NO. 01-10107-DD

UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

ETS PAYPHONES, INC.,

Defendant,

and

CHARLES E. EDWARDS,

Defendant-Appellant.

On Appeal From the United States District Court
for the Northern District of Georgia

BRIEF OF *AMICUS CURIAE* NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., IN SUPPORT OF SECURITIES AND EXCHANGE COMMISSION'S PETITION FOR REHEARING AND REHEARING *EN BANC*

ROYCE O. GRIFFIN
General Counsel
North American Securities
Administrators Association, Inc.
10 G Street, N.E., Suite 710
Washington, D.C. 20002
202-737-0900

PETER J. ANDERSON
Local Counsel
Sutherland, Asbill & Brennan, LLP
999 Peachtree Street, N.E.
Atlanta, GA 30309
404-853-8000

SEC v. ETS Payphones, Inc., No. 01-10107-DD

CERTIFICATE OF INTERESTED PERSONS AND CORPORATE DISCLOSURE STATEMENT

Pursuant to Fed. R. App. P. 26.1, and 11th Cir. R. 26.1, NASAA submits the following list of the trial judge(s), attorneys, persons, associations of persons, firms, partnerships, or corporations that have an interest in the outcome of this case, including subsidiaries, conglomerates, affiliates, and parent corporations, including any publicly held company that owns 10% or more of NASAA's stock, and other identifiable legal entities related to a party:

Alabama Securities Commission

Alaska Department of Community & Economic Development, Division of Banking, Securities & Corporations

Alberta Securities Commission

Arizona Corporation Commission, Securities Division

Arkansas Securities Department

British Columbia Securities Commission

Broderick, Catherine A.

California Department of Corporations

Camp, Honorable Jack T.

Cohen, Ethan H.

Colorado Division of Securities

Connecticut Department of Banking

Davis, Mark J.

Delaware Department of Justice

District of Columbia

Edwards, Charles E.

Eisenberg, Meyer

ETS Management Services

ETS Payphones, Inc.

ETS Payphones of California, Inc.

ETS Vending, Inc.

Florida Office of Comptroller, Department of Banking

Georgia Office of the Secretary of State, Division of Securities & Business Regulation

Griffin, Royce O.

Hall, Stephen W.

Hawaii Department of Commerce & Consumer Affairs

Idaho Department of Finance

Illinois Office of the Secretary of State, Securities Department

Indiana Office of the Secretary of State, Securities Division

Iowa Insurance Division, Securities Bureau

Kansas Office of the Securities Commissioner

Kentucky Department of Financial Institutions

Kutak Rock, LLP

Louisiana Securities Commission

Maine Office of Securities

Manitoba Securities Commission

Maryland Office of the Attorney General

Massachusetts Securities Division

McDonald, Susan S.

Mexico Comision Nacional Bancaria y de Valores

Michigan Office of Financial & Insurance Services

Minnesota Department of Commerce

Mississippi Office of the Secretary of State, Business Regulation & Enforcement Division

Missouri Office of the Secretary of State

Montana Office of the State Auditor, Securities Department

Nebraska Department of Banking & Finance, Bureau of Securities

Nevada Secretary of State, Securities Division

New Brunswick Department of Justice, Securities Administration Branch

Newfoundland Securities Commission

New Hampshire Bureau of Securities Regulation, Department of State

New Jersey Department of Law & Public Safety, Bureau of Securities

New Mexico Regulation & Licensing Department, Securities Division

New York Office of the Attorney General, Investment Protection Bureau

North Carolina Department of the Secretary of State, Securities Division

North Dakota Securities Commission

Northwest Territories Securities Registry, Department of Justice

Nova Scotia Securities Commission

Nunavut Department of Justice, Legal Registries Division

Ohio Division of Securities

Oklahoma Department of Securities

Ontario Securities Commission

Oregon Department of Consumer & Business Services, Division of Finance & Corporate Securities

Pennsylvania Securities Commission

Prezioso, Giovanni P.

Prince Edward Island Office of the Attorney General

Puerto Rico Commissioner of Financial Institutions

Quebec Commission des Valeurs Mobilieres

Rhode Island Department of Business Regulation

Saskatchewan Securities Commission

Sauriol, Laura J.

South Carolina Office of the Attorney General, Securities Division

South Dakota Division of Securities

Stillman, Jacob H.

Tennessee Department of Commerce & Insurance, Securities Division

Texas State Securities Board

U.S. Securities and Exchange Commission

Utah Department of Commerce, Division of Securities

Vermont Department of Banking, Insurance, Securities & Health Care Administration

Virginia State Corporation Commission, Division of Securities & Retail Franchising

Washington Department of Financial Institutions, Securities Division

West Virginia Office of the State Auditor, Securities Division

Wisconsin Department of Financial Institutions, Division of Securities

Wolensky, Michael K.

Wyoming Secretary of State, Securities Division

Yukon Department of Justice

TABLE OF CONTENTS

TABLE OF CITATIONS

FEDERAL AND STATE CASES

IDENTITY, INTEREST, AND AUTHORITY OF AMICUS CURIAE

The North American Securities Administrators Association, Inc. ("NASAA"), is a nonprofit association of the state, provincial, and territorial securities regulators in the United States and Canada, and of the Mexican national government. Formed in 1919, it is the oldest international organization devoted to the protection of investors in securities.

As securities regulators, the members of NASAA are primarily concerned with protecting investors from fraud and abuse in the offer and sale of securities. The Panel's decision in this case, holding that ETS pay phone investments are not securities, undermines investor protection on three levels: (1) it strips away the protections of securities regulation from pay phone investment contracts, which are notorious vehicles for fraud and abuse; (2) it narrows the definition of "investment contract" under *Howey*, creating significant loopholes for unscrupulous promoters selling other types of investments; and (3) it sets a precedent that will adversely affect the evolution of state securities law, insofar as many state courts look to federal decisions for guidance on issues common to state and federal securities law. For these reasons, NASAA and its members have an interest in the outcome of this case.[1]

[1]NASAA is filing this brief pursuant to Fed. R. App. P. 29(a) and is concurrently filing a motion seeking leave of court.

STATEMENT OF ISSUES

Whether a return on investment should be excluded from the definition of "profits" under *Howey* merely because the promoter of the investment chose to fix the rate of return.

Whether a return on investment, which is in fact wholly dependent upon the efforts of others, should nevertheless be deemed to fail the "efforts of others" test under *Howey* merely because the promoter contractually guaranteed the return.

SUMMARY OF ARGUMENT

The SEC's petition for rehearing and rehearing *en banc* should be granted on both of the grounds set forth in Fed. R. App. P. 35. First, the Panel's decision conflicts with Supreme Court precedent as well as decisions of this and other federal circuit courts. Second, the Panel's decision raises issues of exceptional importance to thousands of investors, who, by virtue of the decision, will be more susceptible to fraud and abuse at the hands of pay phone promoters and others selling a host of investments no longer subject to regulation as securities.

ARGUMENT

I. The Panel's Decision Conflicts With Supreme Court and Circuit Court Precedent

A. The Panel's Narrow Interpretation. Under *Howey* and a venerable line of Supreme Court cases, courts must interpret the definition of "investment contract" broadly, and must seek to

effectuate the remedial purposes of the federal securities laws – the protection of investors. *See SEC* v. *Howey*, 328 U.S. 293, 299, 301 (1946); *see also Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

In its decision, the Panel ignored these rules of construction and the interests of investors. It thus halted an enforcement action against a Ponzi scheme that fraudulently induced thousands of investors to part with millions of dollars, a result thoroughly at odds with the remedial purposes of the federal securities laws.

B. The Panel's Decision on Profits. The Panel held that because the returns promised by ETS were at a fixed rate, they could not be classified as a participation in earnings, and therefore could not be considered profits for purposes of the *Howey* test. *See* Op. at 8. This determination finds no support in either *Howey* or *Forman*, and it directly conflicts with holdings in other circuits.

In both *Howey* and *Forman*, the Court used a variety of terms to describe an investor's expectations under an investment contract, including "income," "profit," "participation in earnings," and "financial returns." *See Howey,* 328 U.S. at 298, 300; *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851-53 (1975). The Court used these terms not to graft technical distinctions – such as fixed versus variable rates –

onto investment contract analysis, but to differentiate the expectations of an investor from those of someone seeking to use or consume a commodity. *See, e.g., Forman,* 421 U.S. at 852-53.

The Panel's novel interpretation of profits conflicts with at least two other circuit court cases. In *SEC v. The Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), the Third Circuit addressed precisely the same issue confronting the Panel, and held that "the definition of a security does not turn on whether the investor receives a variable or fixed rate of return." *Id.* at 189. In *SEC v. SG Ltd.*, 265 F.3d 42 (1st Cir. 2001), the First Circuit had no difficulty finding an "expectation of profits" even where the promoter "flatly guaranteed that investments in the shares of the privileged company would be profitable, yielding monthly returns of 10% . . . ." *Id.* at 54.[2]

B. The Panel's Decision on the Efforts of Others. The Panel also ruled that because investors' returns were contractually guaranteed, those returns were not derived from the efforts of others. *See* Op. at 8-9. This startling result

[2] The panel's decision also conflicts with cases holding that an investment contract should be measured by the promoter's representations. *See, e.g., SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943). The Eleventh Circuit has adopted this approach. *See SEC v. Unique Financial Concepts*, 196 F.3d 1195 (11th Cir. 1999) (sham investment in foreign currency options evaluated under *Howey* in terms of the promoter's representations). Edwards unabashedly used the lure of "profits" to sell his pay phone investments. *See* R1-1-Exh. 15. at 9, Exh. 17 at 9, and Exh. 20 at 46, 78-79.

cannot be reconciled with precedent or logic. Under a legion of Supreme Court and circuit court decisions, the appropriate focus of the third *Howey* element is not on whether returns are contractually guaranteed, but on "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *See SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir. 1973).

The Eleventh Circuit has previously followed this approach. In *Albanese v. Florida Nat'l Bank of Orlando*, 823 F.2d 408 (11th Cir. 1987), a case involving an ice machine sale and leaseback scheme, this Court found that the promoters retained managerial control over the ice machines and on this basis held that the "efforts of others" test was satisfied. *Id.* at 410-412[3]. Similarly in this case, any returns that investors received were derived not from any guarantee, but from ETS's continuing efforts to manage the pay phones or entice additional investors.

II. The Panel's Decision Involves Questions of Exceptional Importance

By holding that the ETS pay phone investments are not securities, the Panel has placed investors at risk. Over the

[3] *See also United States v. Carman,* 577 F.2d 556, 563 (9th Cir. 1978) (fixed interest guaranteed by federal government was derived from efforts of others due to investors' passive role and their continuing dependence upon promoter's sound management and solvency).

past decade, there have been widespread abuses in the marketing of pay phone schemes, and as a consequence, thousands of investors have lost money. Federal and state securities regulators have been able to enjoin many of these illegal offerings and impose fines and restitutionary remedies.[4] However, the Panel's decision ties the SEC's hands in this Circuit with respect to these products.

The Panel's decision also threatens a much broader harm by narrowing the application of the *Howey* investment contract test. "Guaranteed" and "fixed returns" are often meaningless labels that promoters attach to their investment contracts to attract investors. Under the Panel's decision, these same terms – easily inserted into a contract – will also serve as a convenient shield against regulation under the securities laws. Promoters offering a wide variety of bogus investment contracts can now be expected to seek refuge in the Panel's decision.

---

[4] *See, e.g., SEC v. Phoenix Telecom,* Civil Action No. 100-CV-1970-JTC (N.D.Ga.), 2001 WL 874314 (SEC Release No. 17089, Aug. 3, 2001); *SEC v. Linktel Communications,* Civil Action No. 100-CV-3169-WBH (N.D. Ga.), 2000 WL 1773106 (SEC Release No. 16816, Dec. 4, 2000); *United States v. Kuhlmann,* 97-CR-2871H (S.D. Cal.), 1999 WL 306881 (SEC Release No. 16145, May 14, 1999); *SEC v. Kendall,* Civil Action No. 94Z-1227 (D. Colo.), 1996 WL 635380 (SEC Release No. 15145, Nov. 4, 1996); *SEC v. Levine*, Civil Action No. 946898-CIV-ZLOCH (S.D. Fla.), 1994 WL 559076 (SEC Release No. 14279, Sept. 30, 1994); *SEC v. Haje,* Civil Action No. 92-510-CIV-J20 (M.D. Fla.), 1993 WL 347148 (SEC Release No. 13772, Sept. 3, 1993). State regulators also have been active in this area. In March 2001, NASAA announced the results of a

Finally, the Panel's decision will undermine state, as well as federal, securities regulation. State courts and state administrative agencies frequently consult federal decisions for guidance on securities issues. Two cases illustrate the point. In October last year, the Tennessee Court of Appeals adopted the "common enterprise" test espoused by the Sixth Circuit in *Cooper v. King*, No. 96-5361, 1997 WL 243424 (6th Cir. May 9, 1997), and thereby held that a pay phone investment very similar to the one before the Panel was not subject to regulation as an investment contract. *See King v. Pope*, No. M2000-02127-COA-R3-CV, 2001 WL 1191384, at *2, 3 (Tenn. Ct. App. Oct. 10, 2001). This unfortunate result reflects the downstream influence of federal securities law on state securities case law.

Recently, an Administrative Law Judge with the Florida Division of Administrative Hearings relied heavily on the **district court's** opinion in this case to find that the same ETS pay phone agreements at issue here **were** investment contracts and therefore securities subject to regulation under Florida law. *See Dep't of Banking & Finance v. Mehl*, No. 02-0526, at 37-39 (Fla. Div. Admin. Hgs. July 16, 2002) (Recommended Order), attached in the Appendix. The ALJ imposed over $5 million in administrative fines against the two respondents for

---

crackdown by securities regulators in 25 states and the District of Columbia against fraudulent pay phone programs.

registration and licensing violations under the Florida securities statute. *Id.* at 44-45. The ALJ deemed the penalty to be fair given the "enormity of the harm caused by the respondents," who had "left many persons in irreversible financial ruin for the remaining years of their lives." *Id.* at 44. The Panel's decision should be reconsidered and corrected to help protect future investors in similar cases.

CONCLUSION

For the reasons set forth above, the SEC's petition for rehearing and rehearing *en banc* should be granted.

Respectfully submitted,

ROYCE O. GRIFFIN
General Counsel
STEPHEN W. HALL
Associate Counsel
North American Securities
Administrators Association, Inc.
10 G Street, N.E., Suite 710
Washington, D.C. 20002
(202) 737-0900

Peter J. Anderson
Georgia Bar Number 017837
Local Counsel
Sutherland, Asbill & Brennan, LLP
999 Peachtree Street, N.E.
Atlanta, GA 30309
404-853-8000

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on the ___ day of September, 2002, the required number of copies of the foregoing brief of *amicus curiae* North American Securities Administrators Association, Inc., were served by next day delivery service, on the following persons at the following addresses:

Michael K. Wolensky, Esq.
Ethan H. Cohen, Esq.
Laura J. Sauriol, Esq.
Kutak Rock, LLP
225 Peachtree Street, N.E.
Suite 2100
Atlanta, GA 30303
Counsel for Appellant

Susan S. McDonald
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549-0606
Counsel for Appellee

_____
Peter J. Anderson
Georgia Bar Number 017837