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The SEC Retains its House Advantage During Administrative Proceedings

August 5, 2016

Amendments to the Rules of Practice Do Little to Address Criticism that the Deck is Stacked

Facing pressure from industry practitioners and in the wake of constitutional challenges in multiple jurisdictions, the Securities and Exchange Commission ("SEC") recently amended its Rules of Practice that apply to proceedings before an administrative law judge ("ALJ").[1] Over the past few years the SEC has increasingly brought enforcement actions before ALJs, rather than in federal district court, where respondents lack certain due process protections such as a jury trial, application of the Federal Rules of Civil Procedure ("FRCP") and the Federal Rules of Evidence ("FRE"), and an independent appeals process. Despite a few modest and incremental reforms relating to prehearing deadlines and discovery opportunities, the amendments do little to address the most fundamental inequities of the SEC's in-house courts and continue to leave respondents before an ALJ at a significant disadvantage.

The amended Rules of Practice will go into effect on September 27, 2016, and will apply to all administrative proceedings initiated on or after that date.

I. Background and Legal Challenges

Once the Division of Enforcement completes an investigation and obtains authorization to institute enforcement proceedings, the SEC can either (1) initiate civil proceedings in federal district court or (2) institute administrative proceedings before an ALJ.[2] The former provides substantive and procedural safeguards for defendants, including the application of the FRCP and the FRE, the right to a jury trial, and the presence of an independent trier of fact. The latter does not. Instead, respondents before an ALJ face a trier of both law and fact that is employed by the SEC, they receive limited discovery and evidentiary protections, and their initial appellate route is through the SEC – the very body that authorized the action in the first place. Only after the SEC has reviewed

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[1] *See* Amendments to the Commission's Rules of Practice, 17 CFR Part 201, *available at* https://www.sec.gov/rules/final/2016/34-78319.pdf.

[2] *See* SEC Enforcement Manual (June 4, 2015), *available at* https://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

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the ALJ's determination and issued a final order can a respondent seek review with the United States Court of Appeals.

According to recent data, the SEC's success rate in contested cases before its own ALJs is approximately 90%, compared to roughly 69% for cases brought in federal court.[3] During the same time period, the SEC affirmed on appeal approximately 95% of its ALJ's determinations.[4] Not surprisingly, the SEC has increasingly opted to refer matters to administrative proceedings, particularly since passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 expanded its jurisdiction and ability to use such proceedings to seek increased civil monetary penalties. That year, the SEC filed 252 cases as civil injunctive actions and 429 as administrative proceedings.[5] Four years later, in 2014, those numbers were 145 and 620, respectively.[6]

Nor has the SEC been deterred by various constitutional challenges to its in-house courts, all of which to date have been unsuccessful. Each of the Seventh Circuit in *Bebo v. SEC*,[7] the D.C. Circuit in *Jarkesy v. SEC*,[8] the Second Circuit in *Tilton et al. v. SEC*,[9] and most recently the Eleventh Circuit in *Hill v. SEC*,[10] have rejected challenges to the SEC's administrative proceedings process on jurisdictional grounds. In each case, the courts were not persuaded either by the argument that ALJs cannot adjudicate as they are not appointed to the judiciary in accordance with the Appointments Clause (Article II) of the United States Constitution (as in *Bebo* and *Hill*), or that the administrative proceeding's expedited timeframes and failure to provide a trial by jury violate the Due Process Clause and the Seventh Amendment (as in *Jarkesy* and *Tilton*). Based on these holdings, and the Supreme Court's refusal to grant certiorari in *Bebo*, future constitutional challenges along these lines are also unlikely to succeed.

II. Amendments to Rules of Practice

Nevertheless, and despite its undefeated record in defending its in-house courts, the SEC amended its Rules of Practice. As a threshold matter, the amended Rules of Practice do nothing to change the fact that the SEC still has complete discretion as to whether to bring an action in district court or before an ALJ. Nor do they go as far as some industry insiders had hoped, such as

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3 *See* Jean Eaglesham, SEC Wins With In-House Judges, *The Wall Street Journal*, May 6, 2015, a*vailable at* http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

4 *Id.*

5 *Id.*

6 *Id.*

7 799 F.3d 765 (7th Cir. Aug. 24, 2015), *cert. denied*, 136 S. Ct. 1500 (Mar. 28, 2016).

8 803 F.3d 9 (D.C. Cir. Sept. 29, 2015).

9 2016 U.S. App. LEXIS 9970 (2d Cir. Jun. 1, 2016).

10 2016 U.S. App. LEXIS 10946 (11th Cir. Jun. 17, 2016).

a full incorporation of the FRCP and FRE. However, they do provide some degree of relief to beleaguered respondents.

Limited Extension of Prehearing Period. The amended Rules of Practice provide additional time for respondents to review the SEC's investigative record and prepare for their hearing before the ALJ. Previously, Rule 360 provided a maximum of four months from the time a respondent was served an order instituting proceedings to the hearing date. Now, depending on a case's timeline,[11] the prehearing period will span from four months (for 30-day cases), to six months (for 75-day cases), to a maximum of 10 months (for 120-day cases). While this change provides some degree of relief to respondents, the SEC declined to extend the timelines further to reflect, for example, the current realities of electronic discovery where an investigative file could contain thousands or even millions of pages of material that needs to be reviewed. Similarly, the SEC rejected industry suggestions to dispel with hard deadlines altogether and permit ALJs the discretion to set hearing timelines, similar to how judges issue scheduling orders in district court.

Expanded Ability to Take Depositions as Discovery. Historically, the SEC argued against a respondent's need to take witness depositions, citing the extensive factual record typically generated by the Enforcement Division during the course of an investigation. As a result, Rule 233 permitted respondents to move for permission to depose only those witnesses who were likely to be unavailable to testify at a hearing before the ALJ. Going forward, respondents, but importantly, the SEC as well, will be permitted to take witness depositions to develop arguments and defenses – but only in those cases designated for the 120-day timeline, and only in limited numbers (three depositions per side for single-respondent cases, and five depositions per side for multi-respondent cases). Additional witness depositions may be taken only if the ALJ permits upon a showing of "compelling" circumstances, and only to a maximum of an additional two per side. Despite industry comments encouraging it to further lessen these restrictions, the SEC declined to modify Rule 233 to give ALJs the discretion to determine an appropriate number of depositions based on the complexity of a case.

Greater Ability to Seek Dismissal. The previous Rule 250 permitted respondents to move for summary disposition only after filing an answer to the SEC's case in chief, similar to a motion for summary judgment under FRCP 56. Under the amended Rule 250, respondents will now be permitted to file dispositive motions in various ways and at different stages of the proceedings, including: (1) as a motion to dismiss on the pleadings (similar to a motion to dismiss under FRCP 12(b)(6) or 12(c)), (2) as a motion for summary disposition (without permission in a 30-day or 75-day case, with permission in a 120-day case), and (3) as a motion for a ruling following completion of the SEC's case in chief.

[11] Under the amended Rules of Practice, based on their complexity, cases will be designated as having an initial decision due either 30, 75, or 120 days from the completion of post-hearing or dispositive motion briefing or a finding of default.

Limited Use of Hearsay Evidence. As with other administrative tribunals, hearsay evidence is admissible at SEC administrative proceedings under Rule 320 provided it is relevant, material, and not unduly repetitious. The amended Rules of Practice impose an additional requirement that such evidence also be "reliable." While industry commenters had proposed the SEC limit hearsay evidence consistent with the rules set forth in the FRE, the SEC declined to do so opting for a case-by-case analysis rather than a broader exclusionary rule.

While the amended Rules of Practice largely benefit respondents who are facing an administrative proceeding, they also impose a new burden that respondents must keep in mind. In addition to any other affirmative defense they plan to raise, under Rule 220 respondents will now have to indicate whether they will assert any "reliance" defense, including a reliance 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 of that defense.

III. Conclusion

While the amended Rules of Practice provide a few incremental changes that appear to improve the fairness of the SEC's administrative proceedings, they do not fundamentally alter the balance of power. Additional prehearing preparation time and a limited ability to depose witnesses hardly compares to the fact that the Enforcement Division has virtually unlimited discovery opportunities during the course of an investigation (for example, during SEC investigative testimony, only the SEC counsel and the witnesses' counsel are present, and the target of the investigation cannot even attend – much less examine – a witness or object to the questions asked). The new deposition provisions could help respondents develop a defense in cases with simple fact patterns and small numbers of witnesses – for example, allowing a tippee defendant to depose a tipper in a simple insider trading case could provide a significant boost to the tippee's defense. However, the limited number of depositions permitted is likely insufficient to have much impact on larger scale investigations involving numerous actors or multiple jurisdictions.

The amended Rules of Practice are a step in the right direction for administrative proceedings, but they are by no means equivalent to the degree of constitutional and procedural protections afforded civil defendants who find themselves in federal district court. Until further amendments are enacted, or a constitutional challenge succeeds, the SEC will continue to hold a strong advantage over respondents who find themselves standing before an ALJ.

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