No. 04-1723

In the Supreme Court of the United States

HENRY C. YUEN, ET AL., PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENT IN OPPOSITION

GIOVANNI P. PREZIOSO
General Counsel
RICHARD M. HUMES
Associate General Counsel
MELINDA HARDY
Assistant General Counsel
THOMAS J. KARR
Special Trial Counsel
Securities and Exchange Commission
Washington, D.C. 20549

PAUL D. CLEMENT
Solicitor General
Counsel of Record
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

QUESTIONS PRESENTED

1. Whether termination payments of more than $37 million that petitioners' employer proposed to make to petitioners while their conduct was the subject of a Securities and Exchange Commission (SEC) investigation for securities fraud were "extraordinary payments" under Section 1103 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 78u-3(c)(3)(A)(i) (Supp. II 2002).

2. Whether Section 1103 violates the Fourth Amendment.

3. Whether Section 1103 is void for vagueness as applied to petitioners, because the SEC did not tell them in advance whether it would seek to escrow the entire $37 million in termination payments.

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OPINIONS BELOW

The en banc opinion of the court of appeals (Pet. App. 68a-123a) is reported at 401 F.3d 1031. The vacated panel opinion of the court of appeals (Pet. App. 23a-67a) is reported at 367 F.3d 1087. The June 20, 2003 memorandum decision of the district court (Pet. App. 1a-22a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on March 22, 2005. The petition for a writ of certiorari was filed on June 20, 2005. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Section 1103 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 78u-3(c)(3) (Supp. II 2002), authorizes the Securities and Exchange Commission (SEC or the Commission) to freeze temporarily certain payments to corporate officers during the course of an investigation.[1] Under Section 1103, if during an SEC investigation it appears that an issuer of publicly traded securities will likely make "extraordinary payments (whether compensation or otherwise)" to a corporate insider under investigation, the SEC can petition a district court to place those payments in escrow for 45 days. 15 U.S.C. 78u-3(c)(3)(A)(i) (Supp. II 2002). That brief pre-litigation escrow can be extended, upon a showing of good cause, for 45 additional days, after which the escrow order may continue, with court approval, only if the SEC files suit before it expires. 15 U.S.C. 78u-3(c)(3)(A)(iv) and (B)(i) (Supp. II 2002). The temporary escrow order may be entered "only after notice and opportunity for a hearing, unless the court determines that notice and hearing prior to entry of the order would be impracticable or contrary to the public interest," 15 U.S.C. 78u-3(c)(3)(A)(ii) (Supp. II 2002), and any person affected by the temporary escrow order has the right to petition the court for relief, 15 U.S.C. 78u-3(c)(3)(B)(i). If the SEC does not seek to extend the escrow, the escrowed monies are released with accrued interest. 15 U.S.C. 78u-3(c)(3)(B)(ii). See Pet. App. 71a-72a.

2. Gemstar-TV Guide International, Inc. (Gemstar) is a publicly traded company that develops and licenses intellectual property and proprietary technologies, pub-

[1] The text of Section 1103 is set out in full in the petition (at 2-4).

lishes *TV Guide* magazine, and operates the TV Guide Channel. Petitioner Yuen became Gemstar's Chief Executive Officer in 1994 and its Chairman of the Board in 1999. Petitioner Leung became Gemstar's Chief Financial Officer in 1994. In 2002, Gemstar began a series of corrections to substantial financial misstatements that it had made in public filings with the SEC while petitioners were at its helm. On April 1, 2002, Gemstar filed its Form 10-K for 2001, revealing that $107.6 million that Gemstar had previously claimed as revenue had not actually been realized. The filing also disclosed that Gemstar had improperly claimed substantial revenue from a "non-monetary transaction." Those revelations caused Gemstar's stock price to drop 37% the next day. Four days before the disclosure and resulting stock price decline, Yuen had sold 7 million Gemstar shares, receiving an initial payment of $59 million. SEC C.A. Br. 5-6; Pet. App. 74a-76a.

On August 14, 2002, Gemstar declared in a Form 8-K—a current report filed with the SEC to "announce major events that shareholders should know about," see http://www.sec.gov/about/forms/form8-k.pdf; 15 U.S.C. 78m(a)(1); 17 C.F.R. 240.13a-11—that it intended to restate its 2001 financial results and to reverse an additional $20 million in revenue and make other significant corrections. Gemstar attached sworn statements from petitioners that they were unable to certify the accuracy of some of Gemstar's financial statements, and that they were unable to comply with SEC orders to do so. Pet. App. 74a-75a.[2]

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[2] In June 2002, the SEC ordered the principal executive officer and principal financial officer of each company with annual revenues over $1.2 billion to file a report with the Commission regarding the accuracy of their company's financial statements and their consultation with the

On September 25, 2002, Gemstar filed another Form 8-K. In it, Gemstar disclosed that: NASDAQ had warned Gemstar that its securities were subject to delisting for failure to timely file a Form 10-Q for the quarter ending on June 30, 2002; because of its unresolved dispute with KPMG (its independent auditor), Gemstar could not file its Form 10-Q report; and any resolution of those accounting and financial matters was "uncertain" and "unpredictable." Pet. App. 75a.

At the same time that the accounting problems were coming to light, petitioners engaged in extensive negotiations with Gemstar's board of directors and eventually entered into an agreement in which they agreed to resign, effective November 7, 2002, from their respective executive positions. In return, Gemstar agreed to pay Yuen $29.48 million and Leung $8.16 million, and both of them remained as employees. The payments extinguished petitioners' rights under their existing severance packages, but did not reflect the payment amounts promised in those prior packages. Gemstar also agreed to give Yuen 5.27 million shares of restricted stock or stock units and to give Leung options to purchase over 1.1 million shares of common stock and 353,680 shares of restricted stock or stock options. Gemstar reported those developments on November 12, 2002, filing another Form 8-K. Pet. App. 76a.

After petitioners stated that they could not certify Gemstar's financial statements, the SEC began investigating Gemstar, petitioners, and others for possible securities-law violations. Upon learning in October 2002

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company's audit committees. See File No. 4-460: Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934 (June 27, 2002) <http://www.sec.gov/rules/other/4-460.htm>.

of the proposed $37 million in termination payments to petitioners, the SEC asked Gemstar and petitioners to place those payments in escrow. On November 6, 2002, shortly before the termination payments were to be made, Gemstar and petitioners signed side agreements providing that Gemstar would hold the monies in escrow until May 6, 2003. Pet. App. 5a, 26a-27a.

The SEC subpoenaed Yuen to testify in its investigation. Yuen appeared on April 1, 2003, for testimony and answered general background questions. He appeared again on April 23, but he invoked the Fifth Amendment privilege against self-incrimination, refusing to answer questions regarding any matters beyond his general background. SEC C.A. Br. 9-10 n.4; Pet. App. 82a.

3. On May 5, 2003, the day before Gemstar was scheduled to make the termination payments to petitioners, the SEC filed in the United States District Court for the Central District of California an *ex parte* application for a 45-day pre-litigation escrow under Section 1103, 15 U.S.C. 78u-3(c)(3) (Supp. II 2002), naming Gemstar (which held the funds) as respondent. Pet. App. 80a. The district court granted petitioners' request to intervene to resist the SEC's application for a 45-day escrow, afforded them an opportunity to file an opposition to the escrow, and held a hearing, at which it granted the SEC's application. After further briefing and an additional hearing, the district court issued an opinion setting forth its reasons for granting the SEC's application and denying petitioners' requests to dissolve the 45-day escrow. *Id.* at 6a, 27a-28a.

Before the 45-day escrow expired, the SEC filed a civil complaint against petitioners, charging that they had engaged in a fraudulent scheme to inflate Gemstar's revenues by at least $223 million. Pet. App. 28a. The

complaint also charged that, because their compensation was linked to Gemstar's reported financial results, petitioners reaped millions of dollars—in excess salary, bonuses, and options—from their fraudulent manipulation of Gemstar's revenues. The SEC also asked the district court to continue the escrow until the conclusion of legal proceedings pursuant to Section 1103, 15 U.S.C. 78u-3(c)(3)(B)(i).

On June 20, 2003, the district court issued an opinion rejecting petitioners' contentions that the termination payments were not "extraordinary payments" within the meaning of Section 1103, 15 U.S.C. 78u-3(c)(3)(A)(i). Pet. App. 1a-22a. The court explained that "Congress intended for the courts to look to a variety of factors to determine whether a payment is extraordinary," including "the size of the payment, the circumstances under which a payment is made, and the purpose of the payment." *Id*. at 13a. The court concluded that, whatever the outer bounds of the definition of "extraordinary payments," the payments at issue "fall squarely within" it. *Ibid*. The district court also rejected petitioners' contention that the statute was unconstitutionally vague. *Id.* at 13a-17a. The district court therefore entered an order continuing the escrow pursuant to Section 1103. SEC C.A. Br. 12-13; Pet. App. 28a.[3]

4. A divided panel of the court of appeals vacated the escrow, holding that the SEC had not shown that the termination payments to petitioners were "extraordinary payments" under Section 1103. Pet. App. 32a-39a. The court of appeals subsequently granted the SEC's

[3] Petitioners stipulated that, once the SEC filed suit, the termination payments were to remain in escrow, even though the district court expressly noted that petitioners could petition the district court for relief from the escrow "[i]f they so desire." C.A.E.R. 379.

petition for rehearing en banc, see *SEC* v. *Yuen*, 384 F.3d 1090 (2004). On rehearing, the court of appeals affirmed the district court's entry of the escrow. Pet. App. 68a-123a.

The court of appeals rejected petitioners' contention that their negotiated termination payments were not "extraordinary payments" within the meaning of Section 1103. The court explained that "'[e]xtraordinary' means, in plain language, out of the ordinary." Pet. App. 92a-93a. The court further observed that "extraordinary" "means a payment that would not typically be made by a company in its customary course of business," *id*. at 93a. Because "[t]he standard of comparison is the company's common or regular behavior," *ibid.*, the court reasoned that "the determination of whether a payment is extraordinary will be a fact-based and flexible inquiry," *ibid*. That inquiry, the court explained, should take into account "the circumstances under which the payment is contemplated or made," its purpose, and its size. *Ibid*. The court identified a "nexus between the suspected wrongdoing and the payment," and the practices of similarly situated businesses as additional factors that a court could consider. *Id*. at 93a-94a.

The court of appeals further held that the district court had correctly applied this analysis in finding that the proposed termination payments were extraordinary. It observed that the termination payments to petitioners were far greater than their respective annual salaries; differed from the amounts of the severance payments under their employment agreements; appeared to be at least in part the fruit of Gemstar's "alleged fraudulent financial results"; were arrived at as part of petitioners' ouster from Gemstar management; and were reported by Gemstar in a Form 8-K filing with the SEC. Pet.

App. 95a-96a. The court of appeals also cited the "glaring fact" that Yuen invoked the Fifth Amendment rather than testify about his compensation. *Id*. at 95a.

Finally, the court of appeals rejected petitioners' Fourth and Fifth Amendment challenges to the escrow. The court held that the escrow procedures were reasonable under the Fourth Amendment and that Section 1103 was not unconstitutionally vague because it neither fails to provide people of ordinary intelligence a reasonable opportunity to understand what conduct it prohibits, nor authorizes arbitrary and discriminatory enforcement. *Id*. at 70a n.1, 98a-99a.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is not warranted.

1. Petitioners contend (Pet. 17-21) that the court of appeals adopted an overly broad definition of the phrase "extraordinary payments" as used in Section 1103 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 78u-3(c)(3). That contention is incorrect, and in any event does not merit review.

a. The court of appeals interpreted Section 1103 consistently with the plain meaning of the phrase "extraordinary payments," the historical context in which it was enacted, the legislative history, and the broader purposes of the federal securities laws. See *Household Credit Servs., Inc.* v. *Pfennig*, 541 U.S. 232, 239 (2004) (in ascertaining statute's plain meaning, courts "must look to the particular statutory language at issue, as well as the language and design of the statute as a whole"). As the court of appeals explained, "extraordinary" simply means "out of the ordinary; . . . employed for an

exceptional purpose or on a special occasion." Pet. App. 93a (quoting *Black's Law Dictionary* 586 (6th ed. 1990)); see also *Oxford English Dictionary* 614 (2d ed. 1989) (defining "extraordinary" to mean, *inter alia*, "[o]ut of the usual or regular course of order * * * exceptional; unusual; singular"). The court of appeals' reliance on factors such as the circumstances in which the payments would be made (here, in connection with petitioners' termination as officers), the size of the payments in relation to other benchmarks such as petitioners' base salary, and the purpose of the payments (here, as a settlement of disputed matters) is consistent with the plain-meaning understanding of "extraordinary."[4]

The flexible approach adopted by the court of appeals is consistent with this Court's observation that the Securities and Exchange Act of 1934, 15 U.S.C. 78a *et seq.*, into which Section 1103 was incorporated, should be construed "flexibly to effectuate its remedial purposes." *SEC* v. *Zandford*, 535 U.S. 813, 819 (2002) (internal quotation marks omitted); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963). As the court of appeals recognized, Congress enacted Section 1103 to address the concern that the SEC's traditional remedies against corporate wrongdoers—disgorgement, civil penalties, and restitution—were of limited, if not illusory, value when the wrongdoers received corporate funds and were able to hide or spend them before the SEC could finish its investigation and file suit. Pet. App. 72a-73a. By eschewing "a specific litmus test that determines what is or is not an 'extraordinary payment,'" *id.* at 99a, the court of appeals' flexible approach effectuates

[4] By adopting this multi-factor approach, the court of appeals clearly did not establish a standard that "encompass[es] *any* payment to be made by a company under investigation by the SEC." Pet. 16.

Congress's intent to combat the dissolution of corporate assets in anticipation of an enforcement action.

The court of appeals' reading of Section 1103 is also supported by the statute's legislative history. For example, Senator Lott, Section 1103's sponsor, stressed that corporate executives had been receiving "rewards" "[w]hile an [SEC] investigation is underway," and that "corporate executives [were] taking increased payments, extraordinary payments, while they are being investigated." 148 Cong. Rec. S6542, S6545 (daily ed. July 10, 2002). Others members of Congress noted that if corporate executives "have manipulated the books and benefitted themselves," the SEC could use Section 1103 to freeze extraordinary payments "until appropriate investigation may be concluded to determine whether such payments were warranted or not." *Id*. at H4687 (daily ed. July 16, 2002) (statement of Rep. Baker); see generally Pet. App. 73a-74a, 101a-102a.

b. Petitioners urge (Pet. 17) an interpretation of "extraordinary payments" advanced by the dissent below, which would require the SEC to offer evidence of what constitutes "usual or ordinary" payments to a CEO and a CFO at a "comparable compan[y]" under "comparable circumstances." See Pet. App. 115a. Nothing in the text of Section 1103 suggests, however, that the SEC must establish that the payment is extraordinary in comparison to some general industry standard. Moreover, such an approach ignores the congressional purpose in enacting Section 1103 and would seriously undermine its utility.

As the court of appeals observed, "[o]dd it would be indeed to shield payments from escrow simply because an ousted insider at some other corporation has been similarly enriched." Pet. App. 96a. An "industry prac-

tice" approach would not only unjustifiably shield wrongdoers, but it would also multiply the complexities and burden of applying Section 1103. While the SEC may possess some information regarding the amount of compensation paid to executives at other companies, any consideration of "industry practice" would require the SEC to obtain, both from the company under investigation and from companies that could possibly serve as a basis for comparison (and that might not cooperate), information bearing on whether those other executives are indeed "similarly situated." The question of what constitutes a "comparable" corporation—including whether comparability should be judged by industry, revenues, assets, return-on-investment, corporate governance structure, or some other factors—is fraught with ambiguity, as is the question of how many comparisons the SEC would have to present to show that a payment to a corporate insider deviates sufficiently from the "ordinary."

Such ancillary investigations and proceedings are anathema to the aim of Section 1103. By congressional design, Section 1103 temporarily preserves the status quo while an SEC investigation continues. Thus, Section 1103 escrows will often be sought on an expedited (or emergency) basis. See Pet. App. 102a (Reinhardt, J., concurring in the result). Congress would not enact a provision designed to provide short-term protection to corporate assets in fluid circumstances, while simultaneously imposing such crippling constraints on its use. Cf. *SEC* v. *McCarthy*, 322 F.3d 650, 659 (9th Cir. 2003) (noting importance of SEC's ability to use congressionally enacted summary proceedings for vigorous fulfillment of its enforcement functions).

Equally unavailing is petitioners' contention that Section 1103 should be applied only when the payments are "improper * * * in some proven respect," Pet. 17, which they equate with embezzlement or payments otherwise lacking formal corporate approval. Pet. 17-20. Section 1103 contains no indication that its application should be so limited. It does not use the term "improper"; rather, it uses the term "extraordinary," and expressly states that "extraordinary payments" may include "compensation." 15 U.S.C. 78u-3(c)(3)(A)(i) (Supp. II 2002). The term "extraordinary payments" admits of no reading that is limited to "pilfered" payments or those otherwise not authorized by the board of directors. See Pet. 20. If Congress had intended such a meaning, it could easily have included such a limit in the statute. Moreover, since Section 1103 comes into play only when an SEC investigation is *ongoing*, the SEC could not be expected to have already reached a conclusion regarding the "proper" or "improper" nature of a particular payment.

c. In any event, petitioners point to nothing in the court of appeals' interpretation of Section 1103 that would merit this Court's intervention. Petitioners do not assert the existence of a circuit conflict; indeed, they do not cite any other appellate decision construing Section 1103 in any respect. Nor do petitioners suggest any other basis for the exercise of certiorari jurisdiction. This question is therefore not worthy of review.

2. Petitioners also err in contending (Pet. 21-25) that Section 1103 violates the Fourth Amendment's proscription against unreasonable seizures. As the court of appeals held, the Section 1103 escrow process is reasonable and does not offend Fourth Amendment principles. See Pet. App. 70a n.1.

The Fourth Amendment's warrant requirement and its concomitant probable-cause standard do not apply to Section 1103 escrows. As this Court has repeatedly emphasized, the touchstone of the Fourth Amendment is "reasonableness." *Board of Educ.* v. *Earls*, 536 U.S. 822, 828 (2002); *Illinois* v. *McArthur*, 531 U.S. 326, 330 (2001); *Soldal* v. *Cook County*, 506 U.S. 56, 71 (1992). Warrantless administrative searches and seizures directed at "closely regulated" businesses are reasonable under the Fourth Amendment if the government's interest is substantial, the process is necessary to further the regulatory scheme, and the program is "a constitutionally adequate substitute for a warrant." Pet. App. 70a n.1 (citing *New York* v. *Burger*, 482 U.S. 691, 702-703 (1987)).[5] Such is the case here.

First, the SEC has a substantial interest in investigating the persons and entities it regulates without risk-

[5] Petitioners contend (Pet. 24) that *Burger* is inapposite, because it involved "*searches*" rather than seizures, and the "time, place and scope" of the searches was limited there. But this Court has never suggested that seizures are subject to more rigorous standards than searches. See, *e.g.*, *McArthur*, 531 U.S. at 330-331 (discussing the Court's flexible approach to "warrantless search[es] or seizure[s]" in cases involving "special law enforcement needs, diminished expectations of privacy, minimal intrusions, or the like"). If anything, the Section 1103 regime is farther removed from the criminal process than the administrative inspection at issue in *Burger*. See 482 U.S. at 716-717 (inspecting officers may discover evidence of crimes during administrative inspection, and police officers may conduct the inspection). Moreover, the Section 1103 process is limited in time, place, and scope: the escrow order may last no more than 90 days in the absence of an SEC enforcement action, and, in the event an action is filed, the order may not last beyond the conclusion of the proceeding; the escrow order may only be entered by a federal district court; and the order may extend only to "extraordinary payments." 15 U.S.C. 78u-3(c)(3)(Supp. II 2002).

ing the dissipation of funds that may compensate victims of securities violations; indeed, courts have long held that measures to prevent such dissipation further an important public interest. See, *e.g.*, *SEC* v. *Infinity Group Co.*, 212 F.3d 180, 197 (3d Cir. 2000), cert. denied, 532 U.S. 905 (2001); *SEC* v. *Lauer*, 52 F.3d 667, 671 (7th Cir. 1995) (asset freeze "was and is essential to prevent the dissipation of assets"). Second, by permitting the SEC to seek the temporary escrow of corporate assets while it conducts its investigation into possible violations of the securities laws, Section 1103 "add[s] necessary teeth to the Commission's ability to perform its mission" to protect investors by "ensur[ing] that recovery by way of disgorgement, etc., is effective rather than empty." Pet. App. 97a. Third, the Section 1103 escrow process—by which the SEC must apply to a district court for an escrow order and anyone affected by the escrow has an opportunity to respond—adequately substitutes for a warrant.

Finally, the facts that a Section 1103 escrow order (1) is not part of a criminal prosecution; (2) is temporary; and (3) does not reveal private information further support the court of appeals' conclusion that Section 1103 is reasonable. See *Earls*, 536 U.S. at 828 (probable-cause standard "is peculiarly related to criminal investigations"); *United States* v. *Place*, 462 U.S. 696, 703 (1983) (discussing "exception to the probable-cause requirement for limited seizures" and observing that whether a seizure is reasonable turns on a balancing of "the nature and quality of the intrusion * * * against the importance of the governmental interests").

Petitioners suggest that the burden on them is substantial because the termination payments have been escrowed until resolution of the SEC's case against

them, which could last "months or years." Pet. 24. But that argument goes only to the post-complaint continuation of the escrow, and petitioners consented in the district court to the continuing escrow, see note 3, *supra*. In any event, the continuation of the escrow is attributable to the fact that the SEC has filed a lawsuit charging petitioners with federal securities law violations. See 15 U.S.C. 78u-3(c)(3)(B)(i). In those circumstances, the balancing of interests even more strongly favors the government, and the escrow remains subject to judicial oversight. Petitioners' Fourth Amendment challenge is thus entirely without merit.

3. Petitioners contend (Pet. 25-27) that Section 1103, as applied to them, is unconstitutionally vague under the Fifth Amendment's Due Process Clause. Their vagueness challenge is based on their claim that, before they and Gemstar agreed in November 2002 to postpone the termination payments, the SEC allegedly "did not clarify its position on the breadth of Section 1103." Pet. 25. That fact-bound contention does not merit further review.

Although petitioners suggest (Pet. 25) that the "SEC [m]isled" them, their underlying factual contention is merely that the SEC "appeared" to admit that it would not seek an escrow of that part of the termination payments purportedly attributable to vacation pay, and that the SEC at that time "did not clarify its position." Pet. 25. In reality, the SEC consistently maintained that the termination payments in their entirety were potentially subject to a Section 1103 escrow. Indeed, petitioners' agreements with Gemstar expressly recognized that the SEC might ask that "all or a portion" of the $37 million be placed "into an escrow pursuant to the Sarbanes-Oxley Act." C.A.E.R. 7-8; see Pet. App. 26a.

Moreover, the SEC had no obligation to inform petitioners whether it would seek a Section 1103 escrow of the entire $37 million before it actually applied for the escrow. The SEC did not breach any agreement with petitioners and did not cause them to incur any liability they might otherwise have escaped. The only case on which petitioners rely, *Chalmers* v. *City of Los Angeles*, 762 F.2d 753 (9th Cir. 1985), is readily distinguishable. There, faced with one city ordinance that appeared to bar a vendor's T-shirt sales and another ordinance that appeared to allow her sales, the vendor consulted the City Clerk's Office, which "assured her that her planned activities were permitted." *Id.* at 756. When the vendor tried to sell her shirts, however, "she was harassed, threatened with arrest and prosecution, and ultimately prevented from selling the T-shirts" by police who contended the sale was illegal. *Ibid.* The *Chalmers* court held that the city deprived the vendor of due process by taking action against her for activity that the city had assured her was legal. *Id.* at 759. Nothing remotely analogous occurred here.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

PAUL D. CLEMENT
Solicitor General

GIOVANNI P. PREZIOSO
General Counsel
RICHARD M. HUMES
Associate General Counsel
MELINDA HARDY
Assistant General Counsel
THOMAS J. KARR
Special Trial Counsel
Securities and Exchange Commission

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