Supreme Court of the United States

In the Matter of:

SECURITIES AND EXCHANGE COMMISSION, Petitioner, vs. NATIONAL SECURITIES, INC., et al. Respondents.	:	Docket No. 41

Place Washington, D. C.

Date November 18, 1968

ALDERSON REPORTING COMPANY, INC.

300 Seventh Street, S. W.

Washington, D. C.

NA 8-2345

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IN THE SUPREME COURT OF THE UNITED STATES

October [redacted] Term, 1968

SECURITIES AND EXCHANGE COMMISSION,

Petitioner;

vs. No. 41

NATIONAL SECURITIES, INC., et al.,

Respondents.

Washington, D. C.
Monday, November 18, 1968

The above-entitled matter came on for argument at 2:05 p.m.

BEFORE:

EARL WARREN, Chief Justice
HUGO L. BLACK, Associate Justice
WILLIAM O. DOUGLAS, Associate Justice
JOHN M. HARLAN, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
ABE FORTAS, Associate Justice
THURGOOD MARSHALL, Associate Justice

APPEARANCES:

ERWIN N. GRISWOLD, Esq.
Solicitor General
Department of Justice
Counsel for petitioner

JOHN P. FRANK, Esq.
114 West Adams
Phoenix, Arizona 85003
Counsel for respondents

oOo

P R O C E E D I N G S

MR. CHIEF JUSTICE WARREN: No. 41, Securities and Exchange Commission, petitioner, versus National Securities, Incorporated.

THE CLERK: Counsel are present.

MR. CHIEF JUSTICE WARREN: Mr. Solicitor General.

ORAL ARGUMENT OF ERWIN N. GRISWOLD, ESQ.

ON BEHALF OF PETITIONER

MR. GRISWOLD: Mr. Chief Justice, and may it please the court.

This case is here on a writ of certiorari to the Ninth Circuit Court of Appeals. It involves the construction and application of the McCarran-Ferguson Act and its inter-relation with Section 10-b of the Securities Exchange Act of 1934.

The text of those two statutes is given on pages 33 and 34 of the Government's brief in this case. I would call attention to the provision in Section 10-b, which makes it unlawful for any person to use or employ in connection with the purchase or sale of any security registered on a National Security Exchange or any security not so registered. The net result of those two phrases is simply to apply to any security, any fraudulent device as defined by the rules of the Securities and Exchange Commission, and the relevant rule 10-b-5 is set out at the bottom of page 34 and on page 35.

The text of the McCarran-Ferguson Act is on page 33 of our brief, and the relevant portion there, although it is all relevant, but the part that comes closest is Section 2-b, "No Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance."

And I would suggest that the key words in that provision of the McCarran-Ferguson Act are "the business of insurance."

The present case began in March, 1965, when the Securities and Exchange Commission filed its petition in the District Court for Arizona. It sought to have that court enjoin the respondent here, National Securities, Inc., and its subsidiary and certain officers and employees, from violating Section 10-b, and rule 10-b-5, on the ground of asserted fraud in connection with the purchase or sale of securities.

In due course, the defendants filed a motion for judgment on the pleadings, or, in the alternative, for summary judgment. The motion for judgment on the pleadings was granted by the District Court, and this was affirmed by the Court of Appeals.

As the Court of Appeals stated in its opinion, "In this situation, the allegations in the amended complaint must

be presumed to be true."

And these allegations may be summarized this way.

It is alleged that the respondent, National Securities, Inc., is a holding company, which owned two-thirds of the slightly more than a million shares outstanding of National Life, which was an Arizona Insurance Company.

Producers Life Insurance Company was another Arizona company. It had some 881,000 outstanding shares held by approximately 14,000 stockholders in many States.

In other words, it was quite widely distributed.

The allegation is that the defendants formed an illegal scheme, contrary to Section 10-b, under which National Securities would acquire control of Producers Life, National Life, and Producers Life would be consolidated, and the consolidated company would pay a large part of National Securities' cost of acquiring control of Producers Life.

In carrying out this scheme, National Securities purchased the stock in Producers which was held by four of the Producers' directors, and agreed to pay them a very large sum for their agreement not to compete with Producers Life or any successor company.

And National Securities also purchased from Producers Life more than 50,000 shares of its treasury stock, and assumed some $600,000 of liabilities of Producers Life, arising out of previous agreements which had been made with other persons

not to compete with it.

It was further alleged that National Securites did not disclose to Producers Life or its stockholders that it intended to impose both of these liabilities with respect to agreements not to compete upon the corporation which would result from the planned consolidation of Producers Life and National Life.

After obtaining control of Producers Life, according to the allegations again, National Securities caused the latter to mail to its stockholders materials soliciting them to approve the proposed consolidation with National Life. And it was then alleged that this material was false and misleading on four grounds:

A. That it did not disclose the liability on the agreements not to compete.

B. That it predicted substantial consolidated earnings, without disclosing that Producers Life and National Life had each had losses in the prior year.

C. It set forth on the pro forma balance sheet for the consolidated company an asset shown as treasury stock in the amount more than a million dollars that was alleged to be illusory, and finally, that it did not disclose that in its report to the Arizona Insurance Commission, and National Life had written down the value of its investment in Producers Life by more than a million dollars.

The court allowed the defendants to submit the proposal to the Arizona Insurance Commission, and to the stockholders, both approved the plan and it was carried out. It was then that the Securities and Exchange Commission filed the amended complaint, which is now before the court, seeking such relief as might be appropriate under the circumstances.

In its answer to the amended complaint, and in its motion for judgment on the pleadings, the defendant contended that the District Court has no jurisdiction because the matters complained of are entirely within State jurisdiction, as provided in the McCarran Act, thus raising the issue which is here.

The District Court accepted this contention as one of its grounds of decision, and the Court of Appeals affirmed the District Court's judgment on this ground alone.

The opinion of the Court of Appeals is in rather sweeping terms. The relevant portions for this part of my argument appears on pages 156 and 157 of the appendix near the bottom of page 156, "We are left, then, with a general intention to set the insurance business outside the scope of all existing and future legislation regulating Interstate Commerce without any more direct evidence that Congress had in mind the Securities Exchange Act.

"However, Congress was apparently seeking to define an exemption for insurance," and then the word is

"conterminous", but I suppose we usually say "co-terminous" -- "with its power to regulate Interstate Commerce."

The court is there saying that with respect to insurance insofar as Congress would have power to regulate any aspect of it under its commerce power, the effect of the McCarran Act is to say that that power is not being exercised.

Over on page 157, just above the middle, the court said, "An equally vital purpose of the McCarran Act was to preserve intact from any Federal intrusion based on the commerce clause existing and future State regulations of the insurance industry."

Thus, the sole issue here is whether this construction of the McCarran-Ferguson Act and determination of its effect are correct, or whether the facts alleged are sufficient to state a cause of action under Section 10-b of the Securities Exchange Act of 1934, despite the provisions of the McCarran-Ferguson Act, which was passed in 1946.

I will now turn to the legal questions involved in this case. It may be that I have a somewhat narrow ledge to stand on, but I think the footing is firm.

When Section 10-b was enacted in 1934, there was no doubt that it applied to fraud and the purchase and sale of all securities. You will recall the phrase in the statute is "any security," including those in insurance companies. This was true despite the fact that it was the common understanding

at that time that the Federal Government had no power to regulate "the business of insurance."

A clear distinction was evident between the business of insurance on the one hand and securities of a company which is engaged in conducting the insurance business.

In 1944, the Southeastern Underwriters case was decided, followed in 1946 by the enactment of the McCarran-Ferguson Act.

The Southeastern Underwriters case undoubtedly involved the conduct of the business of insurance, the way in which insurance companies operate together in fixing their rates, and had nothing to do with transactions in securities of an insurance company.

The distinction was explicitly made in the McCarran-Ferguson Act itself, where it said that no act of Congress should supersede any law enacted by any State for the purpose of regulating the business of insurance.

This was emphasized in the report of the House Committee set forth on page 24 of our brief, where the committee said, "It is not the intention of Congress in the enactment of this legislation to clothe the States with any power to regulate or tax the business of insuracne beyond that which they had been held to possess prior to the decision of the United States Supreme Court in the Southeastern Underwriters Association case."

In short the function of the McCarran-Ferguson Act was to restore the status quo, to put things back where they were before the Southeastern Underwriters case was decided, except that it was made explicit that the Sherman Act, the Clayton Act, and the Federal Trade Commission Act should apply to the business of insurance to the extent that such business is not regulated by State law.

It was only with respect to these three statutes that there is any indication that Federal law should apply only if there was an applicable provision in State law.

Throughout their history, both before and after the enactment of the McCarran-Ferguson Act, the provisions of the Securities law, relating to securities, and the securities laws don't relate to the business of insurance -- the provisions of the securities laws relating to securities have been regarded as applicable to securities in insurance companies.

We have listed many of these instances in the footnotes on pages 16 and 17 of our brief.

Thus, issues of insurance companies' securities had been registered under Section 6 of the Securities Act of 1933, securities of insurance companies listed on National Exchanges have been registered with the Commission under Section 12 of the Securities Exchange Act of 1934, persons who buy and sell insurance company securities have been registered under Sections 15-b of the Securities Exchange Act, investment

companies with portfolios consisting of insurance company securites have been registered under Section 8 of the Investment Company Act, and persons selling insurance company securities in a fraudulent manner have been enjoined and convicted in a considerable number of cases.

The decision of the court below, which fails to recognize the distinction between the business of insurance, to which the McCarran-Ferguson Act applies, and dealings in securities which happen to be stocks in insurance companies, would sweep all this away, and broadly exempt all dealings in insurance securities from application of the Federal laws.

This is the effect of the decision below, where the court said, "Congress was apparently seeking to define an exemption for insurance conterminous with its power to regulate interstate commerce."

If Congress was intending to do that, obviously it swept away all application of the securities laws to dealings in insurance securities.

Q Mr. Solicitor General, one of my difficulties in reading the briefs in advance of argument of this case which continues now, is that you and your adversary don't really seem to agree as to what this case is about.

Is that fair to say?

A Well, I think there is something about that. Mr. Frank raises a lot of other questions which present some

difficulties which were not decided by the ---

Q I am not referring to the purchase and sale difficulties. I am talking, really, about the broad question to which you are now addressing yourself, and you are quoting to us some very broad language of the United States Circuit Court of Appeals, but the decision was on the part of the District Court, as affirmed by the Court of Appeals, simply that the McCarran Act foreclosed the undoing of a merger that had been approved by the Arizona Commission.

That is the holding in this case, isn't it?

A Not exactly, Mr. Justice Stewart. We didn't ask for the undoing of the merger in the e- exclusively, as our only relief, in the amended complaint. We asked for such relief as would be appropriate under the circumstances, and it may well be that the merger should be left merged, but that individuals who have profited by the transaction should be required in some way to account, either by disgorging to the merged company, or by making payments to the shareholders who did not participate from it.

All the questions of relief are left undecided, both by the District Court and the Court of Appeals, because they didn't get to them, having held that the McCarran-Ferguson Act eliminated the whole matter.

Q Well, I didn't under the District Court or the Court of Appeals really to have held that the 1933 Act or the

1934 Act was completely inapplicable, or completely inapplicable to the dealings in securities of insurance companies.

A Well, Mr. Justice, I can't read that language on page 157 of the Court of Appeals in any other way, "An equally vital purpose of the McCarran Act was to preserve intact from any Federal intrusion based on the Commerce clause existing in future State regulation of the insurance industry."

And that would apply to any fraudulent sale of insurance stocks.

Now, it is true that this case does involve a merger of an insurance company, and Mr. Frank argues that approving a merger is in some way analogous to the question of chartering an insurance company.

I find it difficult, even with that, to find anything in the McCarran-Ferguson Act which says that when this is done in a fraudulent way that the provisions of the Securities and Exchange Act are superseded, are written off, are in effect repealed.

I pointed out that the practice has been consistently to the contrary, both before the McCarran-Ferguson Act was passed, and I think what is very relevant, before the Southeastern Underwriters case was decided.

It was then regarded as the appropriate construction of the Securities Act that they were applicable to transactions for purchases and sales, in the language of the statute, with

respect to insurance companies as to any other securities, and we think that the effect of the decision of the Ninth Circuit is to make the Securities statutes inapplicable to transactions, to dealings, to actions, with respect to securities in insurance companies, and it is our contention that that is not the proper construction of the McCarran-Ferguson Act, which relates to the business of insurance, to the things done by insurance companies with respect to their policy holders, but not to transactions done by other persons with respect to securities in insurance companies.

There obviously are other Federal statutes of general application which were applicable to insurance before the McCarran-Ferguson Act was passed, and which continued to be applicable toinsurance thereafter. These include the Copyright and Patent laws.

An insurance company is not exempt from the telephone tax or the Social Security tax. It is not free to issue counterfeit money if it doesn't have enough to meet its legitimate claims. It is subject to the postal laws, including those making it a crime to use the mails for the purposes of fraud, and I would point out that Section 10-b is based on the postal laws as well as on Interstate Commerce, and that the mails were so used, and that there are a sizeable number of prosecutions, before and after the McCarran-Ferguson Act, for using the mails to defraud with respect to

the sale of insurance securities.

These matters are not referred to in the McCarran-Ferguson Act, but it cannot be supposed that Congress contemplated any change in the law with respect to them.

As I have said, we are dealing here with a statute which is based in part on the postal power. There is no reason to think that Congress in passing the McCarran-Ferguson Act intended to allow an insurance company to use the mails to defraud stockholders.

Q Mr. Solicitor General, I take it then you would say this is because this is not a matter of regulating insurance, but of regulating stock transactions, that if there are Federal regulations as to what should be in a proxy statement in connection with the merger conflict between the Federal regulation and the State regulation, and the State regulation approves the proxy statement and the Federal authorities disapproves, a Federal Act governs?

A At this particular time, there was no Federal provision with respect to ---

Q But you would say that the Federal law would govern?

A The Federal law would govern to the extent that the fraud was proved and found by the court.

Yes, Mr. Justice.

Q What if there had been no Southeastern case,

none at all. Is it your belief, that under the law as it then existed, that Congress could have passed a bill regulating this very thing under the Commerce clause?

A Yes, Mr. Justice, It is our view that that is just what Congress did do in 1933 and 1934, that it passed a law regulating transactions of purchase and sale of any security, and that that included securities in insurance companies, and was so construed by the Commission, and in a very few cases by the courts, between 1933-34, and 1944, when the Southeastern Underwriters case was decided.

Q I asked you that question because I had been under the impression, having summed up evidence in the Southeastern Underwriters case, that it was the purpose of Congress to do away entirely with this effect, was relying on the Commerce clause was concerned in the Insurance Business Act. I am sure it is the Insurance Business Act.

Would you not have, if that were the case, would you not have to show that even without that, if that case had never been decided, you had not changed the rule, that Congress could have and would have passed this Act?

A Yes, Mr. Justice. That is exactly the argument we do make, that Congress had this power and exercised it before 1944, and that for that reason the enactment of the McCarran-Ferguson Act, which was intended to restore the status quo, did not and was not intended to take away the

effect of the statutes which Congress had previously passed with respect to securities.

Q Have there been any cases before the Southeastern that were so held?

A No cases in this court, certainly. There was a modestly, considerable amount of practical experience in the Securities Exchange Commission, including registration of securities and things of that sort.

Q It had not be challenged on that ground?

A Never has been challenged on that ground that I am aware of.

Q But, Mr. Solicitor General, I would like to direct your attention again to this line of thought.

As I understand your adversary, he says that the merger, the merger itself of these companies was approved by the Insurance Commissions.

Now, arguably, I suppose, you could say that the merger is certainly an insurance company. We are talking about the merger of two insurance companies here. Then along comes the SEC and says that this aspect of that merger is subject to Federal law, namely, the terms of the offer of exchange, the solicitation of the stockholders, and says that therefore it is in conflict with the McCarran Act, because this is something, the merger, that is insurance business, it is a merger of two insurance companies.

I don't profess to state ---

A Mr. Justice, I think you have stated the issue very clearly, and very precisely. There is, of course, some overlap here. I think a considerable part of our concern with the sweeping nature of the opinion of the Court of Appeals, which says that the McCarran-Ferguson Act wiped out completely all aspects of the securities regulation with respect to insurance.

When you come to the question of a merger, I think it is a nice question as to what is meant by the business of insurance, and I think an argument can be made, which is the one we stand on, that the business of insurance relates to the internal operations of insurance, and not to dealings in securities which Congress has so clearly taken over for Federal authority.

Q Let me see if I understand you, because I do believe this is where the argument of the two parties comes in collision.

What you are saying is that perhaps a merger of two insurance companies is the business of insurance in some respects, but to the extent that it involves the solicitation of stockholders' consent, that that aspect of it is not the business of insurance?

A The dealing with the security holders, we would contend is not "the business of insurance," as was meant by

Congress when it used those words in the McCarran-Ferguson Act.

There is one decision of this court which is pretty close in many ways, which is the United Benefit Life Insurance Company case decided only a short while ago.

There, the company was undoubtedly an insurance company, and the decision of the court that it could not sell variable annuity policies without registering them with the SEC is directly that the securities of an insurance company are subject to the securities law, and are not taken out of the provisions of the securities laws by the McCarran-Ferguson Act.

In that case the ---

Q The holding in that case was that that company was engaged in selling securities, not insurance policies. Suppose that the insurance company went into the telephone business, they had to pay the tax on telephones?

A That would be applicable to the variable annuity life insurance company, which sold nothing but variable annuities, but this -- but the United Benefit Life Insurance Company was undoubtedly an insurance company. It sold large quantities of what everybody would agree was insurance. It also sought to sell variable annuities, and this court held that it couldn't do it without registering them with the SEC, and that, it seems to me, is inevitably a direct decision that the securities of an insurance company are subject to the

registration provisions of the securities laws, despite the fact that Congress has passed the McCarran-Ferguson Act, or to put it another way, that dealings in the securities of an insurance company are not "the business of insurance," within the McCarran-Ferguson Act.

There are other cases which are close, but I think that the United Benefit case comes very close to supporting our position. The decision of the court below would wipe out every application of the securities laws to securities in insurance companies. This is contrary to the long-continued understanding in this area. It is not required by the language of the McCarran-Ferguson Act, and it is inconsistent with that Act's purposes.

Accordingly, the judgment below should be reversed and the case remanded for consideration there of the other questions involved in the case.

Q A good many insurance companies, particularly life insurance companies, these days, are owned not by stockholders, or by shareholders, but are owned by the policy holders.

I suppose a merger of two mutual companies would be, I suppose those policy holders as owners -- I guess they are specifically exempted, aren't they?

A We would have to find something, Mr. Justice, that would constitute securities in such companies before

Section 10-b would apply, because it applies only to purchases and sales of any security.

Now, conceivably in a mutual company, you could say that the policy holders are security holders.

Q Except I believe there are express exemptions in the Securities Act, aren't there?

A With respect to the mutual companies?

Q Yes.

A There may be, I am not sure.

Q There may be.

A With respect to the security holders? I am not sure.

Q I am not sure.

MR. CHIEF JUSTICE WARREN: We will hear your argument tomorrow, Mr. Frank.

We will adjourn now.

MR. FRANK: Thank you, Mr. Justice.

THE CLERK: The Honorable Court is now adjourned until tomorrow at 10 o'clock.

(Whereupon, at 2:30 p.m. the Court adjourned, to reconvene at 10 a.m. Tuesday, November 19, 1968.)