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A Look At SEC's Rules Of Practice, A Year After Amendments

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The U.S. Securities and Exchange Commission should be given credit for at least trying to modernize its rules of practice governing administrative proceedings to better match the complexity of some of the cases it has chosen to bring in its in-house forum since the passage of the Dodd-Frank Act. But the resulting amended rules of practice — which became effective one year ago this week[1] — provide little added procedural benefits for respondents and suffer from a general lack of clarity. They are a series of contradictory and at times illogical procedural changes which, on balance, do as much to increase the inherent advantage of the Enforcement Division in administrative proceedings as they do to help respondents. Let's take a look.

Answers

In a proceeding where the Enforcement Division is allowed to plead fraud without particularity,[2] respondents are now required in their answer to raise all affirmative and "avoidance" defenses to the claims against them, lest they be "deemed [] waive[d]."[3] This includes any defense that a respondent relied on the advice of "counsel, accountants, auditors, or other professionals" in connection with any alleged violation or any remedy the commission seeks.[4] The breadth of this requirement is surprising given that the commission recognized in its adopting release that a reliance on professionals can be "part of an assertion of a formal affirmative defense *or* an argument in response to the claims alleged in the OIP on which the Division retains the burden of proof."[5]

The commission is thus requiring respondents to raise at the pleadings stage (and under penalty of waiver) defenses which can be factual in nature and which respond to claims where the Enforcement Division holds the burden of proof. This new rule is a bit galling when one considers that the Enforcement Division is able to conduct, in advance of filing its cases, ex parte investigations which, for practical purposes, are unlimited in time and supported by subpoena power. Respondents — especially officers and directors who have been separated from their former companies — are often left with very limited access to information while an investigation proceeds.

By requiring respondents to identify at the pleadings stage various nonaffirmative defenses, the

commission has placed a burden on respondents in administrative proceedings far exceeding the requirements on defendants under the Federal Rules of Civil Procedure.[6] Rather than taking the opportunity of amending its rules to require the Enforcement Division to plead fraud charges with particularity — as is the practice in federal and state courts across the country — the commission instead "doubled down" on this innate disadvantage in its proceedings.

Motions Addressed to the Pleadings

At the pleadings stage, the commission now provides respondents the option of filing a motion for judgment on the pleadings, in addition to a motion for a more definite statement.[7] While these provisions on their surface resemble practice under the federal rules, the limited time periods allowed for exercising these rights removes any meaningful benefit to respondents. A respondent must file a motion for more definite statement with its answer (not in lieu of an answer), after which time the Enforcement Division is given five days to file a response and respondents three days for a reply, before the motion is ripe for consideration.[8]

A motion for judgment on the pleadings must be filed within 14 days of the answer, regardless of whether a motion for a more definite statement is pending.[9] A respondent on a practical level is thus deprived of the benefit of receiving a more definite statement of the charges against it before deciding whether to move for judgment on the pleadings. Like so many changes in the amended rules of practice, the procedural protections offered to respondents on this issue exist largely only on paper.

Depositions

Perhaps the most significant change to the rules of practice was the addition of a provision allowing respondents (as well as the Enforcement Division) to take depositions during administrative proceedings. The new Rule 233 allows parties in single-respondent cases to take up to three depositions per side, and in multiple-respondent cases up to five depositions per side.[10] Note that the number of depositions that can be taken as of right is counted per side and not per party. Where there are multiple respondents, the respondents collectively have a right to five depositions.[11] The rules do not offer any guidance for how the five depositions should be apportioned between multiple respondents where those respondents are adverse to each other. The administrative law judges hearing such cases will have to wade into the thicket of deciding this issue on a case-by-case basis with no guidance from the commission.

While the ability to take three to five depositions is helpful for respondents — and certainly better than none — the number is far too small to provide respondents a meaningful opportunity to develop a factual record in advance of trial. The Enforcement Division comes into every administrative proceeding with the decided advantage of having conducted an ex parte investigation, unlimited in time, with full access to witnesses through subpoena power and, just as often, through voluntary interviews. Respondents, conversely, have limited ability to obtain information from third parties, who often will decline to speak with counsel for a respondent even after having willingly made themselves available for the government. In one of our recent matters, the Enforcement Division spoke to more than 100 investor witnesses before filing its administrative proceeding. Those same individuals were far less forthcoming in agreeing to speak with us. The limited number of depositions allowed under Rule 233 is inadequate to even begin to close this informational gap that exists in almost every administrative proceeding.[12]

Additional Depositions

The new Rule 233 allows a party to file a motion requesting to take up to two additional depositions beyond the number allowed as of right.[13] A party moving for additional depositions must show a "compelling need" for the extra discovery, but neither the rule nor the adopting release defines a standard for what needs are sufficiently "compelling" to justify the request beyond the bare requirements listed in Rule 233(a)(3)(ii)(A-D).

The commission has indicated that the opportunity for additional depositions under Rule 233 should not be interpreted in a manner that would sacrifice "the goal of providing a prompt and efficient administrative forum" or "compromis[e] the hearing schedule."[14] In advancing such a standard, the commission placed its interest in having cases resolved quickly above a respondent's right to prepare to defend the charges against it. The commission seems to have its priorities upside down on this issue.

Expert Discovery

One area of confusion under the amended rules has concerned whether expert depositions count against the deposition limits set forth in Rule 233. Judge Carol Fox Foelak ruled (correctly we believe) in RD Legal Capital LLC that expert depositions do not count against the number of depositions permitted as of right under Rule 233.[15] As counsel for the respondents in that matter, we argued successfully that some of the public comments during the rule-making period suggested that depositions of experts should not be included in the number of depositions allowed as of right, and since the commission was silent on this issue in the final rule and adopting release, it was within the discretion of the administrative courts to determine. But, in Adrian D. Beamish, CPA, Judge Cameron Elliot decided that expert depositions were included within the limit under Rule 233.[16] The issue remains unsettled.

Summary Disposition

Both the old and amended rules allow a party to move for summary disposition on one or more claims or defenses.[17] As with summary judgment under the Federal Rules of Civil Procedure, a grant of summary disposition in SEC administrative proceedings must be based on "facts, declarations, affidavits, [and] documentary evidence" showing there is "no genuine issue" as to any material fact and that the moving party is entitled to disposition in its favor "as a matter of law."[18]

While the provision for summary disposition under Rule 250 resembles in form its cousin under the federal rules, in application the rule often does not provide respondents in administrative proceedings a meaningful opportunity to dispose of claims in advance of trial. The problem is one of timing. To even file a motion for summary disposition before trial in a 120-day proceeding, a party must first move the court for leave.[19] The motion for leave has its own briefing schedule, with the Enforcement Division filing a response (invariably in opposition) and respondents a reply. If the court grants the motion for leave, then the motion for summary disposition will have its own briefing schedule with the opposing party granted 21 days to respond and a reply to follow thereafter.[20] This all takes time, without even factoring in how much time the court believes that it would require to consider the motion.

For respondents to develop "facts, declarations, affidavits, [and] documentary evidence" to support a motion for summary disposition, they must conduct discovery. They must take depositions (albeit limited by number) and work with expert witnesses to help those experts develop their opinions and reports. By the time this discovery is completed under the expedited schedule of administrative proceedings, respondents often are left with too few days on the calendar to complete a briefing schedule for summary disposition sufficiently in advance of trial for the court to feel that it has enough

time to hear the motion.

Conclusion

Ultimately, the SEC's amended rules fail to address what is the true problem in its administrative proceedings. Namely, that the administrative courts were designed to adjudicate matters that are administrative in nature. Despite the outstanding quality of some of the judges presiding over these proceedings, the forum is not well-suited to hear complex, fact-intensive contested cases.[21] In many enforcement actions, a respondent's basic economic livelihood and financial assets are at risk. They deserve a forum where they have a right to true discovery to understand the claims against them. They deserve a fair fight. No minor tweaks of the rules of practice can change that.

The fix is easy. The commission should use its broad discretion in enforcement matters to bring complex, contested cases in the federal courts, and leave the administrative courts to hear the type of issues for which they were designed. Failure to do so will reinforce the belief of some that the Enforcement Division has, in recent years, chosen to bring some complex cases as administrative proceedings where it thought it would have a hard time winning in federal court. This is a damaging image for the enforcement program, and one the commission should put to rest through appropriate forum selection in the future.

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[1] Amendments to the Commission's Rules of Practice, 81 Fed. Reg. 50,211, 50,212 (July 29, 2016) ("Adopting Release") (noting the final rules are effective Sept. 27, 2016).

[2] Alexander Kon, Admin. Proc. Rulings Release No. 4582, 2017 SEC LEXIS 377, at *4 (ALJ Feb. 3, 2017) ("I therefore hold, apparently as a matter of first impression, that Iqbal, Twombly, and their progeny do not apply to OIPs, and that an OIP need not 'state with particularity the circumstances constituting fraud' within the meaning of Fed. R. Civ. P. 9(b).").

[3] 17 C.F.R. § 201.220(c); see Adopting Release, 81 Fed. Reg. at 50,220.

[4] Id. The final amended Rule 220(c) states, in part:

A respondent must affirmatively state in the answer any avoidance or affirmative defense, including but not limited to res judicata and statute of limitations. In this regard, a respondent must state in the answer whether the respondent relied on the advice of counsel, accountants, auditors, or other professionals in connection with any claim, violation alleged or remedy sought. Failure to do so may be deemed a waiver.

17 C.F.R. § 201.220(c).

[5] Adopting Release, 81 Fed. Reg. at 50,220 (emphasis added). The commission further noted in its adopting release that it believes "this change will not materially alter current practice and will not unfairly advantage the Division because ... respondents often assert reliance in their answers to Commission OIPs" already. Id. The amendment, in the commission's view, "would align administrative proceedings with civil litigation" generally by "eliminat[ing] surprise" and "identifying the issues for the hearing." Id.

[6] Compare Fed. R. Civ. P. 8(c) (stating pleading requirements for affirmative defenses under the Federal Rules of Civil Procedure), with 17 C.F.R. § 201.220(c) (stating requirements for a respondent's answer to allegations in SEC administrative proceedings).

[7] 17 C.F.R. § 201.250(a) (providing for filing of motions for a ruling on the pleadings); 17 C.F.R. § 201.220(d) (providing for a respondent's filing of a motion for a more definite statement).

[8] 17 C.F.R. § 201.220(d) (a respondent's motion for a more definite statement must be filed "with an answer"); 17 C.F.R. § 201.154(b) (setting the time in which briefs in opposition to a motion and replies thereto shall be filed).

[9] 17 C.F.R. § 201.250(a) (providing that a party may move for a ruling on the pleadings no later than 14 days after a respondent's answer has been filed).

[10] 17 C.F.R. § 201.233(a)(1)-(2) (providing for a limited number of depositions in administrative proceedings designated under the 120-day time frame set out in § 201.360(a)(2)).

[11] 17 C.F.R. § 201.233(a)(2) (providing for a limited number of depositions in certain administrative proceedings involving multiple respondents and noting the five depositions are "for all respondents collectively").

[12] At least one SEC administrative law judge has struck an effort by the parties in a case to stipulate to additional depositions beyond what is specified in the rules. See Adrian D. Beamish, CPA, Admin. Proc. Rulings Release No. 4581, 2017 SEC LEXIS 368, at *3 (ALJ Feb. 3, 2017) ("[A]llowing additional depositions merely because the parties have stipulated to them is inconsistent with the rule's text and the Commission's accompanying guidance."). The parties subsequently filed renewed motions for additional depositions under the specific criteria set forth in Rule 233(a)(3)(ii), which were granted. Adrian D. Beamish, CPA, Admin. Proc. Rulings Release No. 4601, 2017 SEC LEXIS 451, at *2 (ALJ Feb. 13, 2017).

[13] 17 C.F.R. § 201.233(a)(3) (providing that parties may seek leave to notice up to two additional depositions beyond those permitted as of right under § 201.233(a)(1)-(2)).

[14] Adopting Release, 81 Fed. Reg. at 50,217 (describing the amendments to Rule 233 concerning

additional depositions).

[15] RD Legal Capital LLC, Admin. Proc. Rulings Release No. 4387, 2016 SEC LEXIS 4373, at *5 (ALJ Nov. 23, 2016) ("In view of the Commission's failure to specify that depositions of experts count toward the limit, it is concluded that they do not. Deposing the opposing party's expert witnesses is a developmental step from the practice of interviewing them. Further, to require depositions of experts to count against the limit would invite gamesmanship.").

[16] Adrian D. Beamish, CPA, Admin. Proc. Rulings Release No. 4581, 2017 SEC LEXIS 368, at *4 & n.1 (ALJ Feb. 3, 2017) ("The parties are informed that I will count expert depositions against Rule 233(a)'s deposition limit. There is no textual basis for excluding them from the count, and the commission did not modify the rule pursuant to a commenter's suggestion 'that the three- and five-deposition limits ... be limited to fact witnesses, and not include experts.'").

[17] See 17 C.F.R. § 201.250(b)-(c) (2016); 17 C.F.R. § 201.250(a) (2006).

[18] Id.

[19] See id. Although parties to administrative proceedings designated as 30- and 75-day proceedings may file motions for summary disposition as of right under Rule 250(b), parties to 120-day proceedings must seek leave of court prior to filing such a motion, pursuant to Rule 250(c).

[20] See 17 C.F.R. § 201.154(b) (setting the time in which briefs in opposition to a motion and replies thereto shall be filed); 17 C.F.R. § 201.250(f)(2)(ii) (setting the briefing schedule for summary disposition motions filed under Rule 250(c)).

[21] See, e.g., Jed S. Rakoff, Address at the PLI Securities Regulation Institute: Is the S.E.C. Becoming a Law Unto Itself? (Nov. 5, 2014), https://securitiesdiary.files.wordpress.com/2014/11/rakoff-pli-speech.pdf.
