Defending An SEC Administrative Proceeding

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A. In General

1. Think of an administrative proceeding (“AP”) like a bench-tried criminal case. That is what it most closely resembles procedurally, except for burden of proof, which is preponderance of the evidence see Steadman v. SEC, 450 U.S. 91, 102 (1981), and the fact (striking to criminal practitioners) that the Division of Enforcement may call your client to testify in its case in chief, see, e.g., In the Matter of Joseph Catapano, Init.Dec.Rel.No. 300, 2005 SEC LEXIS 2939 (Nov. 10, 2005). Your client will view the AP like a criminal trial if his or her license is on the line.

2. As soon as it is instituted by the Commission, an AP will be referred to an Administrative Law Judge (“ALJ”), who will hear the evidence and initially decide the case. Although the ALJ is a Commission employee whose decision can be reviewed de novo by the SEC, winning before the ALJ is possible and very important. One of the reasons that the ALJ’s initial decision is important is that the law judge, unlike the Commission, actually sees the witnesses testify. The Commission normally will not second-guess the ALJ’s assessment of credibility. See, e.g., In the Matter of Robert Thomas Clawson, Exchange Act Rel.No. 48143 at 3, 2003 SEC LEXIS 1598 at *7 (July 9, 2003) (“We accept a fact finder’s credibility finding, absent overwhelming evidence to the contrary”); In the Matter of Brian A. Schmidt, Exchange Act Rel.No. 45330 at n.5, 2002 SEC LEXIS 180 at n.5 (Jan. 24, 2002); In the Matter of Laurie Jones Canady, Exchange Act Rel.No. 41250, 1999 SEC LEXIS 669 at *27 (April 5, 1999) (“As we have consistently held, ‘credibility determinations by an initial fact finder are entitled to considerable weight [and] can be overcome

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only where the record contains “substantial evidence” for doing so.”). The Commission, however, will not always defer to the ALJ’s credibility determinations. See, e.g., In the Matter of Kenneth R. Ward, Exchange Act Rel.No. 47535 at 11-12, 2003 SEC LEXIS 687 at *41-*42 (March 19, 2003).

3. There are two distinct kinds of APs that are prosecuted by the Division of Enforcement:
   a. “Original” APs, in which the ALJ is required to consider whether the respondent broke the law at all; and
   b. “Follow-on” APs, in which the only issue is whether an already-existing injunction or criminal conviction against the respondent should lead to a further sanction, such as revocation or suspension of a license.
      i. Respondents historically have been able to win a number of original APs. In follow-on proceedings, which ALJs never dismiss outright, the only practical upside for a respondent is a light sanction. The Commission has made life hard for a respondent in a follow-on AP based on an SEC injunction, by ruling that such a respondent cannot contest the allegations that were contained in the SEC’s complaint in the injunctive case. See, e.g., In the Matter of Marshall E. Melton, et al., Exchange Act Rel.No. 48228, Investment Advisers Act Rel.No. 2151 at 8-10, 2003 SEC LEXIS 1767 at *22-*30 (July 25, 2003); see also In the Matter of Harold F Harris, et al., Exchange Act Rel.No. 53122A at 9 n.21, 2006 SEC LEXIS 68, at *18 n. 21 (Jan. 13, 2006) (noting possible exception for injunction entered on default if respondent lacked full and fair opportunity to litigate issues in district court).

   a. Effective July 17, 2003, the Commission adopted rules under which each AP, at its institution, is designated to be completed at the ALJ level within 120 days, 210 days, or 300 days. For a discussion of the Commission’s 2003 scheduling rules, see Christian J. Mixter, The SEC’s New Administrative Proceedings Rules, Insights, Sept. 2003, p.1. In In the Matter of Gregory M. Dearlove, CPA, Exchange Act Rel.No. 57244, AAER No. 2779 at 49-57, 2008 SEC LEXIS 223 (Jan. 31, 2008), the Commission considered and, unsurprisingly, rejected a respondent’s due process challenge to its scheduling rules.
      i. Each overall scheduling limit comes with sublimits for the prehearing, briefing, and decisional phases as follows:

<table>
<thead>
<tr>
<th>Overall Limit</th>
<th>Until Hearing (Pretrial)</th>
<th>Sublimits</th>
<th>Decision by ALJ</th>
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<tbody>
<tr>
<td>120 days</td>
<td>1 month</td>
<td>2 months</td>
<td>1 month</td>
</tr>
<tr>
<td>210 days</td>
<td>2.5 months</td>
<td>2 months</td>
<td>2.5 months</td>
</tr>
<tr>
<td>300 days</td>
<td>4 months</td>
<td>2 months</td>
<td>4 months</td>
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</tbody>
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iii. So far, the SEC has largely reserved the 120-day track for proceedings aimed at suspending or revoking the registration of stock where the issuer had failed to file annual or periodic reports. This is a type of administrative action in which little serious resistance by most respondents would be expected. The 210-day track has thus far been reserved for follow-on APs (see above). All other proceedings are put on the 300-day track.

b. Do not count on getting routine extensions of time. An additional rule change in 2003 was the adoption of a policy that the ALJs and the Commission shall “strongly disfavor” requests for extensions unless the moving party makes a strong showing that denial of the request would substantially prejudice his or her case. See Rule 161(b); see, e.g., In the Matter of Gregory M. Dearlove, CPA, Init.Dec. Rel.No. 315 at 64-66, 2006 SEC LEXIS 1684 (July 27, 2006).

i. The 2003 scheduling rules also may have taken their toll on the ALJs’ willingness to tolerate litigation tactics, by either the Division or respondents, that the ALJ perceives as lazy or dilatory. See In the Matter of John A. Carley, Init.Dec.Rel.No. 292 at 32-33, 47, 2005 SEC LEXIS 1745 (July 18, 2005).

c. Bring all your trial skills to the hearing room. An AP hearing is, first and foremost, a trial. In view of the tightness of the new scheduling rules, pretrial preparation should begin before the Order Instituting Proceedings (“OIP”) is issued.

d. Stay alert to settlement possibilities as you learn more about the Division’s case and as you develop your client’s case. The settlement that seemed out of reach when the case was first brought may come within your grasp as the case progresses. The 2003 AP scheduling rules somewhat encourage mid-proceeding settlements by providing a more relaxed standard for delay if one or more respondents offer to settle and wish for the proceeding to be stayed while the Commission considers their settlement offer. See Rule 161(c). In 1998 the SEC issued an Alternative Dispute Resolution Policy Statement, Exchange Act Rel.No. 40306, 1998 SEC LEXIS 1653, which suggests (but hardly encourages) the possibility of mediation in enforcement actions, including APs.

B. Significant Prehearing Milestones

1. Respondent’s Answer (Rule 220). A respondent’s offer is due within 20 days after service of the Order Instituting Proceedings. Like an answer in federal district court, the answer in an AP is an important, but largely technical, document. Histrionics in an answer are a waste of time, may unnecessarily alert the Division to your strategy at the hearing, and may gratuitously supply impeachment material at the hearing. Aim toward simple denials (or, if appropriate, “d.k.i.”’s or admissions).

a. Remember that you must assert specifically “[a] defense of res judicata, statute of limitations or any other matter constituting an affirmative defense,” or else that defense is waived. Rule 220(c). See Canady v. SEC, 230 F.3d 362 (D.C.Cir. 2000).

c. There is no real counterpart, under the SEC’s Rules of Practice, to a Federal Rule of Civil Procedure 12(b)(6) motion to dismiss the proceeding. The closest equivalent is a motion for summary disposition under Rule 250, which is more like a summary judgment motion under Federal Rule of Civil Procedure 56. This is because it is to be made “[a]fter a respondent’s answer has been filed and, in an enforcement or disciplinary proceeding, documents have been made available to that respondent for inspection and copying.” The standard governing a motion for summary disposition appears to be the same—whether the opponent of the motion has raised a genuine issue of material fact—that applies to a motion for summary judgment under Federal Rule of Civil Procedure 56. See, e.g., In the Matter of Roger M. De Trano, Init.Dec.Rel.No. 242 at 2-3, 2003 SEC LEXIS 2867 at *3-*5 (Dec. 4, 2003); In the Matter of Joseph P. Galluzzi, Init.Dec.Rel.No. 187, 2001 SEC LEXIS 1582 (Aug. 7, 2001), aff’d, Exchange Act Rel.No. 46405, 2002 SEC LEXIS 2202 (Aug. 23, 2002).

i. If you think about this, it would be a bit of a long shot to ask an ALJ to dismiss on its face an Order Instituting Proceedings that the full Commission has just issued. A notable, but short-lived, exception to this statement was Chief Judge Murray’s decision In the Matter of Ernst & Young LLP, Admin.Proc.Rul.Rel.No. 600, 2002 SEC LEXIS 1892 (July 2, 2002), vacated, Exchange Act Rel. No. 46710, 2002 SEC LEXIS 2714 (Oct. 23, 2002), dismissing an administrative proceeding on the ground that it was instituted without a quorum. See also In the Matter of E Trade Systems, Inc., Init. Dec.Rel.No. 301, 2005 SEC LEXIS 3137 (Nov. 29, 2005) (dismissing proceeding where Division attempted to substitute a totally different respondent for respondent named in the OIP). In a less-than-evenhanded touch, SEC administrative practice allows the Division of Enforcement to make the equivalent of a Federal Rule of Civil Procedure 12(f) motion to strike legally insufficient defenses from a respondent’s answer to the Order Instituting Proceedings. See, e.g., In the Matter of Piper Capital Management, Inc., Admin.Proc.Rul.Rel.No. 577, 1999 SEC LEXIS 301 at *4-*11 (Jan. 15, 1999). Such motions by the Division are not always granted. See In the Matter of J.W. Barclay & Co., Inc., Admin.Proc.Rul.Rel.No. 599, 2002 SEC LEXIS 1638 (June 13, 2002); moreover, the ALJ may choose to “carry” a motion to strike through the hearing and rule on it after the evidence is in. See In the Matter of Dean Witter Reynolds Inc., Init.Dec.Rel.No. 179, 2001 SEC LEXIS 99 at *2 (Jan. 22, 2001).

d. The Commission’s Rules now include a provision allowing a respondent in a multi-respondent case to move to sever. Rule 201(b). Such a motion must be directed to the Commission (not the ALJ) and must represent that “a settlement offer is pending before the Commission” or “otherwise show good cause.” The Commission is not particularly receptive to respondents’ severance motions that are made under the good cause standard. See In the Matter of David A. Finnerty, et al., Exchange Act Rel.No. 56756, 2007 SEC LEXIS 2588 (Nov. 6, 2007); In the Matter of John A. Carley, Exchange Act Rel.No. 50954, 2006 SEC LEXIS 1 (Jan. 3, 2005); In the Matter of John A. Carley, Exchange Act Rel. No. 50695, 2004 SEC LEXIS 2645 (Nov. 18, 2004). Consolidation of separately instituted APs is also possible where appropriate to avoid unnecessary cost or delay. See Rule 201; In the Matter of Lawrence A. Campbell, Admin.Proc.Rul.Rel.No. 634, 2007 SEC LEXIS 1068 (May 21, 2007).