversial issues. The modern Section 21(a) report of

55. *See, e.g.*, Report of Investigation in the Matter of Greater Wash. Invs., Inc., Exchange Act Release No. 34-15673, at 11 (Mar. 22, 1979); Sec. & Exch. Comm'n Staff Rep. on Transactions in the Marine Protein Corp. Indus. Dev. Revenue Bonds, Exchange Act Release No. 34-15719, at 5 (Apr. 11, 1979); Sec. & Exch. Comm'n Staff Report on Proxy Solicitations in Connection with Compass Investment Group, Exchange Act Release No. 34-16343, at 6 (Nov. 15, 1979). About a month after *Spartek*, the SEC issued a statement on its use of reports of investigations. In that statement, it announced a new policy where parties could resolve an enforcement action by submitting a written statement describing the matter and committing to certain actions. *See* The Commission's Practice Relating to Reports of Investigations and Statements Submitted to the Commission Pursuant to Section 21(a) of the Securities Exchange Act of 1934, *supra* note 2. The same day, the SEC published such a statement by two individuals. *See* Securities Exchange Act Release No. 34-15665 (Mar. 21, 1979). Karmel dissented from the decision to issue the statement on the ground that this new practice was an administrative remedy which the SEC did not have the authority to impose. *Id*. Years later, the SEC attempted to revive these signed statements in requiring WorldCom to explain the circumstances of its accounting restatement. *See* Report of the Task Force on Exchange Act Section 21(a) Written Statements, 59 BUS. LAW. 531, 539 (2004).

56. *See* Report of Investigation in the Matter of Inv. Info., Inc. Relating to the Activities of Certain Inv. Advisers, Banks, & Broker-Dealers, Exchange Act Release No. 34-16679 (Mar. 19, 1980) (discussing soft dollars); Report of Investigation in the Matter of Certain Activities of South Chicago Savings Bank and James A. Fitch, Exchange Act Release No. 34-17928 (July 10, 1981) (misleading annual reports); Report of Investigation in the Matter of Bull & Bear Mgmt. Corp., Bassett S. Winmill & Robert D. Anderson, Exchange Act Release No. 34-769 (Aug. 7, 1981) (investment advisor self-dealing); Report of Investigation in the Matter of Sharon Steel Corp. as it Relates to Prompt Corp. Disclosure, Exchange Act Release No. 34-18271 (Nov. 19, 1981) (insider trading); In the Matter of Fid. Fin. Corp. & Fid. Sav. & Loan Ass'n, Exchange Act Release No. 34-18927 (July 30, 1982) (disclosure of repo transactions); In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 34-19070 (Sept. 21, 1982) (broker-dealer duty to monitor advisor); In the Matter of Union Home Loans, Union Home Loans of Arizona, W. Computer Servs. d/b/a W. Loan Servs., Exchange Act Release No. 34-19346 (Dec. 16, 1982) (loan product was a security); In The Matter of Aetna Life and Casualty Company, Exchange Act Release No. 34-19949 (July 7, 1983) (reporting of tax benefits); In the Matter of Seaboard Assocs., Inc., Exchange Act Release No. 34-20867 (Apr. 16, 1984) (duty of investment company directors); In the Matter of Howard Bronson & Co. and Thomas F. Pate, Exchange Act Release No. 34-21138 (July 12, 1984) (obligation of public relations firms); In the Matter of Carnation Co., Exchange Act Release No. 34-22214 (July 8, 1985) (duty to disclose preliminary acquisition discussions); E.F. Hutton & Co. Inc. and The E.F. Hutton Group Inc., Order of Temporary Exemption and Notice of and Order for Hearing on Application, Investment Company Act Release No. IC-14774 (Oct. 29, 1985) (internal controls for cash management practices).

57. The SEC has a list on its website of the reports of investigation it has filed since the mid-1990s. *See* SEC. & EXCH. COMM'N, REPORTS OF INVESTIGATIONS, https://www.sec.gov/litigation/investreports.shtml (last visited Aug. 30, 2021).

investigation has been most frequently used to clarify basic duties under the securities laws. This Part discusses the major subjects of these reports – compliance, municipalities, stock markets, and enforcement.

A. COMPLIANCE

Compliance is a common subject of SEC investigative reports. Such reports often reach beyond the facts of a particular case to clarify the SEC's views on the obligations of regulated parties.[58] They include discussions similar to dicta in judicial opinions that may not be necessary to adjudicate a case but explain the law in order to encourage compliance.

For example, during the early 1990s, the SEC issued a report of investigation relating to Salomon Brothers and its top executives. One of the bank's traders had circumvented federal limits on its ability to submit bids for treasury bonds by issuing bids in the name of customers without their consent.[59] The report discussed the obligations of the legal officers of broker-dealers to report misconduct by lower-level employees. Like *Spartek*, the report of investigation accompanied an administrative proceeding, but unlike *Spartek*, the legal officer whose conduct was discussed was not sanctioned in the proceeding.[60]

Investigative reports can also collect a variety of examples to underscore the importance of an issue. A 2018 SEC report of investigation described how nine different issuers lost a total of nearly $100 million in an e-mail scam.[61] The issuers "had procedures that required certain levels of authorization for payment requests, management approval for outgoing wires, and verification of any changes to vendor data," but the procedures failed, "at least in part, because the responsible personnel did not sufficiently understand the company's existing controls or did not recognize indications in the emailed instructions that those communications lacked reliability."[62] The SEC did not bring enforcement against the companies but issued a report "to make issuers and other market participants aware that these cyber-related threats of spoofing or manipulated electronic communications exist and should be considered when devising and maintaining a system of internal accounting controls as required by the federal securities laws."[63] While it was "not suggesting that every issuer that is the victim of a cyber-related scam is, by extension, in violation of the internal accounting controls requirements of

58. A less confrontational approach can generate more effective compliance than adversarial enforcement. *See* Miriam H. Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949 (2009).

59. In the Matter of Gutfreund, Exchange Act Release No. 34-31554 (Dec. 3, 1992).

60. *Id.*

61. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding Certain Cyber-Related Frauds Perpetrated Against Public Companies and Related Internal Accounting Controls Requirements, Exchange Act Release No. 34-84429 at 1–3 (Oct. 16, 2018).

62. *Id.* at 5–6.

63. *Id.* at 2.

the federal securities laws," the SEC made it clear that issuers had an obligation to "calibrate their internal accounting controls to the current risk environment and assess and adjust policies and procedures accordingly."[64]

The SEC also uses reports of investigation to define ambiguous regulatory requirements. It issued a report instructing that auditor independence rules would prohibit an auditor from loaning staff members to its clients.[65] Even though it had decided not to bring an action, the SEC issued a report to "address uncertainty regarding the Commission's interpretation" of the relevant provisions.[66] It has also issued reports on the scope of Regulation Fair Disclosure (FD), which prohibits selective disclosure of material information by issuers to research analysts.[67] Regulation FD has been controversial because it attempted to change the established practice of private meetings between company managers and analysts. Such meetings are a way that corporations can supplement their written disclosures and increase the efficiency of stock markets.[68] A report concluded that Motorola ran afoul of Regulation FD by calling research analysts to clarify that an earlier release indicating "significant weakness" in sales reflected a decline of 25 percent or more.[69] The SEC maintained that the information was material and thus its release violated Regulation FD.[70] But the SEC did not impose sanctions on Motorola because the company had acted on the advice of its counsel.[71] Another report of investigation sought to address "uncertainty concerning how Regulation FD [applied] to disclosures made through social media channels" and warned that posting company information to a Facebook page could violate Regulation FD.[72]

B. MUNICIPALITIES

The SEC also often uses reports of investigation in cases involving securities law violations by municipalities. Local governments routinely sell securities to finance their operations. Default on such obligations is rare but

64. *Id*. at 6.

65. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: KPMG, LLP, Exchange Act Release No. 34-71390 (Jan. 24, 2014).

66. *Id.*

67. 17 C.F.R. § 243 (2019).

68. *See, e.g.*, James J. Park, *Insider Trading and the Integrity of Mandatory Disclosure*, 2018 WISC. L. REV. 1133, 1160–63, 1170–71. For Karmel's views on insider trading, *see* Roberta S. Karmel, *The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why a Property Rights Theory of Inside Information is Untenable*, 59 BROOK. L. REV. 149, 152 (1993).

69. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Motorola, Inc., Exchange Act Release No. 34-46898, at 1 (Nov. 25, 2002).

70. *Id*. at 4.

71. *Id*. at 4–5.

72. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings, Exchange Act Release No. 34-69279, at 1 (Apr. 2, 2013).

can have a substantial impact on the public when it occurs.[73] Municipal officials, who are often elected, may not have the experience to provide accurate disclosures to investors concerning the risks of a financial crisis.[74]

The bankruptcy of Orange County, California, following significant losses from its purchase of interest rate derivatives, prompted a report that found it had issued misleading disclosures.[75] The SEC concluded that the county's officials had "failed to disclose material information" about its "ability to repay its securities absent significant interest income" from a county investment fund.[76] The SEC warned that the antifraud provisions of the federal securities laws impose responsibilities on public officials in addition to the "responsibilities imposed on issuers of municipal securities."[77]

Years later, the bankruptcy filing of the City of Harrisburg, Pennsylvania prompted the SEC to reiterate the obligation of municipalities to issue truthful information.[78] A report of investigation concluded that the city "misrepresented and omitted to state material information regarding Harrisburg's deteriorating financial condition and credit ratings downgrades" and "did not provide to the public current and accurate information regarding the City's financial condition."[79] The SEC warned that public officials, at a minimum, should identify those "involved in the disclosure process" and ensure that such individuals are trained in their obligations under federal securities laws.[80]

The SEC has also issued reports relating to various intermediaries that facilitate municipal finance and investment. In one report, it provided an example of a conflict of interest that would prevent an investment banker from servicing a municipal client.[81] In a case involving an Alabama pension fund, which was represented by Stanley Sporkin (who had by then moved into private practice),[82] the SEC decided not to penalize the fund for insider trading because it knew that the costs of any fine would be borne by

73. The SEC issued such a report in connection with New York City's default on $4 billion in municipal securities during the 1970s. STAFF OF S. COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, supra note 36.

74. Wall Street banks may view such municipal officials as easy targets. *See* FRANK PARTNOY, FIASCO: THE INSIDE STORY OF A WALL STREET TRADER (1999).

75. Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors, Exchange Act Release No. 34-36761 (Jan. 24, 1996).

76. *Id.* at 2.

77. *Id.* at 7.

78. Report of Investigation in the Matter of the City of Harrisburg, Pennsylvania Concerning the Potential Liability of Public Officials with Regard to Disclosure Obligations in the Secondary Market, Exchange Act Release No. 34-69516 (May 6, 2013).

79. *Id.* at 1.

80. *Id.* at 2.

81. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: JP Morgan Securities, Inc., Exchange Act Release No. 34-61734 (Mar. 18, 2010).

82. Perlman, *supra* note 5, at 927.

pensioners.[83] However, it warned that such funds have obligations to prevent insider trading on material information, and wrote to "emphasize the responsibilities of all investment professionals, including large public retirement systems and other public entities, under the federal securities laws and to highlight the risks they undertake when they operate without a compliance program."[84]

C. STOCK MARKETS

The SEC has also used reports of investigation to publicize systemic problems in stock markets.[85] The Exchange Act gives the SEC authority over such markets, which are primarily self-regulated. The SEC has occasionally intervened to correct substantial deficiencies in market regulation.[86]

In the mid-1990s, the SEC faulted the National Association of Securities Dealers (NASD), for failing to investigate anticompetitive practices at the Nasdaq Stock Market.[87] The NASD did not adequately respond to evidence of collusion with respect to bid-ask spreads in the Nasdaq market.[88] The SEC found that market makers on the Nasdaq used an arbitrary pricing convention that led to an artificially larger spread than the market would have dictated.[89] The report concluded that the failure to respond could be traced to the failure of the NASD to adequately separate its regulatory functions from the business interests of its governing actors.[90] The NASD agreed to form a separate regulatory body and increase its staff and resources.[91]

About a decade later, the SEC again found that the NASD's enforcement was lacking.[92] The Nasdaq market failed to report questionable practices to

83. *Id*. at 906.

84. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The Retirement Systems of Alabama, Exchange Act Release No. 34-57446, at 1 (Mar. 6, 2008).

85. Early examples of such reports involved the New York and American Stock Exchanges. *See* In the Matter of Richard Whitney, et al. (1938); SEC STAFF REPORT ON ORGANIZATION, MANAGEMENT, AND REGULATION OF CONDUCT OF MEMBERS OF THE AMERICAN STOCK EXCHANGE (1962).

86. Karmel wrote extensively on stock exchanges and their regulation. *See, e.g.*, Roberta S. Karmel, *Securities Industry Self-Regulation–Tested by the Crash*, 45 WASH. & LEE L. REV. 1297, 1299 (1988) (calling for stronger government oversight); Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 369 (2002) (describing regulatory issues raised by demutualization of exchanges).

87. Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market 1 (Aug. 8, 1996).

88. *Id*. at 2–3.

89. *Id*. at 2; *see also* Karmel, *supra* note 86, at 386 (describing "pricing convention where Nasdaq stocks were quoted in even eighths").

90. *See* Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market, *supra* note 87, at 35–42.

91. *Id*. at 44.

92. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding The Nasdaq Stock Market, Inc., as Overseen By Its Parent, The National Association of Securities Dealers, Inc., Exchange Act Release No. 34-51163 (Feb. 9, 2005).

NASD enforcement because of insufficient protocols and procedures.[93] The SEC again warned that Self-Regulatory Organizations (SROs) "must ensure that they effectively manage the inherent conflicts between their role as a market and their role as a regulator."[94] Just a few years after this report was issued, the NASD and New York Stock Exchange merged their regulatory bodies to create a more independent enforcement body, the Financial Industry Regulatory Authority (FINRA).

D. ENFORCEMENT

Finally, the SEC uses reports of investigation to communicate aspects of its enforcement policy. For example, in 2001, it used a report to define factors it would consider in bringing an enforcement action and seeking damages against a company.[95] The report arose out of an investigation where the SEC chose not to file a case against a company for misstatements caused by its controller. It explained that in making its decision not to pursue an action, it considered the company's internal investigation after the discovery of the misconduct, dismissal of the responsible individuals, restatement of the erroneous financial statements, and cooperation with the SEC's investigation.[96] The SEC listed thirteen factors it would consider in determining whether to bring an action and seek sanctions.[97]

In a report issued soon after the Dodd-Frank Act confirmed that the SEC had the power to apply Rule 10b-5 to extraterritorial conduct,[98] the agency signaled its intention to rely on that provision.[99] In the course of investigating errors in the credit ratings of European bonds, the SEC noted that while its jurisdiction was uncertain over the transactions at issue, in other cases it would use the "recent legislative provisions granting jurisdiction for enforcement actions alleging otherwise extraterritorial fraudulent misconduct that involves significant steps or foreseeable effects within the United States."[100]

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93. *Id*. at 4.

94. *Id*. at 6.

95. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 34-44969 (Oct. 23, 2001).

96. *Id*. at 1.

97. *Id*. at 2–3.

98. In *Morrison v. National Australia Bank*, 561 U.S. 247 (2010), the Supreme Court affirmed the dismissal of a private Rule 10b-5 class action by investors who purchased their shares on a foreign stock exchange. Section 929P(b) of Dodd-Frank clarified that the SEC has wider extraterritorial jurisdiction than private parties. One of Karmel's first law review articles cautioned against the extraterritorial application of federal securities law. *See* Roberta S. Karmel, *The Extraterritorial Application of the Federal Securities Code*, 7 CONN. L. REV. 669, 672 (1975); *see also* Roberta S. Karmel, *The Second Circuit's Role in Expanding the SEC's Jurisdiction Abroad*, 65 ST. JOHN'S L. REV. 743, 747–48 (1991).

99. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Moody's Investors Service, Inc., Exchange Act Release No. 34-62802 (Aug. 31, 2010).

100. *Id*. at 5.

The SEC also continues to file reports involving issuer misstatements. For example, it published a report taking the position that a representation in a merger proxy statement that the acquired company was compliant with the Federal Corrupt Practices Act was misleading given the firm's later settlement of an SEC action alleging such violations.[101] Another example was a report faulting a company for its failure to disclose retirement benefits in various filings.[102] The SEC explained it wanted "to emphasize the affirmative responsibilities of corporate officers and directors to ensure that the shareholders whom they serve receive accurate and complete disclosure of information required by the proxy solicitation and periodic reporting provisions of the federal securities laws."[103]

IV. THE DAO REPORT

For the last twenty-five years, SEC reports of investigation have generally not delved into issues of law that are particularly complex. They have mostly used examples of straightforward factual situations to emphasize the importance of basic obligations under the securities laws.

Several years ago, the SEC departed from this norm in using a Section 21(a) report of investigation to signal its view that it had jurisdiction to regulate digital tokens issued through ICOs. Such tokens are distributed using blockchain technology, which creates a digital ledger that is maintained by a decentralized network of participants who confirm the validity of transactions involving the tokens. ICO tokens can be sold to investors for cash or other digital currencies. They may convey the right to access some service.

Unless they are securities, the SEC does not have the power to regulate tokens. The disclosure and anti-fraud provisions of the securities laws only apply to the interstate sale of securities. Not all investments are securities. For example, currencies are often viewed as investments but they are generally not regulated by the securities laws. At the time ICOs became widely used, some digital currencies based on blockchain technology such as Bitcoin had been freely sold to investors without SEC registration.

The question of whether novel investments such as ICO tokens are securities is governed by the Supreme Court's decision in *Howey*.[104] That case set forth a test for determining whether a transaction involved an

101. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on Potential Exchange Act Section 10(b) and Section 14(a) Liability, Exchange Act Release No. 34-51283 (Mar. 1, 2005).

102. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co., Exchange Act Release No. 34-39157 (Sept. 30, 1997). One Commissioner dissented, contending that the disclosure rules were vague and that the company could rely on the advice of counsel in the case. *Id.* at 10.

103. *Id.* at 2.

104. SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

"investment contract" that would be classified as a security.[105] *Howey* found that the combination of a land contract conveying an interest in Florida land containing orange trees and a service contract to maintain, harvest and sell the oranges, was a security. The investment was not just in the orange trees but in a venture that pooled funds to operate a business that grew and sold oranges for profit.

A key consideration in determining the status of an investment under *Howey* is whether the investors rely on the "efforts of others" to generate profits. The purchase of a security is essentially an investment in a business that is run by third parties. The securities laws are necessary to protect investors who are uninvolved in the day-to-day operations of the venture and thus are unfamiliar with its condition. The "efforts of others" element of the *Howey* test differentiates investments in securities from investments where there is less need to monitor others.

For example, the "efforts of others" test has been applied to distinguish between general and limited partnerships. General partnership interests that are sold to partners who make an investment in the business and are actively part of it are not securities. In contrast, limited partnership interests, which are sold to limited partners who delegate operational decisions to a general partner but share its profits, are often considered to be securities. General partners do not rely mainly on the "efforts of others" and can monitor their own business, while limited partners rely on others to run a business and need disclosure to adequately assess the venture's condition and prospects.[106]

The SEC's first major application of the *Howey* test to digital assets involved the sale of tokens by an investment fund called the DAO. The DAO was organized to invest in tokens issued by other blockchain projects. Purchasing a DAO token entitled the investor to profits from such investments. DAO tokens thus differed from cryptocurrencies like Bitcoin that did not promise profits from a venture.

The DAO, though, was arguably not a security under *Howey* because it was designed so it would function without a central organizer that investors would rely upon to generate profits. Because DAO token holders had the right to vote on which projects the DAO would invest in, the fund would essentially run itself. If DAO investors actively participated in the fund's investment decision making, they would be in a similar position as general partners and their investments would not rely on the "efforts of others" for profits.

In its report of investigation, the SEC took on an issue that was much more complex than the typical compliance violation it addressed in such

105. *Howey* provides that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party." *Id.*

106. *See, e.g.*, United States v. Leonard, 529 F.3d 83 (2d Cir. 2008).

reports. The DAO Report had to navigate a difficult jurisdictional issue in the context of a new technology.

The SEC rejected the argument that the investor's right to choose projects meant that the DAO tokens did not fall under the *Howey* test. It highlighted the fact that the projects investors would vote on were pre-screened by a small group of individuals.[107] It was thus not a purely decentralized investment club that crowdsourced promising token investments. The success of the venture would hinge on the ability of the DAO group to identify promising investments that would then be voted on by the DAO investors.

The SEC's conclusion that the DAO investors relied on the "efforts of others" was reasonable, but it was not the only possible outcome of an application of the *Howey* test to this arrangement.[108] A fact finder could have concluded that the screening was not sufficient to establish that the investors relied on the "efforts of others." There was ambiguity with respect to how the screening would work in practice, especially because the DAO only operated for a short time before essentially shutting down.[109] While the SEC claimed that the screeners had the power to impose subjective criteria to control the proposals that were voted on, it did not provide evidence that they actually did so to arbitrarily exclude proposals from consideration. The SEC relied on a "few draft proposals" that were not accompanied by adequate information to conclude that the token holders could not make informed voting decisions. But it was possible that future proposals would have contained enough information to make the votes meaningful.[110]

In addition to being a close call, the DAO Report related to a very specific set of facts – an investment fund where token-holders had the right to approve pre-screened investments. Most blockchain projects did not fit this mold. Many ICO tokens did not give investors the explicit right to profits. One of the essential elements of *Howey* is that the investment must be made with the expectation of profits. In what circumstances could tokens that did not convey a right to profits but might rise in value in secondary trading markets be considered securities?

107. DAO Report, *supra* note 10, at 5.

108. *See* Randolph A. Robinson II, *The New Digital Wild West: Regulating the Explosion of Initial Coin Offerings*, 85 TENN. L. REV. 897, 940–43 (2018); *see also* Usha R. Rodrigues, *Law and the Blockchain*, 104 IOWA L. REV. 679, 700 (2019).

109. The DAO was subject to a hacking attempt that resulted in the diversion of its funds. *See* Nathaniel Popper, *A Hacking of More Than $50 Million Dashes Hopes in the World of Virtual Currency*, N.Y. TIMES (June 17, 2016), https://www.nytimes.com/2016/06/18/business/dealbook/hacker-may-have-removed-more-than-50-million-from-experimental-cybercurrency-project.html [https://perma.cc/FN78-C5CK].

110. DAO Report, *supra* note 10, at 15. The SEC also noted that token holders were too dispersed to effectively exercise control over the enterprise, *id.* at 14–15, but prior blockchain efforts such as Bitcoin involved dispersed stakeholders who effectively ran the enterprise. *See, e.g.*, Rainer Böhme, Nicolas Christin, Benjamin Edelman & Tyler Moore, *Bitcoin: Economics, Technology, and Governance*, 29 J. ECON. PERSP. 213, 213–14 (2015).

Because the SEC did not bring an enforcement case against the founders of the DAO, they did not have a strong incentive to dispute the report's characterization of the facts. The DAO might have faced the prospect of private litigation from its investors, who could have sought recission under the securities laws. But because the DAO was essentially defunct by the time the DAO Report was issued, the investors likely would have had a strong case for a refund of their investment regardless of whether their purchase involved a security. The SEC's characterization of how the DAO actually operated, which was critical in concluding that the DAO tokens were securities, was thus not subject to the normal adversarial process.

The DAO Report represented the SEC's views with respect to just one close case, but the SEC treated *DAO* as establishing the regulatory status of other tokens. In later cases, the SEC implied that once it issued the DAO Report, ICO promoters should have been on notice that they would have to register their token sales. For example, in a complaint it filed against Kik Interactive, it noted that the DAO Report had been issued two months before its ICO, and that "[t]he DAO Report focused on the *Howey* test, the same legal standard Kik had been discussing for months."[111] The SEC thus implied that Kik should have known that its tokens were securities under the *Howey* test.

In using the DAO Report in this way, the SEC failed to heed the lessons of Karmel's *Spartek* dissent. First, as in *Spartek*, the SEC's jurisdiction in the DAO case was questionable. It is very possible that a court that looked closely at the facts would have come to a different conclusion than the SEC about whether the DAO tokens were securities. Second, the report's vague guidance raised due process concerns when it was used as a basis for claiming that parties were on notice that they were selling securities in later cases. The DAO Report was complex and nuanced and thus did not provide comprehensive guidance for ICO projects. Yet the SEC insisted that the report had clarified the law to an extent where further violations might trigger sanctions.

V. IMPROVING SEC REPORTS OF INVESTIGATION

Despite her criticism of the SEC, Karmel has always strongly supported the agency's mission to protect investors.[112] She began her career as an SEC enforcement attorney and understood the myriad of ways that corporations seek to evade their regulatory obligations. Congress worded the securities laws broadly so that they could be developed and extended over time through

111. Complaint at 28, SEC v. Kik Interactive Inc., 492 F.Supp.3d 169 (S.D.N.Y. 2020) (No. 19-cv-5244).

112. *See, e.g.*, KARMEL, *supra* note 9, at 18 ("It caused me great personal pain and anxiety to be such an outspoken critic of the SEC, because I have so much respect for the agency, its leaders and its staff.").

enforcement.[113] At the same time, Karmel resisted the tendency to bend the rules to punish a violation of the securities laws. She believed that over the long run, the SEC could only succeed if it scrupulously maintained a reputation for fairness and integrity. Her objections were meant to strengthen securities regulation, not undermine it.

Karmel's dissent in *Spartek* highlighted the importance of the limits on the SEC's jurisdiction. The agency was not formed to scrutinize every questionable investment, recover every loss, and reform every problematic corporate governance practice. Congress created the SEC to address particular issues rather than to generally ensure that corporations act responsibly. The securities industry and public companies have accepted the necessity of strong regulation to protect investors, in part because the agency has acted judiciously in exercising its power.[114] To the extent that the SEC exceeds its authority, it risks backlash that can undermine its effectiveness.

The SEC should thus tread very carefully with respect to matters relating to its jurisdiction. Its response to the explosion of ICOs in 2017 was generally measured and effective in establishing control over questionable investments and practices that circumvented securities regulation.[115] Administrative agencies are entitled to deference when they interpret a statute, even when the provision at issue relates to their jurisdiction.[116] Courts would have likely deferred to the SEC's view of the statute, but a substantial opinion by an objective adjudicator would have provided additional legitimacy to the agency's position.

When the SEC's jurisdiction is unclear, it should deliberately seek adjudication in federal court.[117] This may require insisting on sanctions in some initial cases so that defendants have an incentive to contest the SEC's position on its jurisdiction. Admittedly, the pace of litigation is slow, and reports of investigation can be effective in quickly conveying information about the SEC's view of its jurisdiction to parties.[118] But to the extent it is

113. *See, e.g.*, James J. Park, *Rule 10b-5 and the Rise of the Unjust Enrichment Principle*, 60 DUKE L.J. 345, 403–04 (2010) (describing use of unjust enrichment principle to shape the contours of Rule 10b-5).

114. *See, e.g.*, James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws*, 100 CALIF. L. REV. 115, 165 (2012) (describing pressure on SEC to balance its enforcement and regulatory functions).

115. For a fuller description of the SEC's enforcement strategy, see James J. Park & Howard H. Park, *Regulation by Selective Enforcement: The SEC and Initial Coin Offerings*, 61 WASH. U. J. L. & POL'Y 99, 126 (2020).

116. *See* City of Arlington, Tex. v. FCC, 569 U.S. 290, 327 (2013). However, there is an argument that a Section 21(a) report would not be entitled to as much deference as a formal rule. *See* Yuliya Guseva, *The SEC, Digital Assets, and Game Theory*, 46 J. CORP. L. 629, 658 (2021).

117. In contrast, a report may be appropriate when a jurisdictional issue is straightforward. *See, e.g.*, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Eurex Deutschland, Exchange Act Release No. 34-70148 (Aug. 8, 2013) (noting jurisdiction over narrow security index fund).

118. More than three years after the SEC issued the DAO Report, two federal district courts issued decisions concluding that certain ICO tokens were securities. In one of those cases, the SEC agreed

possible, it is important to supplement administrative materials with court decisions.

In addition, private parties should do more to prompt courts to issue rulings on the scope of the securities laws. The recent lawsuits alleging that various Special Purpose Acquisition Companies (SPACs) are investment companies is an example of such an effort.[119] While the SEC has reviewed regulatory filings relating to SPACs for years without insisting that they register as investment companies, courts ultimately have the authority to determine whether particular SPACs are investment companies.

Even if the SEC's views on its jurisdiction in the DAO Report were correct, the report did not provide meaningful notice to the industry about the boundaries of the *Howey* test. The SEC's enforcement efforts in this area should have placed less emphasis on the argument that the industry was on notice after the release of the report. The problem with the DAO Report was that at best, it showed that the SEC believed that a token in a particular set of circumstances could be a security.

When possible, the SEC should issue Section 21(a) reports that compare and contrast the findings from several investigations in areas where the law is evolving, developing, or just unclear. For example, as noted earlier, the SEC recently reported on multiple investigations that found internal control deficiencies relating to cybersecurity.[120] The SEC could have reported on several different fact patterns relating to ICO tokens that illustrated more clearly its views about when such tokens are securities. Such an approach would have improved the effectiveness of the SEC's response and provided notice to the industry about its expectations.

The SEC ultimately did more to clarify its views on the application of the *Howey* test to a wider range of settings.[121] At this point in time, there is substantial guidance on the issue of when a token is a security. The DAO Report by itself, though, was not sufficient to resolve the issue.

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to a settlement where the defendant waived its right to appeal to the U.S. Court of Appeals for the Second Circuit. *See* Carol R. Goforth, *Regulation of Crypto: Who is the Securities and Exchange Commission Protecting?*, 58 AM. BUS. L.J. 643, 702 (2021). In settling the case, the SEC missed a potential opportunity to present its position to a federal appellate court.

119. *See, e.g.*, Derivative Complaint at 6, Assad v. Pershing Square Tontine, Case No. 1:21-cv-06907 (S.D.N.Y. Aug. 17, 2021). The plaintiffs in these cases are represented by two law professors, John Morley and Robert J. Jackson.

120. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding Certain Cyber-Related Frauds Perpetrated Against Public Companies and Related Internal Accounting Controls Requirements, *supra* note 61.

121. Almost two years after the DAO Report, the SEC published a framework for analyzing whether a token is a security. *See* SEC. & EXCH. COMM'N, FRAMEWORK FOR "INVESTMENT CONTRACT" ANALYSIS OF DIGITAL ASSETS (Apr. 3, 2019).

CONCLUSION

When Roberta Karmel authored her *Spartek* dissent, the SEC's enforcement program was still in its adolescence. The SEC during the 1970s sought to take on the role of a general regulator of public companies. Karmel's contrarian views helped push the SEC to focus more narrowly on its core competence, securities fraud and market regulation. More than forty years later, the SEC's enforcement division is widely respected and viewed as an elite training ground for ambitious young lawyers.

As the SEC is increasingly pushed to regulate everything from climate emissions to workers' rights, Karmel's dissent is worth re-examining. In defining its mission for the Twenty-First Century, the SEC should think carefully about its jurisdiction and policy goals before attempting to broaden its regulatory reach. It should do more to confirm its positions on its jurisdiction with the federal courts.

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