On appeal, former State Street exec challenges new SEC fraud interpretation

(Reuters) - Remember the strange case of John Flannery, the former chief investment officer of the Boston-based investment manager State Street? After the financial crisis, the Securities and Exchange Commission sued Flannery and another onetime State Street executive, James Hopkins, for deceiving investors about their exposure to subprime mortgages. The two men were cleared in 2011 by an SEC administrative law judge, but last December, the full commission, in a split 3-2 ruling, partially reversed its in-house judge and found both men liable for securities fraud.

It was a controversial decision. The SEC used the vehicle of the State Street case to clarify what the agency described as uncertainty in the lower courts about the application of the U.S. Supreme Court's 2011 ruling in Janus Capital v. First Derivative Traders. Janus took a restricted view of who can be held liable in private class actions for making purportedly fraudulent statements about securities, but in the State Street opinion, the SEC offered a much broader interpretation of its enforcement power under anti-fraud provisions in both the Securities Act of 1933 (Section 17a) and the Securities Exchange Act of 1934 (Rule 10b).

Flannery and Hopkins this week filed separate appellate briefs at the 1st U.S. Circuit Court of Appeals, contesting the commission's findings and penalties against them. (Hat tip to the White Collar Securities Defense blog.) Hopkins, a former State Street product engineer represented by Mintz Levin Cohn Ferris Glovsky & Popeo, sticks closely to the facts of his case, arguing that the SEC ignored evidence and "stepped over the line when it explicitly embraced a hindsight justification for its theories of both materiality and scienter."

Flannery's lawyers at McDermott Will & Emery also contend the evidence against their client does not justify the SEC's liability ruling. But their brief asserted the additional argument that the SEC exceeded its authority and breached Flannery's due process rights when it used his case to promulgate a new interpretation of the Securities Act. "The commission concedes its decision debuts a new legal theory," the brief said. "The commission's theory suffers from a lack of fair notice and violated due process as applied to Flannery."

Apologies in advance for a deep-in-the-weeds explanation, but Flannery's lawyers claim the SEC improperly conflated two of the three prongs of the Securities Act's anti-fraud provision in order to conclude that two alleged misstatements constitute a prohibited "course of business." According to the brief, each subsection of the provision bars distinct conduct. Misstatements are covered in the second prong and a deceitful course of business in the third. Flannery's lawyers said the SEC reached beyond the language of the statute to find their client liable under the third subsection.

The brief contends the statute is unambiguous so the SEC's interpretation is not entitled to deference under Chevron v. Natural Resources Defense Council. And even if the law is ambiguous, Flannery's lawyers said, the rule of lenity requires it to be construed against the commission because the anti-fraud provision carries both criminal and civil penalties.

"Before the commission's opinion in this case, nobody was on notice that two purportedly negligent misstatements, made without obtaining money or property, could give rise to Section 17(a) liability," the brief said. "At a minimum, applying the commission's interpretation to Flannery would violate his due process right to fair notice, where the two supposed misstatements were made years before the Commission announced its new theory of liability."
I'll let you know what the SEC has to say about its authority when the commission's response comes in next month.

(Reporting by Alison Frankel)

---- Index References ----

Company: CHEVRON CORP; JANUS CAPITAL GROUP INC; MCDERMOTT WILL AND EMERY LLP; STATE STREET CHANNEL ISLANDS LTD

News Subject: (Corporate & Business Law (1XO58); Crime (1CR87); Criminal Law (1CR79); Financial Fraud (1FI18); Fraud (1FR30); Funding Instruments (1FU41); Judicial Cases & Rulings (1JU36); Legal (1LE33); Securities Law (1SE59); Social Issues (1SO05))

Industry: (Financial Services (1FI37); Investment Management (1IN34); Securities Investment (1SE57))

Language: EN

Other Indexing: (Mintz Levin Cohn Ferris Glovsky; James V. Hopkins; James Hopkins; Alison Frankel; John L. Flannery; John Flannery)

Keywords: (MCC:OEC); (N2:US); (N2:USANY); (N2:AMERS); (N2:USA); (MCCL:OVR)

Word Count: 643