THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 48 No. 9 May 6, 2015

# LITIGATING WITH — AND AT — THE SEC

*Last year, the Enforcement Division of the SEC announced its intention to bring more enforcement actions in its own administrative forum rather than in federal court. The authors describe these administrative proceedings under the Commission's Rules of Practice, beginning with the filing of charges, the run-up to the hearing, the hearing itself, and the appeal process. Although there are significant differences between the SEC's rules and those of a federal district court, not all such differences, the authors find, favor the Enforcement Division.*

By Douglas Davison, Matthew Martens, Nicole Rabner,
John Valentine, and Natalie Rastin *

The Enforcement Division of the U.S. Securities and Exchange Commission last year announced its intention to bring more enforcement actions in its own administrative forum, rather than in federal district court. Since that time, several federal lawsuits and a growing chorus of defense lawyers have argued that SEC enforcement actions brought in its administrative forum are unconstitutional and generally give the Enforcement Division an unfair advantage. A recent analysis indicates that the SEC Staff won all six contested administrative hearings in fiscal year 2014[1] and, in the same year, instituted twice as many administrative cases as it did in fiscal year 2009.[2] Similarly, the SEC won nine out of 10 contested administrative proceedings in fiscal year 2013 and all seven in fiscal year 2012.[3] While the benefits of "home court" advantage for the Division should not be discounted, the Division's published win rate may have more to do with how it

[1] Jean Eaglesham, *SEC Is Steering More Trials to Judges It Appoints*, Wall St. J., Oct. 21, 2014, *available at* http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it-appoints-1413849590.

[2] Jenna Greene, *The SEC's On a Long Winning Streak*, National Law J., Jan, 19, 2015 (noting that the SEC instituted 235 administrative cases in fiscal year 2014 and 118 in fiscal year 2009).

[3] Eaglesham, *supra* note 1.

* *DOUGLAS DAVISON, MATTHEW MARTENS, NICOLE RABNER and JOHN VALENTINE are partners in the Washington, D.C. office of Wilmer Cutler Pickering Hale and Dorr, LLP. NATALIE RASTIN is a counsel in the New York office. Their e-mail addresses are Douglas.Davison@wilmerhale.com; Matthew .Martens@wilmerhale.com; Nicole.Rabner@wilmerhale.com; John.Valentine@wilmerhale.com; and Natalie.Rastin@wilmerhale.com.*

***IN THIS ISSUE***

***RSCR Publications LLC*** Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (866) 425-1171 or visit our Web site at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb.  ISSN: 0884-2426. 

counts a "win"[4] and with the types of cases it has historically chosen to bring administratively — delisting proceedings and matters against registered persons and accountants, for example, which tend to be more straightforward. In the past, there have been noteworthy rulings by SEC ALJs that fully exonerated respondents or gave the Division only partial victories.[5]

That said, certain of the rules governing the SEC's administrative proceedings clearly favor the Division Staff. The Division Staff is empowered to investigate and collect evidence for years prior to bringing an action, while defense counsel typically has at most a few months with the full record to prepare for trial. In addition, defense counsel generally cannot supplement the Division's evidentiary record with discovery depositions, and opportunities for motion practice are extremely limited. In June 2014, the SEC's General Counsel (speaking for herself, not the Commission) acknowledged that the rules of the agency's administrative proceeding were last revised "quite some time ago," and indicated the agency may be open to modernizing them.[6] While there is some chance these rules may change, we expect that revisions will not be made in the near future. In the meantime, the Enforcement Division has indicated it expects to use its administrative proceedings frequently, and the reality is that targets of SEC enforcement inquiries need to plan for the possibility of litigating their cases in the SEC's in-house forum.

With careful preparation and a clear understanding of the ins and outs of SEC administrative litigation, prevailing in those proceedings is far from impossible. In this article we discuss why the Commission is authorizing more cases to be heard in administrative proceedings, how those proceedings differ from federal district court actions, and what targets and their counsel can do to prepare for and succeed in those proceedings.

## FILING THE CHARGES: THE LITIGATION BEGINS

Investigations by the SEC are typically long-running affairs that can, and often do, stretch over many years. If, at the conclusion of its investigation, the Commission decides to bring an action against an individual or entity, it may do so in either a federal district court action or in an agency proceeding before an administrative law judge ("ALJ"). The Commission has discretion to pick the forum and does not publicly explain its choice. It may select one forum over another for any number of strategic, prudential, or tactical reasons. For example, administrative proceedings are heard on the merits by ALJs, rather than juries, and thus the Enforcement Division may propose to bring an action in an administrative forum if the subject matter involves complex issues that would be outside the experience and understanding of a typical layperson jury. Technically, there are two types of enforcement proceedings that may be brought before an ALJ: an administrative

[4] The Enforcement Division records as a "win" any case in which it secures a finding of liability on any claim. So, for example, in *Harding Advisory LLC*, Initial Decision Rel. No. 734, 2015 SEC LEXIS 118 (Jan. 12, 2015) (a case tried in fiscal year 2014), the Initial Decision found the respondents not liable on certain significant claims, but the Enforcement Division would record it as a win. *Id.* (finding that respondents committed multiple violations of the securities laws, but also noting, as to a key transaction at issue, that the Enforcement Division failed to prove wrongdoing by respondents in a number of respects or that respondents' conduct was intentional).

[5] *See, e.g.*, *Thomas R. Delaney II*, Initial Decision Rel. No. 755, 2015 SEC LEXIS 1014 (Mar. 18, 2015) (finding that respondent Delaney did not willfully aid and abet the company's violations of Regulation SHO but that he was a cause of the violations, and finding that respondent Yancey did not fail to supervise); *Miguel A. Ferrer*, Initial Decision Rel. No. 513, 2013 SEC LEXIS 3407 (Oct. 29, 2013) (finding that respondents did not make material misrepresentations or omissions to customers and did not engage in a fraudulent course of conduct or scheme to mislead customers regarding closed-end funds whose shares were issued and sold to investors); *Theodore W. Urban*, Initial Decision Rel. No. 402, 2010 SEC LEXIS 2941 (Sept. 8, 2010) (finding in favor of respondent chief legal officer of broker-dealer on failure-to-supervise claims and pointing out the "loss of professional reputation, employment opportunities, expense, and pride" to the respondent as a result of the Division's prosecution); *Harding Advisory LLC*, *supra* note 4.

[6] Stephanie Russell-Kraft, *Attys Ready To Pounce on SEC's Outdated Admin Rules*, Law360, June 18, 2014.

proceeding[7] and a cease and desist proceeding.[8] In most cases, an agency proceeding is initiated as both an administrative and a cease and desist proceeding.[9] (Accordingly, we will refer to such a combined proceeding in this article as an "administrative proceeding" unless specified otherwise.)

An administrative proceeding is initiated by the issuance of an Order Instituting Proceeding ("OIP"), which is analogous to the filing of a complaint in federal court.[10] The defendant in the OIP is called a "respondent." The issuance of an OIP is authorized by an affirmative vote of a majority of the Commission, but the allegations of the OIP are only those of the SEC's Division of Enforcement. While the OIP will typically state that the allegations are made "[a]fter an investigation," there is no provision in the agency's rules comparable to Federal Rule of Civil Procedure 11 that governs the degree of diligence the Enforcement Division must exercise in making its allegations.[11] The OIP typically directs that a hearing be held on the Enforcement Division's allegations in accordance with the agency's procedural rules and that the respondent file an Answer to the allegations within a set period of time, usually 20 days.[12]

The Secretary of the Commission serves a copy of the OIP on the respondent by delivering a copy to the person by hand, at their residence, at their place of business, or, in the case of an entity, to the entity's officer or agent.[13] In addition to these methods, an OIP may be served on a respondent in a foreign country "by any other method reasonably calculated to give notice, provided that the method of service used is not prohibited by the law of the foreign country."[14] If a respondent fails to appear or to respond to the allegations of the OIP as ordered, the respondent may be deemed to be in "default," as a result of which the ALJ may deem the Enforcement Division's allegations to be true and enter an order against the respondent based on those allegations.[15]

In contrast to the often slow pace of SEC investigations and, at times, federal court actions, administrative proceedings brought by the SEC now move at a brisk pace. By statute, a cease and desist proceeding must move to a hearing within 60 days unless the respondent consents to a longer time period.[16] Accordingly, the OIP initiating a cease and desist proceeding (whether alone or in combination with an administrative proceeding) will usually direct that the hearing occur within 60 days.[17] Depending on the complexity of the matter, the Commission will typically set, in the OIP, the time period in which the ALJ presiding over the matter must issue an "initial decision," which is the ALJ's decision on the merits of the matter and the relief sought.[18] The Commission can

[7] Securities Exchange Act § 15(b)(4), 15 U.S.C. 78o(b)(4); Investment Company Act § 9(b), 15 U.S.C. § 80a-9(b); Investment Advisers Act § 203(e), 15 U.S.C. § 80b-3(e).

[8] Securities Act § 8A, 15 U.S.C. § 77h-1; Securities Exchange Act § 21C, 15 U.S.C. § 78u-3; Investment Company Act § 9(c), 15 U.S.C. § 80a-9(c); Investment Advisers Act § 203(k), 15 U.S.C. § 80b-3(k).

[9] *See, e.g., Harding Advisory LLC*, Rel. No. 33-9467, 2013 SEC LEXIS 3302 (Oct. 18, 2013). Prior to 2010, the Commission was somewhat limited in the types of cases it could bring in agency proceedings before an ALJ and in the remedies that it could obtain in those proceedings. With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203, 124 Stat. 1376 (2010), however, the Commission is able now to obtain in agency proceedings remedies that are essentially identical to those it can obtain in federal district court actions. 15 U.S.C. § 78d-5.

[10] SEC Rules of Practice, Rules 101(a)(7), 141(a) and 200(a).

[11] There are, however, federal statutes that authorize a respondent to recover attorney's fees if the agency's allegations prove to be unfounded. *See, e.g.*, Equal Access to Justice Act ("EAJA"), 5 U.S.C. § 504. The Commission's EAJA Regulations provide that no award of attorney's fees may exceed a rate of $75.00 per hour. 17 C.F.R. § 201.36(b).

[12] *See, e.g.*, Harding Advisory LLC, *supra* note 9.

[13] SEC Rules of Practice, Rule 141(a)(2).

[14] SEC Rules of Practice, Rule 141(a)(2)(iv). *See, e.g., BDO China Dahua CPA Co., Ltd.*, Rel. No. 34-68335, 2012 SEC LEXIS 3704 (Dec. 3, 2012) (ordering that the OIP "shall be served upon Respondents through the respective domestic registered public accounting firms or other United States agents that Respondents have designated under Section 106(d) of Sarbanes-Oxley").

[15] SEC Rules of Practice, Rule 155.

[16] 15 U.S.C. §§ 77h-1(b) ("The notice instituting proceedings . . . shall fix a hearing date not earlier than 30 days nor later than 60 days after service of the notice unless an earlier or later date is set by the Commission with the consent of any respondent so served."), 78u-3(b) (same), 80b-3(k)(2) (same).

[17] *See, e.g.*, Harding Advisory LLC, *supra* note 9.

[18] SEC Rules of Practice, Rule 360(a)(1) ("[T]he hearing officer shall prepare an initial decision in any proceeding in which the Commission directs a hearing officer to preside at a hearing"), 360(b) ("An initial decision shall include: findings and conclusions, and the reasons or basis therefor, as to all the material issues of fact, law, or discretion presented on the

order that the initial decision be issued in 120, 210, or 300 days from the service of the OIP.[19] If the Commission sets a 300-day deadline for the ALJ's initial decision, the hearing on the allegations in the OIP must occur, according to agency rules, "approximately four months" from the date of the OIP.[20] In circumstances where the time period allowed by rule to begin the administrative hearing is longer than the statutory 60-day period in which a hearing in a cease and desist proceeding must begin, the respondent will typically consent to the longer period and a scheduling order will be issued by the ALJ setting the date of the hearing as allowed by the rules.[21]

While the Commission or the hearing officer can postpone or adjourn the hearing date beyond the deadlines set by the agency's rules "for good cause shown,"[22] the SEC Rules of Practice express "a policy of strongly disfavoring" such postponements or adjournments absent a "strong showing" that the failure to postpone or adjourn the hearing would "substantially prejudice" the respondent's case.[23] In a recent case, the respondents' counsel represented that the documents produced to him by the Enforcement Division were more expansive than the entire printed Library of Congress, and the parties agreed that the files were not entirely searchable, yet the ALJ denied a request for a six-month extension to review those materials.[24] Thus, even in extraordinarily complex matters, the respondent (and the Enforcement Division) can, and generally will, be forced to a hearing on the matter in approximately four months from the filing of the OIP. By contrast, the ALJ presiding over the matter can request that the Commission grant additional time after the hearing for the ALJ to issue his or her initial decision,[25] and those requests are routinely granted.[26]

As noted above, the hearing on the Enforcement Division's allegations will be held before an ALJ who is an employee of the SEC.[27] An ALJ is assigned by the agency's Chief ALJ to preside over a particular matter.[28] The Commission currently employs five ALJs: Brenda Murray, Carol Foelak, Cameron Elliott, James Grimes, and Jason Patil.[29] We have no reason to believe these

*footnote continued from previous page…*

record and the appropriate order, sanction, relief, or denial thereof.").

[19] SEC Rules of Practice, Rule 360(a)(2).

[20] *Id.*

[21] *See, e.g., Miguel A. Ferrer*, Admin. Proc. Rulings Rel. No. 706, 2012 SEC LEXIS 1843 (June 13, 2012). The ALJ has the power to issue this revised scheduling order pursuant to authority delegated from the Commission. 17 C.F.R. § 200.30-10(a)(1), (3).

[22] SEC Rules of Practice, Rule 161(a).

[23] *Id.*, Rule 161(a), 161(b) and 360(a)(3); *see also Dearlove*, Rel. No. 34-57244, 2008 SEC LEXIS 223, at *137-38 (Jan. 31, 2008) (explaining that the Rules of Practice provide ALJs "some flexibility" to postpone a hearing beyond the designated time limits by seeking relief from the Commission). The Rules separately provide for the possibility of a stay at the request of a federal, state, or local prosecutor during the pendency of criminal investigation or prosecution arising out of the same or similar facts. In administrate proceedings, such motions are "favored" and will be granted upon a showing that it is in the public interest or for the protection of investors. SEC Rules of Practice, Rule 210(c)(3). In cease and desist proceedings, however, such motions can only be granted with the consent of the respondent because of the statutory requirement that the hearing occur within 60 days. *See supra* note 16. The Rules also allow for a stay pending Commission consideration of offers of settlement. *Id.*, Rule 161(c)(2).

[24] *Harding Advisory LLC*, Admin. Proc. Rulings Rel. No. 1195, 2014 SEC LEXIS 280 (Jan. 24, 2014). In the Order, the ALJ noted that he already had set the hearing date more than four months after service of the OIP and extended other deadlines as well. In *Dearlove v. SEC*, 573 F.3d 801, 807(D.C. Cir. 2009), an accountant challenged on constitutional due process grounds the SEC's failure to postpone his administrative hearing to allow him time to review the large administrative file. The court sided with the SEC, reasoning that the ALJ considered the relevant factors under the SEC's Rules of practice and that the agency has "broad discretion … in ordering the conduct of its proceedings." *Id*.

[25] SEC Rules of Practice, Rule 360(a)(3).

[26] *See, e.g., Harding Advisory LLC*, Rel. No. 33-9632 (2014), 2014 SEC LEXIS 2993 (Aug. 21, 2014); *Donald J. Anthony*, Rel. No. 33-9628, 2014 SEC LEXIS 2854 (Aug. 7, 2014).

[27] SEC Rules of Practice, Rule 110 ("All proceedings shall be presided over by the Commission or, if the Commission so orders, by a hearing officer.").

[28] 17 C.F.R. § 200.30-10(a)(2).

[29] Judge Murray has been an SEC ALJ since 1988 and has been the Chief ALJ since 1994. Judge Foelak has been an SEC ALJ since 1996. Judge Elliott has been an SEC ALJ since 2011, was previously an Assistant U.S. Attorney in Florida and New York, as well as a civil patent and copyright litigator for the U.S. Justice Department. Judge Grimes has been an SEC ALJ since June 2014, previously spent 13 years as a civil litigator with the U.S. Justice Department, and was an attorney with the U.S. Navy JAG Corps. Judge Patil has been an SEC ALJ since

ALJs are anything other than capable, fair, and evenhanded jurists.

## THE RUN-UP TO THE ADMINISTRATIVE HEARING — WHAT HAPPENS

As noted above, the individual or entity against whom charges are leveled in an SEC administrative proceeding is known as the "respondent." As we discuss in this section, this nomenclature speaks volumes. In complex cases tried administratively, the respondent has little time or authority to do more than "respond" to the vast record that the Enforcement Division has built during its investigation.

Perhaps the most important constraint in the pre-hearing phase of an administrative proceeding, from which all others (including discovery limitations) arguably flow, is the rigid time line. The expedited nature of the proceeding and the rules governing the pre-hearing phase serve to constrain how the respondent can build his case and challenge the narrative advanced by the Enforcement Division. First we consider how those rules affect a respondent's opportunities to build out the record and then we address how they affect pre-hearing submissions.

In federal district court cases, the pre-trial period often centers on discovery depositions in which parties command fact and expert witnesses to appear and answer questions under oath. In SEC administrative proceedings, however, discovery depositions are not permitted.[30] This limitation is particularly meaningful in complex cases where the OIP is filed after years of investigation by the Enforcement Division, during which the Staff likely conducted on-the-record examinations of dozens of fact witnesses. During these examinations, the Enforcement Staff decides which topics to pursue and which questions to ask, with no cross-examination. Once charges are filed — a timing the Enforcement Division controls — neither side may develop the evidentiary record further through sworn deposition testimony.[31] Unless a witness agrees voluntarily to meet with the respondent's counsel to discuss the facts at issue, the first interaction with that witness will be at the hearing.

So what can the respondent do to build his case? Within seven days after the OIP is served, the Enforcement Division must begin to make available to the respondent its formal investigative file, which generally includes the documents obtained from third parties and transcripts of all on-the-record testimony taken by the Staff in its investigation.[32] The Staff may withhold certain material, such as documents protected by a privilege or by the attorney work-product doctrine (including, significantly, their own notes of informal witness interviews[33]), but they may not withhold documents that contain material exculpatory evidence under the *Brady* doctrine.[34]

These requirements provide the respondent immediate access to significant material, but the production mandates are limited to those items contained in the investigative file — that is, those documents and information the Enforcement Division decided to collect during its investigation. The mandates do not apply to other documents at the Commission that might aid the respondent's case. For example, in a complex accounting case, the requirement to produce exculpatory material does not extend to documents *outside of the investigative file*, such as documents in the files of the Division of the Chief Accountant or in the files of another, similar investigation. To obtain those kinds of materials, the respondent needs a subpoena. Likewise,

*footnote continued from previous page…*

September 2014 and previously spent 14 years as a civil litigator with the U.S. Justice Department.

[30] Comment to SEC Rules of Practice, Rule 233 (stating that depositions "are not allowed for purposes of discovery"). The SEC Rules of Practice contemplate depositions upon oral or written examination only if a party believes the witness will be unable to attend or testify at the hearing. *Id*., Rules 233 and 234.

[31] In order to continue the investigation of other potential defendants, the Enforcement Division may, however, continue to issue investigative subpoenas under the same investigative file after the OIP is served, so long as the subpoenas are not for the purpose of obtaining evidence relevant to the proceedings and any relevant documents that may be obtained in continuing investigation are made available to the respondents. *Id*., Rule 230(g).

[32] *Id*., Rule 230.

[33] Comment (b) to Rule 230. For this and other reasons, it is important for respondents to request that the Enforcement Division submit a "withheld document list" under Rule 230(c).

[34] *Id.*, Rule 230(b). The Enforcement Division also must make available, at a time specified by the hearing officer, witness statements of any person called or to be called by the Staff that pertains, or is expected to pertain, to that person's direct testimony and that would be required to be produced pursuant to the Jencks Act, 18 U.S.C. § 3500. SEC Rules of Practice, Rule 231(a).

the third-party documents in the investigative file include only those that the Enforcement Division decided to collect. The Enforcement Staff may not have sought documents from persons or in time periods that the respondent considers to be important. Again, to obtain those materials, the respondent needs subpoenas.

Unlike in a federal court action, where parties have the authority to issue subpoenas at the appropriate time, in an administrative proceeding the presiding officer must approve and formally issue subpoenas for documents or testimony.[35] The presiding officer may reject or modify the party's proposed subpoena. Even where ALJs approve the issuance of subpoenas for documents, the condensed discovery period in an administrative proceeding can make it difficult to collect and review substantial new material from third parties. Also, unlike in federal district court actions, there is no mechanism for commanding documents or testimony from persons outside the United States, a limitation that can matter in cases where persons or evidence reside overseas.

Given these limitations, a person facing the prospect of an administrative proceeding would be wise to begin developing defenses before the OIP is filed. Counsel can review whatever materials his or her client has access to, seek to meet with prospective witnesses or their counsel,[36] and begin to plan for the review of the "investigative file" as soon as it is delivered. Counsel also can plan an affirmative discovery strategy, such as making requests of the Commission for materials outside of the investigative file that may be relevant to the case, requests that numerous district courts and even ALJs have granted.[37] Counsel for respondents also can consider working early on with an expert if sufficient information is known about the contemplated charges and theories.

As should be clear from this discussion, the tight timeline and limited discovery available in administrative proceedings present significant challenges to respondents. That said, once the OIP is filed, the Enforcement Division trial lawyers face the same constraints; to the extent they discover holes in their case after the OIP is filed, they too are limited in their efforts to fill them.

Beyond discovery matters, the SEC's administrative proceedings provide for motions and other submissions in the run-up to the hearing. If the respondent wants to assert an affirmative defense, such as the statute of limitations, that defense must be set out in the answer or it is deemed to have been waived.[38] When filing the answer, the respondent also may make a motion for a more definitive statement, essentially asking the Enforcement Division to provide more detail on the legal or factual allegations.[39]

Unlike in federal court actions, there is no option to delay answering the allegations and "move to dismiss" — that is, to ask the court to dispose of some or all of the case on the grounds that even if the facts alleged were true, there was no violation of law. There also is no direct equivalent to a motion for summary judgment in federal district court. The closest analogue in SEC administrative proceedings is a motion for summary disposition, which may be made after the respondent's answer has been filed and after materials have been made available to the respondent. Either side may make such a motion, but the hurdle for the respondent is high. With limited exceptions, the facts pled by the Enforcement Division "shall be taken as true."[40] And of course, the Commission already has authorized the proceeding on the basis of those alleged facts, so the likelihood of convincing that same body (or its ALJ) to throw out the charges if the facts are assumed to be true is remote. However, the Enforcement Division often seeks (and wins) summary disposition in proceedings where the respondent does not contest the facts alleged or where the respondent already was enjoined or convicted, and the sole remaining issue is the appropriate administrative sanction (such as a collateral

[35] *Compare* SEC Rules of Practice, Rule 232(a) *with* Fed. R. Civ. P. 45. In federal district court actions, a subpoena recipient may move to quash the subpoena — or may resist and force the party to move to compel, but the District Court would hear the dispute, rather than approve the issuance of the subpoena in the first instance. Fed. R. Civ. P. 45(d)(3).

[36] When contacting prospective witnesses during an active investigation, it is important for counsel to ensure that they are not interfering with the ongoing investigation.

[37] *See, e.g.*, *SEC v. Collins & Aikman Corp.*, 256 F.R.D. 403 (S.D.N.Y. 2009); *SEC v. Kovzan*, No. 11-2017, 2013 U.S. Dist. LEXIS 23754 (D. Kan. Feb. 21, 2013); *Harding Advisory LLC*, Admin. Proc. Rulings Rel. No. 1256, 2014 SEC LEXIS 636 (Feb. 24, 2014) (ALJ granting in part Respondents' requests for materials outside the investigative case file).

[38] SEC Rules of Practice, Rule 220.

[39] *Id*., Rule 220(d).

[40] *Id*., Rule 250.

bar from practicing before the commission or working in the securities industry).[41]

Finally, the ALJ will hold one or more pre-hearing conferences to discuss scheduling and other matters, and may order the parties to make pre-hearing submissions.[42] The ALJ has discretion to direct the content of those submissions and can require each side to include a narrative summary of their case, their legal theories, the documents that may be introduced at the hearing, and a list of each expected fact or expert witness along with a summary of the expected testimony.[43]

The run-up to the administrative hearing is an abbreviated, busy time. Counsel representing prospective respondents — possibly facing millions of pages of new documents, submissions due, and a looming hearing deadline — must plan and prioritize accordingly.

## THE HEARING: ISN'T A TRIAL A TRIAL?

Practitioners frequently compare SEC administrative hearings to bench trials in criminal cases, the main difference being application of the less stringent "preponderance of the evidence standard" rather than proof "beyond a reasonable doubt."[44] The SEC's Office of the Administrative Law Judge explicitly likens the hearing process "to a trial in federal court."[45] With that in mind, respondents and counsel should conduct themselves and treat witnesses and the ALJ with the same respect and decorum that they would observe in court proceedings.

The Federal Rules of Civil Procedure do not apply in SEC administrative hearings. Hearings are governed instead by the SEC Rules of Practice. The rules require the ALJ to hold the hearing "with due regard for the public interest and the convenience and necessity of the parties, other participants, or their representatives."[46] Hearings are conducted in either the SEC's own hearing rooms, which are similar in function and appearance to courtrooms, or in borrowed venues around the country, which can occur when travel to the SEC's offices would be inconvenient for witnesses or respondents. In all cases, the hearing "shall be public unless otherwise ordered by the Commission on its own motion or the motion of a party."[47]

ALJs also may have "individual practices" — requirements specific to the presiding officer — that are set forth in a "General Pre-hearing Order" issued in advance of the hearing. Counsel should be mindful of these individual practices in preparing for the hearing. For example, some ALJs require the parties to submit comprehensive exhibit lists that include all documents the parties expect to use at the hearing for any purpose, including exhibits that would be relevant only for impeachment purposes.[48] Failing to identify impeachment evidence on these lists runs the risk that it will be excluded.

At the hearing, the parties may make opening statements, and the Enforcement Division, as the party with the burden of proof, puts on its case first. The parties have the right to present witnesses under oath, offer exhibits, submit rebuttal evidence, and cross-examine witnesses.[49] The scope and form of the evidence, however, is determined by the ALJ, who has broad discretion to regulate the proceedings.[50] For example, to streamline the hearing, the ALJ may permit the respondent to exceed the scope of direct testimony when cross-examining a non-party witness who would otherwise be called in the respondent's case-in-chief.[51] It is likewise not uncommon for the ALJ to dispense with the formalities of laying a foundation for the

---

[41] *See, e.g., QSGI Inc.*, Initial Decision Rel. No. 726, 2014 SEC LEXIS 4978 (Dec. 23, 2014); *Daniel Imperato*, Initial Decision Rel. No. 628, 2014 SEC LEXIS 2409 (July 7, 2014); *Gary L. McDuff*, Initial Decision Rel. No. 663, 2014 SEC LEXIS 3207 (Sept. 5, 2014).

[42] SEC Rules of Practice, Rules 221, 222.

[43] *Id.*, Rule 222(a).

[44] *Steadman v. SEC*, 450 U.S. 91, 102 (1981) (applying preponderance of the evidence standard in SEC administrative proceeding).

[45] "Instructions for Respondents," *available at* http://www.sec.gov/alj/alj-instructions-for-respondents.pdf.

[46] SEC Rules of Practice, Rule 200(c).

[47] *Id*., Rule 301.

[48] *See, e.g., Child, Van Wagoner & Bradshaw, PLLC*, Admin. Proc. Rulings Rel. No. 1717, 2014 SEC LEXIS 3002 (Aug. 21, 2014) (providing individual practices for ALJ Cameron Elliot); *David J. Montanino*, Admin. Proc. Rulings Rel. No. 1677, 2014 SEC LEXIS 2856 (Aug. 7, 2014) (providing individual practices for ALJ James E. Grimes) [hereinafter "Individual Practices"]. Under the Federal Rules of Civil Procedure, impeachment evidence need not be disclosed in advance of trial. Fed. R. Civ. P. 26(a)(3)(A).

[49] SEC Rules of Practice, Rules 325 and 326.

[50] *Id*., Rule 326; *see also Wheat, First Sec., Inc.*, 56 S.E.C. 894, 924 (2003) ("We believe that the law judge has wide latitude in regulating the conduct of the proceedings.").

[51] Individual Practices, *supra* note 48.

admission of an exhibit or calling a document custodian as a witness.[52]

Parties may stipulate to pertinent facts and those stipulations become binding when received in evidence.[53] In addition, the ALJ may take "official notice" of "any material fact which might be judicially noticed by a district court of the United States," as well as "any matter in the public official records of the Commission, or any matter which is peculiarly within the knowledge of the Commission as an expert body."[54]

The Federal Rules of Evidence also do not apply in SEC administrative hearings. Instead, ALJs are authorized to "receive relevant evidence" into the record, and they are directed to "exclude all evidence that is irrelevant, immaterial, or unduly repetitious."[55] Notwithstanding that directive, Commission precedent requires ALJs to err on the side of admitting evidence,[56] and ALJs tend to admit the vast majority of evidence offered by the parties. The battle is typically over the credibility and weight of the evidence, rather than its admissibility.

Unlike in federal court, hearsay is admissible in SEC administrative proceedings and "can provide the basis for findings of violation, regardless of whether the declarants testify."[57] At the same time, hearsay should not be considered a substitute for non-hearsay evidence. In determining the probative value of hearsay, its reliability, and the fairness of using it, ALJs consider "the possible bias of the declarant, the type of hearsay at issue, whether the statements are signed and sworn to rather than anonymous, oral, or unsworn, whether the statements are contradicted by direct testimony, whether the declarant was available to testify, and whether the hearsay is corroborated."[58] ALJs do not hesitate to apply these factors strictly in concluding that hearsay statements are unreliable. This is particularly true where the hearsay lacks hallmarks of trustworthiness, such as being documented in writing or sworn under oath, or where the declarant was available to testify at the hearing but not called as a witness.[59]

Respondent's counsel should keep in mind that the relaxed evidentiary standards in administrative proceedings do not always benefit the Enforcement Division. In the past, for example, the Division has been unsuccessful in efforts to exclude character evidence that might have been inadmissible under Federal Rule of Evidence 404.[60] If there is helpful evidence that would normally be excluded in federal court, respondent's counsel should not hesitate to offer it.

As with any trial, the credibility of witnesses is likely to be central to the ALJ's decision. The ALJ is the exclusive finder of fact at the hearing and, as such, makes all credibility determinations. Counsel should be mindful that SEC ALJs are sophisticated, experienced practitioners. Based on a witness's demeanor, prior inconsistent testimony, or contradictory evidence, among other things, ALJs can — and often do — conclude that a witness lacks credibility.[61] Respondent's counsel should accordingly prepare witnesses to testify truthfully and consistently, and should strive at every opportunity to highlight areas where the credibility of the Division's case falls short.

In complex administrative proceedings, expert witnesses are often a prominent feature in the hearing. Unlike the Federal Rules of Civil Procedure, the SEC

[52] *Id.*

[53] SEC Rules of Practice, Rule 324.

[54] *Id*., Rule 323.

[55] *Id*., Rule 320.

[56] *See, e.g.*, *City of Anaheim*, 54 S.E.C 452, 454 & n.7 (1999) (ALJs "should be inclusive in making evidentiary determinations" and admit evidence "when in doubt").

[57] *Guy P. Riordan*, Rel. No. 33-9085 (2009), 2009 SEC LEXIS 4166, at *57 (Dec. 11, 2009) (quoting *Scott Epstein*, Rel. No. 34-59328, 2009 SEC LEXIS 217, at *46 (Jan. 30, 2009)).

[58] *Id.* at **57-58.

[59] *Compare Guy P. Riordan*, *supra* note 57, at **59-60 (finding that hearsay statements of witnesses were reliable where there was no evidence the witnesses were biased, the respondent failed to call the witnesses in his case-in-chief, one witness's testimony during the Enforcement Division's case-in-chief was consistent with his hearsay statements, and the statements were corroborated by other non-hearsay evidence) *with Wheat*, *supra* note 50, at 919 (finding that hearsay statements of Broward County officials to the Enforcement Division investigator were unreliable because they were not written, signed, or made under oath, and there was no showing that the officials were unavailable to testify at the hearing).

[60] *Thomas C. Gonnella*, Admin. Proc. Rulings Rel. No. 1579, 2014 SEC LEXIS 2349 (July 2, 2014) (denying motion to exclude testimony of character witnesses).

[61] *Wheat*, *supra* note 50 at 899 n.8 ("After observing Book's demeanor at the hearing, the law judge found Book's investigative testimony to be more reliable than his hearing testimony."); *Michael J. Fee*, 50 S.E.C. 1124, 1125 (1992) (upholding ALJ's refusal to credit respondent's testimony at hearing that was contradicted by earlier sworn investigative testimony), *aff'd*, 998 F.2d 1002 (3d Cir. 1993).

Rules of Practice do not require the parties to exchange detailed expert reports containing the expert's opinion and bases for it, though a "brief summary" of the expert's expected testimony must be provided.[62] ALJs nevertheless often require the parties to produce more detailed expert reports. Indeed, the standard practice of several ALJs is to streamline the hearing by substituting the expert's report for direct testimony.[63] In those instances, the expert generally is not subject to direct examination but is instead sworn in and proffered immediately for cross-examination.

At times, the Enforcement Division will attempt to use experts as *de facto* summary witnesses to present its preferred version of the facts, particularly where the testimony of fact witnesses is inconsistent with the Division's view of events. In responding to this tactic, the rebuttal opinion of a qualified, experienced defense expert is critically important. As noted, like the respondent, the Division generally is unable to pursue discovery once the OIP is filed and may be left with an investigative record suffering from significant evidentiary gaps. A persuasive defense expert can highlight these deficiencies to demonstrate that the testimony of the Division's expert — and perhaps the Division's entire theory of the case — is unsupported by the evidence.

Once the hearing is over, the parties submit proposed findings of fact, conclusions of law, and supporting briefs to the ALJ. The post-hearing briefing process generally must be completed within two months.[64] The ALJ will then issue his or her initial decision between one and four months later, depending on the timeline established under the OIP.[65]

## APPEALING THE ALJ'S INITIAL DECISION

What happens after the ALJ issues its initial decision? Either the Enforcement Division or the responding party may appeal that decision to the Commission. The ALJ will set the time period by which this appeal — known formally as a petition for Commission review — must be filed, which is not to exceed 21 days from service of the decision.[66] The act of timely filing the petition for review stops the initial decision from becoming a final order as to the filing party.[67] Once a petition for review is filed, the opposing party may file a cross-petition, and even if no party files a petition, the Commission itself has the discretion to decide on its own initiative to review an initial decision.[68]

Some commentators have suggested that winning on appeal to the Commission may be difficult given that it was the Commission itself that decided to initiate proceedings.[69] That may well be true, but the passage of time may result in a different composition of Commissioners hearing the appeal, and the nature of the evidence adduced at the hearing may reveal new facts and defenses that were not considered by the Commission when it authorized the action. Appealing to the Commission is a "prerequisite to the seeking of judicial review" of the case.[70] Accordingly, even if appealing the ALJ's initial decision to the Commission, the very body that decided to file charges in the first place, may seem fruitless, it is a necessary step before seeking review by a federal court.

If the Commission grants the petition for review,[71] it may "affirm, reverse, modify, set aside, or remand for further proceedings, in whole or in part, an initial decision …," and "may make any findings and conclusions that in its judgment are proper and on the basis of the record."[72] As one can see, the Commission

---

[62] *See* SEC Rules of Practice, Rule 222(b) (requiring only a "brief summary" of the expert witness's expected testimony, as well as "a statement of the expert's qualifications, a listing of other proceedings in which the expert has given expert testimony, and a list of publications authored or co-authored by the expert"). As noted, however, neither side has an opportunity to take a deposition of the expert prior to the hearing, a significant difference from federal court actions.

[63] Individual Practices, *supra* note 48.

[64] SEC Rules of Practice, Rule 360(a)(2).

[65] *Id.*

[66] *Id*., Rule 360(b).

[67] *Id*., Rule 360(d)(1); *see also Dearlove,* Rel. No. 34-57244, 2008 SEC LEXIS 223, at *34 n.42 (Jan. 31, 2008).

[68] SEC Rules of Practice, Rules 410 and 411(c).

[69] *See, e.g.,* Susan D. Resley et al., *Dealing With the SEC's Administrative Proceeding Trend*, Law360, Jan. 13, 2015.

[70] SEC Rules of Practice, Rule 410(e).

[71] Other than certain areas of mandatory review, the Commission retains discretion to decline to grant most petitions for review. SEC Rules of Practice, Rule 411(b). In exercising its discretion, the Commission is to consider whether the petition "makes a reasonable showing" that (1) pre-judicial error was committed "in the conduct of the proceeding" or (2) the initial decision "embodies" a finding or conclusion of material fact that is clearly erroneous, a conclusion of law that is erroneous, or an exercise of discretion or decision of law or policy that is important and that the Commission should review. *Id*., Rule 411(b)(2).

[72] *Id*., Rule 411(a).

has broad discretion on what it can do. Indeed, the Commission conducts a *de novo* review,[73] a standard affording the Commission the "broad authority to consider all aspects" of the case on appeal. Significantly, the Commission may accept or hear additional evidence.[74]

A *de novo* review means the Commission may make its own credibility determinations based on the administrative record, and, in doing so, it can reject the findings of the ALJ, who presided at the hearing and observed the witnesses.[75] However, the Commission explained recently that it gives "considerable weight" to the credibility determinations of a "law judge since it is based on hearing the witness' testimony and observing their demeanor."[76] An ALJ's factual determinations "can be overcome only where the record contains substantial evidence for doing so."[77] The fact that the Commission has the power in essence to re-review every issue in the case does not necessarily mean that it will result in an unfavorable outcome for the respondent. Indeed, in *Pelosi*, the Commission's view that the ALJ's conclusions were not supported by the record — and the Commission's decision to substitute its own judgment for that of the ALJ's about the key facts and evidence in the matter — resulted in dismissal of the proceeding against the respondent.[78]

It is worth noting that the SEC's Rules of Practice allow for a party to move for "summary affirmance" within 21 days after a petition for review is filed.[79] If the decision of the ALJ is not summarily affirmed and the petition for review is granted, the Commission then sets a briefing schedule and the parties may seek oral argument before the Commission.[80]

How long does it take for the Commission to issue its decision? Rule 900 provides that a decision "ordinarily" should be issued within seven months from the date the petition for review was filed, or within 11 months if "the Commission determines that the matter presents unusual complicating circumstances."[81] Nevertheless, the Commission "retains discretion to take additional time" if it "determines that extraordinary facts and circumstances of the matter so require."[82] According to the most recent report on SEC Administrative Proceedings, covering the six-month period from April 1, 2014 through September 30, 2014, the median age of Commission decisions on matters involving the review of ALJ matters was more than 520 days, and only one of the Commission's decisions — and there were only six of 26 pending cases disposed of — was decided within the Rule 900 guidelines.[83]

## JUDICIAL REVIEW OF THE COMMISSION'S DECISION

Following an unfavorable ruling by the Commission, which is considered a "final order," a respondent may seek review by a United States Court of Appeals. The Enforcement Division, however, cannot seek review of an adverse ruling by the Commission. The respondent can elect to seek judicial review in the Court of Appeals for the circuit in which he resides, the circuit of his principal place of business, or the District of Columbia Circuit.[84] This presents a respondent his first opportunity — often times, after many, many years — to have someone other than an employee of the SEC consider his case.

Practical advice about how to approach the appeal of the Commission decision is beyond the scope of this article. However, it is important for practitioners to understand that the standards of review in the federal appellate courts present another high hurdle for respondents/appellants in terms of the nature of the review. In particular, on appeal, the "findings of the Commission as to the facts, if supported by substantial evidence, are conclusive."[85] A court of appeals may set aside the SEC's conclusions of law only if they are "arbitrary, capricious, an abuse of discretion, or

---

[73] *See, e.g., Gary M. Kornman*, Rel. No. 34-59403, 2009 SEC LEXIS 367, at *35 n.44 (Feb. 13, 2009).

[74] SEC Rules of Practice, Rules 411(a) and 452.

[75] *See, e.g., Kenneth R. Ward*, Rel. No. 34-47535, 2003 SEC LEXIS 3175 (Mar. 19, 2003), *aff'd*, 75 F. App'x 320 (5th Cir. 2003).

[76] *Michael R. Pelosi*, Adv. Act Rel. No. IA-3805, 2014 SEC LEXIS 4596, at *6 (Mar. 27, 2014).

[77] *Id.* at **6-7.

[78] *Id.*

[79] SEC Rules of Practice, Rule 411(e).

[80] *Id.*, Rules 450 and 451.

[81] *Id.*, Rule 900(a)(iii).

[82] *Id.*

[83] SEC, Report on Administrative Proceedings for the Period April 1, 2014 through September 30, 2014, Rel. No. 34-73458 (Oct. 29, 2014), *available at* http://www.sec.gov/reportspubs/special-studies/34-73458.pdf.

[84] 15 U.S.C. § 78y(a)(1).

[85] 15 U.S.C. § 78y(a)(4).

otherwise not in accordance with law."[86] Again in practice, this is a fairly high bar, similar to the other standards we have identified in this process. Nevertheless, the court of appeals may not find the Commission's conclusions of law to be "in accordance with law," and there is the possibility that the court of appeals could allow more discovery than the ALJ permitted in order to expand the record on certain defenses.[87]

Moreover, courts employ a deferential standard when reviewing the sanctions imposed by the Commission. As recently explained by the District of Columbia Circuit (a court that has presented challenges from time to time for the SEC)[88]:

> The Supreme Court has long instructed that the Commission's choice of sanction shall not be disturbed by the court unless the sanction is either unwarranted in law or is without justification in fact. Our review is deferential: It is a fundamental principle that where Congress has entrusted an administrative agency with the responsibility of selecting the means of achieving the statutory policy the relation of remedy to policy is peculiarly a matter for administrative competence. Because of the Commission's accumulated experience and knowledge its judgment is entitled to the greatest weight.[89]

Notwithstanding the extent to which these standards favor the agency, the appellate courts' deference to the SEC is not limitless. In a rare statement accompanying a recent denial of a petition for a writ of certiorari, Justice Scalia (joined by Justice Thomas) questioned whether a court owes deference to an executive agency's interpretation of a law that contemplates both criminal and administrative enforcement.[90] This comment provides good reason to believe that at least some members of the Supreme Court would be receptive to challenges of over-reaching interpretations of the federal securities laws by the SEC in the enforcement context.

* * *

Given the SEC's recent public statements, we can expect more actions, including more complex matters, to be brought as administrative proceedings. Although the Enforcement Division has had a successful track record in administrative proceedings, individuals finding themselves litigating in this forum should not assume that the outcome is a foregone conclusion. While there are important differences between the rules of the SEC's administrative proceeding and federal district court, those differences do not always favor the Enforcement Division. Diligence, a thorough understanding of the advantages and disadvantages of the administrative forum and relying upon defense counsel with the right substantive and trial experience can make a significant difference in the odds of prevailing. ■

---

[86] 5 U.S.C. § 706(2)(A).

[87] *Shalala v. Ill. Council on Long Term Care,* 529 U.S. 1, 23-24 (2000) (stating that a court of appeals has "adequate authority to resolve any statutory or constitutional contention that the agency does not, or cannot, decide, including, where necessary, the authority to develop an evidentiary record" (citations omitted)); *John Doe, Inc. v. DEA*, 484 F.3d 561, 569-70 (D.C. Cir. 2007) (stating that "where an insufficient administrative record is crippling, a court of appeals always has the option of … remanding to the agency for further factual development").

[88] *See, e.g., Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

[89] *Siris v. SEC*, No. 14-1018, 2014 U.S. App. LEXIS 22606, at **11-12 (D.C. Cir. Dec. 2, 2014) (internal quotation marks & citations omitted).

[90] *Whitman v. United States*, 135 S. Ct. (2014) (Scalia, J., statement respecting the denial of certiorari). In addition, at least one district judge has questioned whether agency interpretations of the law in adjudicatory decisions are entitled to deference on direct review. *Chau v. SEC*, --- F. Supp. 3d ---, No. 14-cv-1903, 2014 U.S. Dist. LEXIS 171658, at *44 n.157 (S.D.N.Y. Dec. 11, 2014) ("[I]t is not at all clear that the Second Circuit definitively has taken the position that Commission interpretations in adjudicatory proceedings are entitled to *Chevron* deference.").