



1985

MEMORANDUM

TO: DEBORAH BACHRACH and MARY ELLEN BURNS

FROM: ORESTES J. MIHALY and HARVEY J. GOLUBOCK

RE: E.F. Hutton Guilty Plea

DATE 8/5/85

Background

On May 2, 1985 E.F. Hutton & Company Inc. pleaded guilty, pursuant to a plea agreement, in the United States District Court for the Middle District of Pennsylvania to a felony information charging it with 100 counts of mail fraud in violation of 18 U.S.C. § 1341 and 1,900 counts of wire fraud in violation of 18 U.S.C. § 1343. Hutton was fined \$2 million and ordered to pay \$750,000 in costs. In addition, it agreed to make restitution to the banks it had defrauded and has set up a reserve of \$8 million for this purpose. Hutton also signed an injunction prohibiting it from engaging in certain practices, including intentionally overdrafting its bank accounts and making multiple transfers among different Hutton bank accounts; the injunction also requires Hutton to disclose its money management practices to all banks with which it does business. Under the plea agreement the Department of Justice may not bring any further criminal charges against Hutton or any of its officers, directors or employees for the matters to which Hutton pleaded guilty.

From the publicly available documents it appears that from 1980 to 1982 Hutton, in essence, obtained interest-free loans from banks without the knowledge or consent of the banks. It did this by consistently overdrawing its bank accounts and engaging in multiple transfers of funds among accounts it maintained at various banks, thereby "capturing the float" during a period of high interest rates.

As a part of the scheme, Hutton intentionally wrote checks on its bank accounts for far more than the accounts contained. Then, one or two days later, it would cover the overdrafts with other checks. As a result of this practice Hutton

obtained interest-free loans from its banks during the periods of the overdrafts. In addition, to extend the period during which it had free use of the banks' funds and to delay detection of the overdrafts, Hutton made multiple transfers of funds among its various bank accounts. Thus, for example, in one day Hutton might write a check on its account in bank X in San Francisco and deposit it in bank Y in Cincinnati and also write a check on bank Y and deposit it in bank Z in New York and write a check on bank Z and deposit it in bank X in San Francisco. This practice resulted in checks being credited to one Hutton bank account a day or more before they were debited to another Hutton bank account.

Possible Action by this Office against Hutton and/or its Principals

1. Action Against Hutton

Section 353.2 of the General Business Law provides that upon an application by the Attorney General, a Supreme Court justice may issue an injunction against a securities dealer who has been convicted of a felony. The statute does not require the judge to issue an injunction based upon a conviction and does not specify the nature or extent of the injunctive relief the judge may grant, leaving these issues entirely within the judge's equitable discretion. Thus, a court could presumably do anything from refusing to grant any injunction, to enjoining Hutton from violating the law, to enjoining Hutton permanently from engaging in the securities business, to doing anything in between. In addition, the statute provides that such an injunction may issue only after a hearing. The hearing requirement strongly suggests that we would need to show more than merely that Hutton was convicted in order to obtain an injunction (since a hearing would not be necessary to show that a party had been convicted of a crime). This form of relief would be brought on by initiation of an action, accompanied by an order to show cause for a temporary injunction. There has not been any litigated application for this relief. Any injunction that we have obtained against persons based on criminal convictions has been on consent.

There are no decisions under section 353.2 to provide guidance in interpreting the statute. However, it appears highly likely that in order to obtain an injunction under it against Hutton we would have to show some relationship between the fraud Hutton was convicted of, Hutton's fitness to act as a securities broker-dealer and any injunctive relief we seek. That is, we would

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have to show that Hutton's conviction and its other conduct demonstrates that Hutton presents such a high degree of risk to investors that the injunction we sought would be in the public interest.

Several factors suggest that a court will be reluctant to issue a strong injunction against Hutton as a result of its guilty plea. First, Hutton's conviction did not come as a result of its conduct in the offer and sale of securities as a broker-dealer; i.e. the investing public was not defrauded. Secondly Hutton is a publicly traded company with many shareholders and employees in New York and has an 80 year history with no suggestion of prior criminal activity. A judge may well be reluctant to take the onerous step of enjoining Hutton permanently from conducting their business both because of the impact of such a decision on New York investors and employees and because is a well established member of the financial community. Finally, this is the first time anyone has been charged with a crime for the activity Hutton engaged in; indeed, even the federal prosecutor has called this a "grey area."

2. Action Against Individual Principals

Section 353.2 does not provide a basis for action against the individuals at Hutton responsible for the conduct, since none of them has pleaded guilty to a crime. Moreover, as described below, serious difficulty would arise in any attempt to prosecute those individuals under other provisions of the Martin Act.

Sections 352 and 352-c specify the conduct prohibited by the Martin Act. Section 352 defines "fraudulent practices" as a variety of conduct engaged in "in the issuance, exchange, purchase, sale ... of any stocks." Thus, in order to prosecute, either civilly or criminally, the architects of Hutton's scheme for violating the Martin Act, we would have to prove that the bank fraud they engaged in was perpetrated "in the issuance, exchange, purchase, sale ... of any stock." This would be quite difficult to do. An argument could be made that the bank fraud was committed in connection with the sale of stock, if Hutton used the money it obtained thereby to trade securities. There are several problems, however, with such a theory: First, we would have to prove that Hutton did, in fact, use the interest on the float to trade securities, which is by no means clear. Second, and more important, this theory is probably not in accord with the purpose

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and scope of the Martin Act since it would put all illegal activity by a broker-dealer within the ambit of the Martin Act, whether or not investors were defrauded.

The same problem would arise in any attempt to prosecute the individuals under section 352-c, which prohibits certain fraudulent acts "where engaged in to induce or promote the ... exchange, sale, negotiation or purchase ... of any securities."

Even if we could prosecute under the Martin Act, regardless of whether we proceeded civilly or criminally, we would be required to prove both the underlying bank fraud and the individual defendants' responsibility for it. According to the Assistant United States Attorney who handled the investigation, it took a team of 20 accountants and postal inspectors working with a computer several years to assemble and analyze the various bank documents necessary to prove the fraud. Even assuming that we could focus on a portion of the case, e.g. the fraud committed by Hutton against several New York banks, it would require a substantial commitment of limited resources.

3. Action Under the Penal Law and the Banking Law

Whether or not we have jurisdiction under the Martin Act here, we may be able to prosecute the company and the individuals responsible for the scheme under the Penal Law and the Banking Law, if we obtain a referral letter from the Superintendent of Banking under section 63(3) of the Executive Law. While Hutton's conduct would not constitute check-kiting in violation of section 190.05 of the Penal Law, because Hutton intended to cover and did cover the checks that were drawn, it would likely constitute a Scheme to Defraud in the first degree (a class E felony) in violation of section 190.65 of the Penal Law, which is modelled after the federal statutes under which Hutton pleaded guilty.

For several reasons, however, it may be difficult to obtain a referral letter from the Banking Department. In 1981, the Banking Department prepared a report on Hutton's activity but took no further action. (We are in the process of obtaining copy of this confidential report. Banking has been reluctant to turn it over to us, but has promised to do so.) We understand that Banking's failure to conclude that Hutton's conduct was illegal caused some conflict with the Assistant United States Attorney who was conducting the Grand Jury investigation and that at one point

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he began, or threatened to begin, an investigation of the Banking Department. Finally, in a telephone conversation on July 24, 1985 Arthur Gelman, First Assistant Counsel for the Banking Department, stated that in his view Hutton had violated neither state nor federal law.

4. Our Activity To Date

We have been getting as much information as possible concerning the actual scheme, the extent of the U.S. attorney's investigation, and those individuals who might be criminally culpable for the Hutton activity. As you know, Orestes J. Mihaly has met with Griffin Bell in Atlanta. At that time Bell gave his explanation of the extent of his investigation and has been in touch with Mihaly by phone since then.

Bell has been retained as special counsel by Hutton to conduct an investigation of the situation and to prepare a report on his findings. His report is supposed to pinpoint those at Hutton responsible for the fraud and to recommend further action indicating the firing of appropriate individuals. Bell has stated that he has a staff of 15 - 20 attorneys working full time on the matter, interviewing witness throughout the country and examining and computerizing records. Bell has also stated that his report will be issued publicly and will be available at the end of August.

We have obtained all the court records from the federal court in Scranton, Pennsylvania involving the plea colloquy in chambers and in open court, and copies of the voluminous legal papers. We are receiving material from Hutton including the memoranda discussed in recent newspaper articles which evidence is described in the media as newly discovered. We have talked in person to Assistant United States Attorney Albert Murray the Assistant United States Attorney who handled the investigation. He has confidentially told us that most of these memoranda as well as stories in the newspapers of banks who had demanded lost interest from Hutton years ago were known to him during his investigation. According to him very little if anything appearing in the newspapers as new evidence was not known to the federal investigations. We are also receiving copies of the claim forms of

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the banks under the restitution programs. It would appear that the amount of claims may be significantly lower than the eight million dollars that Hutton has set aside for restitution purposes.

NASAA (The North American Securities Administrators Association) has been funding a multistate task force to gather and report to the states as much information on the culpability of various individuals at Hutton. It was felt that we should be a part of this group in order to be in a position to know as much of the situation as is possible. As a result we have been able to meet Bell and Murray etc. with no expense to this office. NASAA otherwise is waiting for Bell's report to fix the individual responsibility in the Hutton case and pass this information on to the States for whatever action they deem appropriate.

In a related matter involving the offer and sale of securities of Silver Screen Productions in New York without having filed an issuer statement under the Martin Act we began an immediate inquiry as soon as this came to our attention. We were able to obtain an assurance of discontinuance with a provision for the payment of \$2000 in costs. A few other states initiated inquiries and proceedings as described below but thus far we are the only state that has culminated its action. In New York the violation was technical in nature and caused allegedly by a lawyer failing to file a form with us.

5. Other Jurisdictions

As discussed below, we have contacted other jurisdictions which have begun to take some action against Hutton as a result of its plea.

Connecticut has commenced an administrative proceeding to sanction Hutton as a result of the conviction. Unlike the procedure under our statute, the Connecticut Securities Administrator can himself sanction a broker-dealer after an administrative hearing; there is no need for him to go to court to obtain an injunction. Furthermore, the Administrator can sanction the broker-dealer on the basis of a conviction without any further showing. The Connecticut proceeding does not ask for any specific relief against Hutton and Connecticut officials have advised us that they have not yet decided what relief to request, but that they are considering requiring Hutton to pay some money to charity. Finally, the proceeding is against Hutton only, not any individuals.

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Maine has issued a subpoena to Hutton in anticipation of commencing an administrative proceeding similar to that of Connecticut. It has not yet received any material from Hutton and has not yet decided whether to begin such a proceeding.

Massachusetts has commenced an administrative proceeding against Hutton as a result of false statements allegedly made by Hutton brokers in selling limited partnership interests in Silver Screen. It may attempt to enlarge that proceeding to include Hutton's conviction, although the Director of Massachusetts has not asked for any specific form of relief against Hutton. Their Enforcement Director has suggested to us that a sanction prohibiting Hutton from accepting new investors for a period of time might be appropriate.

The Securities and Exchange Commission has assigned a large staff of attorneys and accountants to review Hutton's conduct, but has, as of yet, taken no action. The SEC, however, has adjourned for 180 days the suspension of Hutton which would have automatically been triggered under the Investment Advisers Act of 1940 by Hutton's conviction.

Summary

In conclusion, because our authority under the Martin Act to prosecute either civilly or criminally is limited to fraudulent practices in connection with the offer and sale of securities and because it is problematic that New York banking laws were violated, it would be unwise to divert our limited resources from other matters which are clearly fraudulent and directly affecting the investing public in what would in essence be an attempt to redo the federal investigation. That prosecution took years of effort and ultimately decided that it was in the interest of the United States and the public to accept the corporate plea and injunction as a final disposition in this matter.

We should, in any case, await the report by Griffin Bell. His investigation, which again involves the expenditure of a great amount of resources, may conceivably develop some evidence or information that would cause us to rethink our present recommendation. For instance, Bell may come up with an informant giving information that would be absolutely new, powerful, and compelling. We should also take a close look at our banking laws to determine whether there is any legislation that can be recommended to our legislature in its next session that would be an appropriate remedy and in the public's interest. We have discussed this matter with Bill Dowling and he concurs with our conclusions.

HG:ea