JULY 2016

COMMENTARY

SEC Publishes Final Rules Amending the Rules of Practice for Administrative Proceedings

On July 13, 2016, the Securities and Exchange Commission ("SEC" or "Commission") voted to adopt amendments to the rules of practice that govern its Administrative Proceedings ("APs").[1] In a press release accompanying publication of the amended rules, SEC Chair Mary Jo White declared, "The amendments to the Commission's rules of practice provide parties with additional opportunities to conduct depositions and add flexibility to the timelines of our administrative proceedings, while continuing to promote the fair and timely resolution of the proceedings."[2]

The amended rules are a step in the right direction but do not fully correct the numerous and severe imbalances that exist in the Commission's administrative enforcement process with respect to the availability of various discovery mechanisms, the timeline for trying a case, and more. Every entity or individual that is involved in an SEC enforcement investigation, or that may become a respondent in an SEC Administrative Proceeding, should take certain practical steps to minimize the structural disadvantages it will face and to maximize the benefits conferred by these latest amendments to the rules of practice.

Background

Since 2010, when Dodd-Frank allowed the Commission to impose civil penalties in cease-and-desist proceedings, the SEC has pursued enforcement actions in APs more frequently than in civil actions brought in federal district courts. That practice has spawned widespread criticism. Media outlets have commented on the SEC's disproportionately high success rate when litigating in front of Commission administrative law judges ("ALJs"), as opposed to district court judges.[3] And a number of potential respondents have pursued lawsuits challenging the SEC's method for selecting ALJs as a violation of the Appointments Clause of Article II, Section 2, of the United States Constitution.[4]

But perhaps the most common criticism is that the AP process is simply unfair. An AP before the SEC is governed by none of the procedural guarantees embodied by the Federal Rules of Civil Procedure, or even the Federal Rules of Evidence. Respondents are given an unrealistically short time in which to review and digest years' worth of investigative materials produced by the SEC, and, until now, they were not entitled by rule to take *any* depositions, while the SEC has license to take a virtually unlimited number during the investigatory phase before initiating an enforcement action.[5]

On top of that, the expansive evidentiary rules applicable to APs allow for the introduction of evidence that would never be considered in federal court, up to and including offers of settlement and related communications.[6]

In 2015, two pieces of legislation were developed seeking to correct the growing power imbalance: (i) the Due Process Restoration Act,[7] which would amend the Securities Exchange Act of 1934 to permit private persons to compel the SEC to seek legal or equitable remedies in a civil action in district court, instead of in an AP; and (ii) the Financial Choice Act, which would do the same and more. The SEC's amendment of the rules of practice appears to be an effort to respond to these criticisms and to alleviate the concerns about fairness raised by so many. The SEC is implementing incremental change before any legislation can change the game entirely.

The Amendments

The SEC's amendments reflect attention to the problem areas most frequently identified by public commentators, though in many respects the changes do not go nearly far enough:

Timing of the Prehearing Period. One of the most significant amendments is an expansion of the prehearing period set forth in Rule 360. The SEC extended the length of the prehearing period—the period of time between the entry of an Order Instituting Proceedings ("OIP") and the date by which a hearing must be held[9]—from four months to a maximum of 10 months for cases designated as 120-day proceedings, a maximum of six months for 75-day cases, and a maximum of four months for 30-day cases.[10] The SEC initially contemplated an eight-month maximum, but commenters stressed the need for longer discovery periods due to the substantial increase in electronic files and documents, the amount of time it takes to receive a complete investigative file, and the time needed to counter the Commission's lengthy and extensive investigations.[11] Taking into consideration the comments, the SEC increased the maximum time period from eight months to 10, concluding that the 10-month maximum time period balanced the Commission's goal of efficiently resolving APs with the time needed to conduct discovery and prepare for a hearing.[12]

Depositions. Another significant addition to the SEC's rules of practice is the allowance of a set number of depositions. The SEC's amended Rule 233 will now allow for three depositions in a single-respondent proceeding, and five depositions per side in a multi-respondent proceeding.[13] In addition, in response to comments, the Commission provided for an additional two depositions if a party can demonstrate a compelling need.[14] Prior to this amendment, parties were not officially given a designated number of depositions and had to move for permission to take the deposition of a witness who would be unavailable to attend or testify at the hearing.[15] The SEC retains the rule allowing for a party to move for permission to take an unavailable witness's deposition and notes that it will not count such a deposition against the permissible number of depositions.[16] Notably, there is no separate provision for the deposition of an expert; the three (or five) depositions afforded to each side must account for both fact and expert witnesses.

Discovery. The amendments ultimately did little to shift the balance of power in discovery, but one important change concerns the timing of the Staff's production of the investigative file. Amended Rule 221(c) adds to the list of subjects to be discussed at the pre-hearing conference the timing for completion of the production of documents as set forth in Rule 230, which requires "the Division of Enforcement [to] make available for inspection and copying by any party documents obtained by the Division prior to the institution of proceedings, in connection with the investigation leading to the Division's recommendation to institute proceedings."

Affirmative Defenses. Before the amendments, Rule 220 required respondents to state any affirmative defenses, including res judicata and statute of limitations, in the respondent's answer to the OIP.[17] Here, the amendments to Rule 220 actually expand a respondent's duties, requiring a respondent to state in its answer whether the respondent is asserting any avoidance or affirmative defenses, including res judicata, statute of limitations, or reliance, even if those theories are "not technically considered affirmative defenses."[18] In practice, the amended rule now requires respondents to state in their answer whether they relied upon "the advice of counsel, accountants, auditors, or other professionals."[19] Failure to do so constitutes a waiver of the defense. Opponents to the amendment argued in their comments that this rule will severely prejudice respondents by requiring them to disclose trial strategy and infringe on privilege.[20] But the Commission ultimately decided to adopt the rule, citing efficiency and efficacy reasons.[21]

Dispositive Motions. Prior to the amendments, Rule 250 was used in SEC proceedings in a manner analogous to the summary judgment mechanism in federal court. It provided that a party may move for summary disposition after a respondent's answer is filed and documents have been made available to the respondent.[22] In addition, it was used to seek a ruling on the pleadings or seek dismissal as a matter of law.[23] The changes to Rule 250 under the final rules would provide for three different types of dispositive motions to be filed at different stages of an AP. The amended Rule provides for:[24]

- **A motion for a ruling on the pleadings.** Any party may file for a ruling on the pleadings 14 days after a respondent's answer is filed. This rule permits a respondent to seek a ruling as a matter of law based on the factual allegations in the OIP, and it is analogous to a motion filed pursuant to Federal Rule of Civil Procedure 12(c) (judgment on the pleadings).

- **A motion for summary disposition in 30-, 75-, and 120-day proceedings.** Any party may move for summary disposition as a matter of law on one or more claims or defenses. While leave of the hearing officer is not required to file such a motion in 30- and 75-day cases, it is required for 120-day cases. This rule is analogous to Federal Rule of Civil Procedure 56 (summary judgment).

- **A motion for a ruling as a matter of law following completion of a case in chief.** Any party may make a motion asserting that it is entitled to a ruling as a matter of law on one or more claims or defenses after completion of the Commission's case in chief at a hearing. This rule is analogous to Federal Rule of Civil Procedure 50(a) (judgment as a matter of law).

This new set of motions presents additional opportunities for early case resolution, narrowing of the issues, and the advocacy of one's position before the ALJ.

Admissibility of Hearsay Evidence. Rule 320 previously required the exclusion of evidence that is "irrelevant, immaterial, or unduly repetitious."[25] The amendments added "unreliable" to the list of evidence that is excluded.[26] The SEC also amended the rule to clarify that hearsay will be admitted if it is deemed to be relevant, material, and reliable.[27] Commenters strongly opposed this amendment, citing memory, bias, and credibility issues, and urging the Commission to incorporate the Federal Rules of Evidence regarding hearsay.[28] The Commission adopted the rule as it was proposed, noting that hearsay evidence is to be evaluated on a case-by-case basis that takes into account memory, bias, and credibility issues. Again citing efficiency and efficacy, the Commission concluded that a case-by-case determination regarding the admissibility of hearsay evidence serves their purposes better than a broad exclusionary rule, as suggested by the commenters.[29]

Analysis and Practical Impact

As an initial matter, the concerns raised by so many individuals and entities concerning the fundamental fairness of SEC APs are valid. To be truly fair, the rules for APs must provide sufficient procedural safeguards to, at the very least, ensure that the proceeding is conducted in a manner consistent with constitutional guarantees of due process. That point is made all the more critical by the Commission's increased authority, under Dodd-Frank, to impose civil monetary penalties in APs; by its increased use of the administrative forum to bring complex financial fraud and other actions historically litigated in federal court; and by the public's growing concern that the AP process is skewed in favor of the Commission. Simply put, the public is not wrong, as evidenced by numerous studies revealing the Commission's substantially stronger track record in the administrative forum as compared to federal court.

The Commission's amended rules of practice for APs are a step in the right direction, but they do not go nearly far enough to address the concerns underlying the continuing constitutional and legislative challenges to the Commission's administrative process. The hard timetables and limits on depositions in the amended rules remain arbitrary and formulaic, while due process demands that procedural rules provide for the ability to tailor such limits to the facts and complexities of a particular enforcement action. This is especially true with many Commission enforcement actions, which can involve accounting, financial, and trading and markets issues far more intricate and complex than many cases litigated in federal court. Moreover, providing "equivalent" discovery—such as the same

number of depositions—to the respondent and to the Division of Enforcement during the pendency of an AP does nothing at all to address the immense informational imbalance in the Commission's favor following the investigatory phase, when the Commission's power to discover and depose is virtually unlimited, while the respondent's ability to do the same hardly exists.

Recommendations

In summary, the amendments to the AP rules are a welcome step in the right direction, and they may assist the SEC in arguing that the AP process is growing increasingly fair. But they ultimately do little to balance out the asymmetrical warfare in which many individuals and entities find themselves when they are involved in an AP. These changes will not quell continuing legislative and constitutional challenges regarding the fundamental fairness of the Commission's AP process, which only serves to unnecessarily undermine the credibility and effectiveness of the Commission's enforcement program. Until further change takes place, however, every respondent's and potential respondent's first concern should be preparing for the tilted playing field that currently exists. The following points should be taken into consideration early and often:

Timing. Review of an investigative record that the staff has accumulated over a course of years, and the coordination of discovery with other respondents, can eat up substantial amounts of preparation time, even within the slightly longer pre-hearing windows provided for by the amended rules. Respondents should continue to do everything that they can to be prepared for an administrative hearing *before* the case is filed. On the to-do list will be coordinating, to the extent possible, with other defense counsel; identifying expert witnesses; and, to the extent the staff has not made the record available during the pre-Wells submission process, seeking to share information with other defense counsel.

Furthermore, given the restrictive pre-hearing timetables still reflected in the amended rules, pre-filing preparation should also include a close review of the rules themselves. Counsel must be ready to address all relevant issues at the initial conference and be prepared to hit the ground running with permitted motions and discovery requests. Advance planning for discovery requests should include preparation of requests for subpoenas, which can be issued only by the assigned ALJ upon a specified showing of need.

Depositions. While the amended provision for three depositions as of right is potentially helpful in single-respondent matters, the Commission often brings multi-respondent matters, and it often does so in situations where the respondents may not have interests that align. Because the rule grants five depositions *per side* in multi-respondent matters, rather than five depositions *per respondent*, some respondents may find themselves left out, with no guaranteed method to explore the factual allegations against them. While they are not often granted, one possible approach may be to request severance from the matter for good cause under Rule 201(b).[30]

Additionally, under the amended rules, respondents will continue to face an old problem: the Commission Staff often informally "interviews" a witness without creating a transcript, and if there are more witnesses that need to be deposed than the limits allow, respondents may confront a "blind" cross-examination at the hearing, having no idea what a witness is going to say. This means that defense counsel will need to continue the practice of requesting from some witnesses' counsel the opportunity to do a voluntary interview of the witness, which does not substitute for a deposition but will limit the potential for surprise. Furthermore, with respect to expert witnesses or other witnesses who may have testified before, counsel should continue to seek to reduce the inherent disadvantage by gathering all available prior deposition and trial testimony for that witness through available expert witness database services and the defense bar network.

Wells Submissions. While it is not new, the amended rules' failure to change the status quo on most evidentiary issues serves as a useful reminder that the Staff will seek to introduce into evidence Wells submissions, and that care should be taken with any statements made in the Wells submission. The client must therefore carefully review and sign off on all statements in any Wells submission.

Availability of the Investigative Record. The Commission makes clear that the investigative record should be made available promptly to defense counsel by amending Rule

221(c) to add to the list of topics to be discussed at the pre-hearing conference the timing of completion of the production of documents. Respondent's counsel needs to make certain that this is spelled out by the hearing officer, so that there is no confusion.

Hearsay. As previously mentioned, one of the largest differences between district court proceedings and an AP is that the Federal Rules of Evidence do not apply to APs. This difference can be most acute when the Staff is able to have a witness testify regarding what is clearly hearsay and would be inadmissible in federal court. The Commission clarified in the amended rules, however, that hearsay must be "relevant, material and bear[] satisfactory indicia of reliability." This is a far cry from adoption of the Federal Rules of Evidence, but it does bear some similarity to the test employed by the residual hearsay exception found in Federal Rule of Evidence 807. Counsel may object to any evidence that would be hearsay under the Federal Rules of Evidence, thereby shifting the burden of admission to the Staff to prove the requisite reliability. Ultimately, this could force the Staff to defend admissibility on grounds more akin to the Federal Rules of Evidence, using the exception doctrines as a shorthand for proving reliability.

Reliance. The amended rules requiring that any defenses based on reliance on attorneys, accountants, or auditors be raised at the answering stage means the decision to use these defenses must be made prior to or immediately after the filing of the OIP; there will be little time for careful analysis of the issues. Defenses based on reliance on counsel necessarily may mean waiving the attorney-client privilege. Care needs to be given to consider whether there are arguments supporting a lack of scienter defense that are similar to, but fall just short of, reliance, as that may be a more prudent approach.

In summary, any potential respondent to an enforcement action and facing an AP is in for a daunting task. Litigating an AP varies greatly from trial practice in the federal district courts. It is therefore critical to obtain the advice of counsel who is experienced with the unique aspects of trial practice before an SEC administrative law judge.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Joan E. McKown
Washington
+1.202.879.3647
jemckown@jonesday.com

Harold K. Gordon
New York
+1.212.326.3740
hkgordon@jonesday.com

Henry Klehm III
New York
+1.212.326.3706
hklehm@jonesday.com

David Woodcock
Dallas
+1.214.969.3681
dwoodcock@jonesday.com

Daniel Bradley, an associate in the Chicago Office, and Kirsten Moran, a summer associate in the Chicago Office, assisted in the preparation of this Commentary.

Endnotes

1 The amended rules generally become effective 60 days after publication in the *Federal Register*, but in matters filed between publication and effectiveness, the parties can petition to have the new rules apply.

2 SEC Press Release, "SEC Adopts Amendments to Rules of Practicefor Administrative Proceedings," No. 2016-142 (July 13, 2016).

3 *See, e.g.,* Jean Eaglesham, "SEC Wins with In-House Judges," *The Wall Street Journal* (May 6, 2015); Peter J. Henning, "New Criticism Over the S.E.C.'s Use of In-House Judges," *The New York Times* (July 20, 2015).

4 At present, several Courts of Appeal have held that these pre-enforcement actions by respondents are procedurally inappropriate. *Hill v. Secs. & Exch. Comm'n*, No. 15-13738 (11th Cir. June 17, 2016); *Tilton v. Secs. & Exch. Comm'n*, No. 15-2103 (2d Cir. June 1, 2016); *Jarkesy v. Secs. & Exch. Comm'n*, 803 F.3d 9 (D.C. Cir. 2015); *Bebo v. Secs. & Exch. Comm'n*, 799 F.3d 765 (7th Cir. 2015), cert. denied, 136 S. Ct. 1500 (2016).

5 For additional background, see *Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices*, U.S. Chamber of Commerce, Center for Capital Markets Competitiveness, July 2015.

6 Contrast with Federal Rule of Evidence 408.

7 *See* Peter J. Henning, "Reforming the S.E.C.'s Administrative Process," T*he New York Times* (Oct. 26, 2015).

8 *See* Victoria Finkle, "Repub*licans Unveil Plan to Revamp Dodd-Frank,"* The New York Times (June 7, 2016).

9 Previously, initial decisions by an ALJ needed to be completed within 120, 210, or 300 days of service from the OIP. Under the amended rules, the initial decision is due 30, 75, or 120 days from the completion date of a post-hearing briefing or dispositive motion briefing or filing of default. Rule 360(a)(2) provides the framework for designating a particular proceeding as one that must be completed in 30, 75, or 120 days. Specifically, "[i]n the order instituting proceedings, the Commission will specify a time period in which the hearing officer's initial decision must be filed with the Secretary," a specification made "[i]n the Commission's discretion, after consideration of the nature, complexity, and urgency of the subject matter, and with due regard for the public interest and the protection of investors[.]" 17 CFR § 201.360(a)(2).

10 *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Final Rule 360.

11 *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Comment to Rule 360.

12 *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Final Rule 360.

13 *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Final Rule 233.

14 *Id.*

15 *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Proposed Rule 233.

16 *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Final Rule 233.

17 *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Proposed Rule 220.

18 *Rules of Practice,* Exchange Act Release No. 34-78319 (July 13, 2016), Final Rule 220.

19 *Id.*

20 *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Comments to Rule 220.

21 *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Final Rule 220.

22 *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Proposed Rule 250.

23 *Id.*

24 *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Final Rule 250.

25 *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Proposed Rule 320.

26 *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Final Rule 320.

27 *Id.*

28 *Rules of Practice*e, Exchange Act Release No. 34-78319 (July 13, 2016), Comments to Rule 320.

29 *Rules of Practice*e, Exchange Act Release No. 34-78319 (July 13, 2016), Final Rule 320.

30 17 CFR § 201.201.