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December 4, 2015

Via Electronic Submission: <http://www.sec.gov/rules/proposed.shtml>

Brent J. Fields  
Secretary  
United States Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

Re: Proposed Rule on Amendments to the Commission's Rules of Practice  
(File Number S7-18-15)

Dear Mr. Fields:

Gibson, Dunn & Crutcher LLP appreciates the opportunity to comment on the proposed rule issued by the Securities and Exchange Commission ("SEC" or "Commission") concerning "Amendments to the Commission's Rules of Practice," 80 Fed. Reg. 60,091 (Oct. 5, 2015) ("Proposed Amendments").<sup>1</sup>

## I. Introduction

The enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") has allowed the Commission to impose the same stringent penalties in administrative proceedings that are available in federal district court. This development has coincided with the Division of Enforcement's recent practice of using administrative proceedings to bring increasingly significant and complex enforcement actions, which historically would have had to be litigated in a federal district court. Although Dodd-Frank makes the same remedies available in both possible venues, the differences between the two fora remain substantial. While a defendant in federal district court has the right to full civil discovery, adjudication by an independent Article III judge, and the full application of the Federal Rules of Evidence and the Federal Rules of Civil Procedure, a respondent in the SEC's administrative proceedings is not entitled to any of these protections. Many commentators have observed that the lack of these procedural protections significantly

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<sup>1</sup> Gibson, Dunn & Crutcher LLP has a substantial interest in the proposed amendments to the Commission's Rules of Practice because the firm regularly represents clients in SEC proceedings and those clients are directly affected by the Commission's procedural rules.

December 4, 2015

Page 2

disadvantages respondents who are charged in the SEC’s in-house courts. A recent independent study of the SEC’s administrative proceedings found that the “SEC won against 90% of defendants before its own judges in contested cases from October 2010 through March [2015],” as compared to a 69% success rate in federal courts.<sup>2</sup>

The perception that administrative proceedings are fundamentally unfair has damaged the credibility of the SEC’s enforcement system. Influential commentators and stakeholders have attacked the legitimacy of the Commission’s administrative proceedings,<sup>3</sup> and respondents have filed an unprecedented series of constitutional challenges attacking various features of the regime in federal district court.<sup>4</sup>

We are therefore encouraged by the SEC’s Proposed Amendments, which laudably propose certain additional protections for respondents, such as greater discovery rights and longer timetables for administrative proceedings. But these proposed revisions do not go nearly far enough. Since the last comprehensive revision of the rules for administrative proceedings in 1995, Congress has enacted two major pieces of legislation—the Sarbanes-Oxley Act of 2002 and Dodd-Frank—that have expanded the SEC’s enforcement powers. In light of the shift that has occurred in the legal landscape, this update to the Rules of Practice is an opportune time to ensure that the rules include the procedural protections necessary to comport with due process and fundamental fairness. To that end, the second and third sections of this letter comment on the text of the Proposed Amendments, while the fourth section proposes additional areas in the Rules of Practice that are ripe for revision.

## **II. Comments on Proposed Amendments**

### **A. Timing of Proceedings**

The current rules impose mandatory timelines for the conduct of administrative proceedings.<sup>5</sup> Requests for postponements are “strongly disfavor[ed]” and must be based on

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<sup>2</sup> Jean Eaglesham, *SEC Wins With In-House Judges*, WALL ST. J., (May 6, 2015), <http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803>.

<sup>3</sup> See, e.g., Judge Jed S. Rakoff, Keynote Address Before the Practising Law 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>.

<sup>4</sup> E.g., *Hill v. SEC*, No. 15-cv-1801, 2015 WL 4307088 (N.D. Ga. June 8, 2015); *Duka v. SEC*, No. 15-cv-357, 2015 WL 4940057 (S.D.N.Y. Aug. 3, 2015).

<sup>5</sup> See 17 C.F.R. § 201.360.

December 4, 2015

Page 3

a “strong showing that the denial of the request or motion would substantially prejudice [the respondent’s] case.”<sup>6</sup> The Proposed Amendments would modestly expand some of these artificial time constraints, but would otherwise leave the current structure intact.<sup>7</sup>

While we certainly support providing additional time to litigate the Division’s most complex cases, even the revised timelines are inadequate given the degree to which administrative proceedings have evolved from their original form. Dodd-Frank empowered the Division to bring its most complex and significant cases as administrative proceedings instead of district court actions. The Rules governing timing of proceedings must be amended to accommodate this increasing complexity. Specifically, the Administrative Law Judge (“ALJ”) should be authorized to depart from the default timelines wherever the complexity or other circumstances of the case reasonably justify such a departure.

It is important to recall that the time limits in the current rules derive from a proposal that was never meant to be mandatory. In 1995, the Commission significantly revised the rules by promulgating a set of “Guidelines for the Timely Completion of Proceedings.”<sup>8</sup> At the time, the Commission explained that it was not creating “a requirement that each portion of a proceeding or the entire proceeding be completed within the periods described” because some matters are “unusually complex” and “fairness to all parties requires that the Commission’s deliberative process not be constrained by an inflexible schedule.”<sup>9</sup> It reasoned that the approach of mandatory timelines “places too great a premium on the benefits of achieving resolution of a proceeding, without due consideration to the resolution reached.”<sup>10</sup>

In 2003, the Commission reversed this position, making the timelines mandatory and creating three different time “tracks” depending on the “nature, complexity, and urgency of the subject matter” of a particular case.<sup>11</sup> Even before Dodd-Frank, the allotted trial preparation time for the most complex matters—four months—was woefully inadequate. The Proposed Amendments do little to improve the situation. For example, the proposed increase

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<sup>6</sup> 17 C.F.R. § 201.161(b)(1).

<sup>7</sup> See 80 Fed. Reg. at 60,092, 60,104-105 (proposed amendments to 17 C.F.R. § 201.360).

<sup>8</sup> See 60 Fed. Reg. 32,738 (June 23, 1995).

<sup>9</sup> *Id.* at 32,742-43.

<sup>10</sup> *Id.* at 32,743.

<sup>11</sup> See 68 Fed. Reg. 35,787, 35,789 (June 17, 2003).

December 4, 2015

Page 4

from four to eight months in trial preparation time for complex matters is still far short of what is needed for the most complicated proceedings. As the emergence of email and other technology has dramatically increased the scope of records generated by firms, the SEC’s investigative files have grown as well.<sup>12</sup> The unfairness to respondents in the current regime is particularly acute given the gap in discovery rules, discussed *infra*, which require that the SEC *begin* its document production promptly after a proceeding is initiated but do not require any date certain by which such production must be completed. Because the most complex cases rely on far more potentially relevant documents than in the past, respondents may need more than eight months to prepare for the contested proceedings.

Authorizing departures from the timelines would result in minimal disruption, since only a portion of the most complex litigated cases would likely justify such extensions. Providing respondents and their counsel with assurances that they will have sufficient time to prepare a thorough defense will help mitigate the current concerns regarding the fairness of the in-house process. A more participatory approach toward timing issues may also result in less acrimonious proceedings, reduced motion practice, and more pre-hearing settlements.

In fact, other agencies have recognized the value of flexible scheduling by allowing decision makers to take into account the particular needs of a case. For example, the Federal Deposit Insurance Corporation rules provide that “the administrative law judge may, for good cause shown, extend the time limits prescribed by the Uniform Rules or by any notice or order issued in the proceedings,” 12 C.F.R. § 308.13, which is done as part of a “scheduling conference” in which the ALJ “direct[s] counsel for all parties to meet with him or her in person at a specified time and place prior to the hearing or to confer by telephone for the purpose of scheduling the course and conduct of the proceeding,” 12 C.F.R. § 308.31(a). Similarly, the procedures for hearings at the Department of Education provide that “[h]earings shall be held . . . at a time fixed by the responsible Department official.” 34 C.F.R. § 100.9(b).

The Proposed Amendments also fail to resolve two other problems with respect to the timing of proceedings. *First*, while the Division’s production is required to “commence . . .

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<sup>12</sup> Cf. Chairman Elisse Walter, Address at the American University School of Law: Harnessing Tomorrow’s Technology for Today’s Investors and Markets (Feb. 19, 2013), <http://www.sec.gov/News/Speech/Detail/Speech/1365171492300> (“Many law firms have similar tools, but no firm handles nearly the quantity of data we do — six terabytes of data a month, or the equivalent of 614 million printed e-mail pages.”).

December 4, 2015

Page 5

no later than 7 days after service of the order instituting proceedings,”<sup>13</sup> the Proposed Amendments do not establish any firm deadline for when the Division must *complete* the production. Indeed, the Division’s production can be and often is accomplished piecemeal over time, further reducing preparation time for the respondent. The rules should provide that whatever hearing inception date is set—whether it is set by rule or preferably negotiated by the parties and the ALJ under a more flexible regime—the date should be calculated from the time when the Division completes its document production. In the alternative, the rules should require the Division to complete its production of documents within 45 days of initiating a proceeding absent a showing that good cause exists to grant an extension.

*Second*, SEC proceedings routinely follow on the heels of investigations that approach the expiration of the statute of limitations. For the large percentage of respondents who are registered individuals or entities, the process often prohibits them from making a living during the lengthy pendency of the investigation and proceeding. In May 2014, the SEC took a step toward transparency by issuing guidance on when it would bring a case in the administrative forum as opposed to federal district court.<sup>14</sup> The SEC should similarly issue informal guidance setting forth more ambitious goals for the completion of the Enforcement Division’s investigations. A pledge by the SEC that enforcement investigations will strive for earlier completion (for example, one to two years for garden variety cases and three years for more complex matters) would help address some of the perceived unfairness in the SEC’s in-house prosecutions.

## B. Scope of Discovery

The Commission’s proposal to allow respondents to take a limited number of depositions prior to administrative hearings is one step toward a more equitable process for respondents and will better enable ALJs to reach the correct outcomes. We suggest, however, that the Commission consider changing the proposed rules on depositions in the following ways: (1) at least five depositions should be available in all matters, regardless of the number of respondents, and (2) ALJs should be given the flexibility to permit more depositions, as appropriate, based on the unique circumstances of a particular enforcement action. Both of these changes will allow ALJs to manage and achieve the Commission’s objective to

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<sup>13</sup> 17 C.F.R. § 201.230(d).

<sup>14</sup> See Securities and Exchange Commission, Division of Enforcement Approach to Forum Selection in Contested Actions (May 8, 2015), <https://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf> (“Division of Enforcement Approach to Forum Selection”).

December 4, 2015

Page 6

“provide parties with the potential benefits of this discovery tool, without sacrificing the public interest in resolving administrative proceedings promptly and efficiently.”<sup>15</sup>

### *1. The Number of Depositions Should Not Be Tied to the Number of Respondents*

The current proposal to afford each side three depositions in single-respondent proceedings and five depositions in multiple-respondent proceedings is ill-matched with the diversity of factual depth both types of proceedings can involve.<sup>16</sup> Cases against single respondents will often involve multiple witnesses. For example, cases involving multiple violations, such as failure-to-supervise and multiple victim cases (*e.g.*, broker-dealer abuses by a single registered representative, offering frauds and Ponzi schemes), will often involve a large number of witnesses.<sup>17</sup> The number of depositions therefore should not be artificially limited by the number of respondents.

Instead, all respondents should be permitted the same number of depositions regardless of whether they are charged with another respondent.<sup>18</sup> This logic is consonant with other parts of the proposed rules, such as the proposed amendment to Rule 330 on timing, which make no distinction between the time afforded for prehearing discovery for cases involving one or many respondents. Moreover, allowing the parties to take the same number of depositions in all cases is consistent with the Federal Rules of Civil Procedure and

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<sup>15</sup> 80 Fed. Reg. at 60,093.

<sup>16</sup> Compare *In re Dohan + Co. CPA*, 110 S.E.C. Dkt. 1973, S.E.C. Release No. 420, 2011 WL 2544473, at \*1 (June 27, 2011) (single-respondent matter in which eleven witnesses were called), with *In re VFinance Invs., Inc.*, 94 S.E.C. Dkt. 1689, S.E.C. Release No. 360, 2008 WL 4826017, at \*1 (Nov. 7, 2008) (multi-respondent matter in which six witnesses were called).

<sup>17</sup> See, e.g., *In re Johnny Clifton*, S.E.C. Release No. 9417, 2013 WL 3487076, at \*7 (July 12, 2013) (action against a single respondent for charges including failure-to-supervise that involved nine witnesses).

<sup>18</sup> If the Commission wishes to select a set number of depositions as a starting point, we propose that it allow five depositions in both single- and multiple-respondent proceedings. Authorizing five depositions is more appropriate than three because the Commission has already determined that this number of depositions will not “sacrific[e] the public interest in resolving administrative proceedings promptly and efficiently,” 80 Fed. Reg. at 60,093, and there is no indication that allowing single respondents to take five depositions will unduly hinder or delay administrative proceedings.

December 4, 2015

Page 7

the Rules of Practice of the Federal Trade Commission (“FTC”), neither of which links the number of depositions to the number of respondents or type of proceeding.<sup>19</sup>

## *2. The Rules of Practice Should Give ALJs the Discretionary Authority to Increase the Number of Depositions Each Party May Take*

Whether respondents are permitted to take three or five depositions, limiting the number of depositions on all proceedings is also arbitrary. The federal rules, for example, permit parties to take ten depositions by default and more than ten by leave of court, Fed. R. Civ. P. 30(a)(2); and the FTC does not apply a limit on the number of depositions, 16 C.F.R. § 3.31(a). Each administrative proceeding is unique—the facts, legal issues, and other factors may affect the number of witnesses needed in any given case.

At a minimum, the Commission should provide ALJs the discretion to increase the number of depositions that each side may take. As in the Federal Rules of Civil Procedure, the Commission’s Rules could provide for a fixed number of depositions that can be altered at the prehearing conference.<sup>20</sup> Moreover, to ensure that ALJs properly balance the parties’ interests in furthering the factual development of their cases against the important interest in efficiency, the Commission can issue guidance to ALJs that will assist them in determining when changing the number of depositions is appropriate. This guidance could be general or, using Rule 26 of the Federal Rules of Civil Procedure as a template, enumerate the specific factors to consider when deciding a request for additional depositions, such as “the importance of the issues at stake in the action, the amount in controversy, the parties’ relative access to relevant information, the parties’ resources, the importance of the discovery in resolving the issues, and whether the burden or expense of the proposed discovery outweighs its likely benefit.”<sup>21</sup> In addition, the full development of the factual record may have the added benefit of allowing respondents to enter into settlement discussions with a more complete understanding of the evidence. This additional information would assist the parties in accurately assessing the strengths and weaknesses of their respective positions and could result in more settlements.

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<sup>19</sup> See Fed. R. Civ. P. 30(a)(2); 16 C.F.R. § 3.31; *see also* 80 Fed. Reg. at 60,093 n.9 (explaining that the Federal Rules of Civil Procedure “represent a well-settled body of procedural rules familiar to practitioners” from which the Commission borrows).

<sup>20</sup> See Fed. R. Civ. P. 30, 1993 Amendment Note (explaining that parties and judges should discuss the appropriate number of depositions to permit each party at the Rule 16 conference).

<sup>21</sup> Fed. R. Civ. P. 26(b)(1).

December 4, 2015

Page 8

### C. Expert Witnesses

Generally, the Proposed Amendments to the rules on expert witnesses<sup>22</sup> are a marked improvement from the existing Rules of Practice. We fully support the Commission's decision to model the revised rule after Rule 26(b) of the Federal Rules of Civil Procedure. The Commission, however, also should specify that experts can give direct testimony at a hearing.

In complex administrative proceedings, expert witnesses are often a prominent feature in the hearing. Several ALJs have attempted to streamline hearings by substituting experts' reports for direct testimony and only allowing the opposing side to cross-examine the proffered expert.<sup>23</sup> This practice is at odds with the reality that, at least in complex administrative proceedings, expert witnesses often are central to each side's case. Preventing either side from conducting direct examinations of their experts diminishes ALJs' ability to fully assess the credibility of these witnesses. The Commission, therefore, should amend the current rules to allow direct expert testimony in all proceedings.

### D. Admission of Hearsay

Given that the Division, following Dodd-Frank, can now seek the same severe sanctions in administrative proceedings as in a federal court action, continuing to allow hearsay evidence in administrative proceedings creates a powerful incentive for the Division to make forum selection decisions based on the quality and nature of its evidence and witnesses rather than on more appropriate considerations.<sup>24</sup> To protect respondents against such manipulation, the Rules of Practice should prohibit the admission of hearsay, subject to the various hearsay exceptions recognized under the Federal Rules of Evidence.

It is true that, as the Proposed Amendments note, courts have construed the Administrative Procedure Act ("APA") as authorizing the admission of hearsay in formal

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<sup>22</sup> 80 Fed. Reg. at 60,094, 60,101 (proposing changes to 17 C.F.R. § 201.222).

<sup>23</sup> See, e.g., *In re 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); *In re David J. Montanino*, Admin. Proc. Rulings, Rel. No. 1677, 2014 SEC LEXIS 2856 (Aug. 7, 2014) (providing individual practices for ALJ James E. Grimes).

<sup>24</sup> See Division of Enforcement Approach to Forum Selection, *supra* note 14 (listing several factors guiding the Division's forum selection determination after Dodd-Frank, and not including the evidentiary rules).

December 4, 2015

Page 9

adjudications.<sup>25</sup> But the reforms in Dodd-Frank have raised the stakes of administrative proceedings (for at least certain respondents) beyond that of a typical APA adjudication. In addition to severe monetary penalties, respondents now face the prospect of a permanent deprivation of their livelihood in the form of a “collateral bar.”<sup>26</sup> Due process demands that procedural protections be commensurate with the stakes of the adjudication.<sup>27</sup> Further, the drafters of the APA did not contemplate that an agency would be free to prosecute individuals either in federal court or within the administrative adjudication and seek the same penalty in either forum, nor did any of the cases cited by the Commission involve such a regime.<sup>28</sup> Dodd-Frank’s equalization of penalties across the two fora has created a distinct risk of procedural abuse, which requires heightened procedural protections.

The Proposed Amendments fail to provide adequate protection. The amended Rule 320 would allow hearsay to be admitted if the ALJ finds, *inter alia*, that it “bears satisfactory indicia of reliability so that its use is fair.”<sup>29</sup> But, under both the APA and the Rules of Practice, the primary mode of determining “reliability” in an administrative proceeding is cross-examination.<sup>30</sup> The Division’s use of hearsay takes this method away from respondents:

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<sup>25</sup> 80 Fed. Reg. at 60,095 n.32.

<sup>26</sup> Dodd-Frank Act, Pub. L. No. 111-203, § 925, 124 Stat. 1376 (2012) (citing 15 U.S.C. §§ 78o, 78o-4, 78q-1, 80b-3).

<sup>27</sup> See *Mathews v. Eldridge*, 424 U.S. 319, 334-35 (1976).

<sup>28</sup> See *J.A.M. Builders, Inc. v. Herman*, 233 F.3d 1350 (11th Cir. 2000) (OSHRC ALJ hearing); *Calhoun v. Bailar*, 626 F.2d 145 (9th Cir. 1980) (Post Office administrative employment hearing); *EchoStar Commc’ns Corp. v. FCC*, 292 F.3d 749 (D.C. Cir. 2002) (FCC review of administrative hearing on provider complaint); *Richardson v. Perales*, 402 U.S. 389 (1971) (social security disability hearing).

<sup>29</sup> 80 Fed. Reg. at 60,095.

<sup>30</sup> See Rule 326 (entitling respondents “to conduct such cross-examination as, in the discretion of the Commission or the hearing officer, may be required for a full and true disclosure of the facts”); 5 U.S.C. § 556(d) (entitling a party in a formal adjudication “to conduct such cross-examination as may be required for a full and true disclosure of the facts”).

December 4, 2015

Page 10

when the Division presents hearsay, the respondent is deprived of the opportunity to probe the declarant’s credibility, memory, or bias through cross-examination.<sup>31</sup>

Further, as the Supreme Court has noted in a related context, reliability is a “malleable” concept.<sup>32</sup> Practice and precedent suggest that ALJs will construe it loosely so that it will fail to offer meaningful protection. Currently, in SEC administrative proceedings, ALJs may admit all relevant evidence or all evidence which “can conceivably throw any light upon the controversy.”<sup>33</sup> Commission precedent has shown that ALJs err on the side of admitting evidence.<sup>34</sup> ALJs may also apply the “reliability” rule inconsistently, leading to the same evidence being admitted in one case and excluded in another.

To be sure, administrative proceedings provide an important and distinct alternative venue for prosecuting securities violations, and we do not argue for the wholesale adoption of the Federal Rules of Evidence. But given the Commission’s expansive powers under Dodd-Frank, the admissibility of hearsay evidence without an adequate basis for probing reliability can no longer be justified. At the very least, hearsay evidence should be inadmissible in administrative proceedings where the Division seeks civil monetary penalties or an associational bar.

### **III. Effective Date**

With respect to the effective date of the Proposed Amendments, we support applying the amended rules to pending matters to the fullest extent possible. Specifically, the new rules for timing and depositions should apply at least to proceedings for which the prehearing conference has not yet taken place, and the new evidentiary rules should apply to any matter for which no hearing has yet taken place.

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<sup>31</sup> See generally 2 McCormick On Evidence § 245 (7th ed. 2013) (outlining reasons for the rule against hearsay); cf. *Crawford v. Washington*, 541 U.S. 36, 50-53, 60-61 (2004) (rejecting “indicia of reliability” test as a substitute for confrontation under the Sixth Amendment).

<sup>32</sup> *Crawford*, 541 U.S. at 60.

<sup>33</sup> *In re Jesse Rosenblum*, 30 S.E.C. Dkt. 692, S.E.C. Release No. 913, 1984 WL 470615, at \*5 (May 17, 1984).

<sup>34</sup> See, e.g., *In re City of Anaheim*, 71 S.E.C. Dkt. 144, 1999 WL 1034489, at \*2 & n.7 (Nov. 16, 1999) (ALJs “should be inclusive in making evidentiary determinations” and admit evidence “when in doubt”).

December 4, 2015

Page 11

Applying the Proposed Amendments in this way conforms with common practice for implementation of changes to the Federal Rules of Civil Procedure. “It is well settled that ‘[c]hanges in procedural rules may often be applied in suits arising before their enactment without raising concerns about retroactivity.’”<sup>35</sup> “The Supreme Court has long held that, because rules of procedure govern secondary conduct rather than primary conduct, applying such rules to cases pending on their effective date does not necessarily violate the presumption against retroactivity.”<sup>36</sup> Accordingly, “a new procedural rule applies to the uncompleted portions of suits pending when the rule became effective.”<sup>37</sup>

There is no reason for the Commission to deviate from this general rule. Many of the proposed rules easily may be applied to pending cases in the same posture. It is entirely logical to apply the amended Rules 222, 233, and 360 to proceedings in which a prehearing conference has not yet been held because those proceedings are at a sufficiently early stage and can accommodate additional time and discovery. Likewise, amended Rules 235 and 320, both relating to evidence at a hearing, should apply to any proceeding in which a hearing has not yet been held. The Commission’s proposed changes to the appellate rules should apply to any case in which an initial decision has not yet been issued because the changes in form of appeal will have no effect on cases not yet completed. And, finally, amended Rules 141, 220, 230 should apply only to newly initiated proceedings because they relate to the initial filings and disclosures. The applicability of other new rules may require a case-by-case analysis, and for those rules, the Commission should give ALJs the discretion to determine whether a new rule should apply to a particular proceeding.<sup>38</sup>

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<sup>35</sup> *Altizer v. Deeds*, 191 F.3d 540, 546 (4th Cir. 1999) (quoting *Landgraf v. USI Film Prods.*, 511 U.S. 244, 275 (1994)).

<sup>36</sup> *Id.*

<sup>37</sup> *Richardson Elecs., Ltd. v. Panache Broad. of Pa., Inc.*, 202 F.3d 957, 958 (7th Cir. 2000); see also *Freudensprung v. Offshore Technical Servs., Inc.*, 379 F.3d 327, 334 n.2 (5th Cir. 2004) (“Our jurisprudence requires that the amended Rules . . . be given retroactive application to the maximum extent possible . . . unless their application [in the case at hand] would work injustice.” (internal citations and quotation marks omitted)).

<sup>38</sup> Cf. *United States v. 5 S 351 Tuthill Rd., Naperville, Ill.*, 233 F.3d 1017, 1026 (7th Cir. 2000) (“The district court knows the posture of this case best, and is in the best position to decide whether the old or new regime should apply on remand.”).

December 4, 2015

Page 12

## IV. Additional Changes to the Rules

Beyond the specific areas discussed above, we submit that the Proposed Amendments fail to address an ongoing problem with the SEC’s use of its in-house administrative proceedings. Specifically, the SEC’s ability to “opt out” of federal court creates the possibility that the Commission will choose to shield controversial cases from the full scrutiny of federal district and appellate courts. Under the proposed rules, there is a significant risk of abuse in the Division’s ability to use administrative proceedings to advance novel and untested theories of liability and thereby promote an enforcement-biased agenda in the development of the securities laws.

The current rules effectively prevent most respondents from challenging the legal theories underlying the Division’s case. Whereas a defendant in a federal court action may test the legal basis for suit immediately by filing a motion to dismiss under the Federal Rules of Civil Procedure, a respondent in an administrative proceeding must ordinarily undergo a full hearing before an ALJ and appeal to the Commission before he can begin to raise questions about the statutory or regulatory basis for his prosecution before an Article III court. Rather than submitting to this arduous and costly process, most respondents choose to settle with the agency, giving up the chance to raise a legal challenge.

The result, as Judge Jed Rakoff has explained, is a system that “hinders the balanced development of the securities laws.”<sup>39</sup> After a respondent settles a case based on a novel theory, the Division relies on that settlement when it brings similar actions in the future. The accumulation of these untested “precedents” distorts securities regulation: without the moderating influence of judicial review, the Division is free to advance interpretations that are detached from the text of the underlying statutes and regulations, increasingly intrusive and disruptive to the securities industry, and lacking any demonstrable benefit to investors.<sup>40</sup> Members of the industry have no choice but to respect these settlements, and the interpretations they rest on, as if they were binding law—or else risk facing an enforcement action themselves.

These concerns are not hypothetical, as administrative proceedings are often the source for “cutting edge” developments in the enforcement program. Chairwoman Mary Jo

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<sup>39</sup> Rakoff, *supra* note 3.

<sup>40</sup> See also *id.* (“Whatever one might say about the S.E.C.’s quasijudicial functions, this is unlikely, I submit, to lead to as balanced, careful, and impartial interpretations as would result from having those cases brought in federal court.”).

December 4, 2015

Page 13

White listed several administrative proceedings filed and settled under her leadership among the “first-of-their-kind cases that expanded our enforcement footprint.”<sup>41</sup> Similarly, the Division’s recently released guidelines regarding forum selection express a preference for administrative proceedings in matters “likely to raise unsettled and complex legal issues under the federal securities laws, or interpretation of the Commission’s rules.”<sup>42</sup> And Director of Enforcement Andrew Ceresney admitted that even the threat of bringing administrative proceedings can be effective in convincing respondents to settle.<sup>43</sup>

To restore fairness to administrative proceedings and ensure the balanced development of the securities laws, the SEC must ensure that respondents have a meaningful avenue to test the Division’s legal theories. To that end, the Commission should adopt a number of additional reforms.

## A. Conditional Stipulation

The SEC should amend its Rules of Practice to provide respondents a right to enter a conditional stipulation, similar to the “conditional pleas” that criminal defendants are entitled to enter under Federal Rule of Criminal Procedure 11(a)(2).<sup>44</sup> That rule provides defendants with the right to accept a plea bargain, and thereby waive the right to a jury trial, while

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<sup>41</sup> SEC Chair Mary Jo White, Chairman’s Address at SEC Speaks 2015 (Feb. 20, 2015), <http://www.sec.gov/news/speech/2015-spch022015mjw.html>. The Division of Enforcement Director made similar comments. Andrew Ceresney, Director, SEC Division of Enforcement, Remarks to the American Bar Association’s Business Law Section Fall Meeting (Nov. 21, 2014), <http://www.sec.gov/News/Speech/Detail/Speech/1370543515297> (describing several administrative proceedings filed in 2014 as “first-of-their-kind actions”).

<sup>42</sup> Division of Enforcement Approach to Forum Selection, *supra* note 14.

<sup>43</sup> “[T]here have been a number of cases in recent months where we have threatened administrative proceedings, it was something we told the other side we were going to do, and they settled.” Brian Mahoney, SEC Could Bring More Insider Trading Cases In-House, LAW360 (June 11, 2014, 6:53 PM EST), <http://www.law360.com/articles/547183/sec-could-bring-more-insider-trading-cases-in-house> (quoting SEC Division of Enforcement Director Andrew Ceresney).

<sup>44</sup> “With the consent of the court and the government, a defendant may enter a conditional plea of guilty or nolo contendere, reserving in writing the right to have an appellate court review an adverse determination of a specified pretrial motion. A defendant who prevails on appeal may then withdraw the plea.” Fed. R. Crim. P. 11(a)(2).

December 4, 2015

Page 14

retaining the right to challenge some legal basis for the government's prosecution—often a Fourth Amendment suppression argument. If the defendant prevails on his legal challenge—either in the district court or on appeal—he may withdraw the plea.<sup>45</sup>

Similarly, the Rules of Practice should be amended to entitle respondents to enter, with or without the consent of the Enforcement Division, a conditional stipulation, accepting as true all (or *substantially* all<sup>46</sup>) of the facts alleged in the order instituting proceedings ("OIP"), but reserving the right to challenge the SEC's legal theory of liability—before an ALJ, the SEC, and ultimately a U.S. Court of Appeals. The stipulation would entail a waiver of the right to a trial before an ALJ, in exchange for the right to attack the SEC's legal theory. The conditional stipulation could be withdrawn if and when the respondent substantially prevailed on his legal challenge. Once withdrawn, it would not have any legal effect. For instance, it could not be used as evidence in a private civil suit. If a respondent were to lose on his legal challenge, the stipulation would become irrevocable, and he would either have to undergo trial for the penalty phase, or reach a settlement with the Commission on that issue.

## B. Summary Disposition

The Rules currently provide a limited method for challenging the Division's legal theories before the hearing via a motion for summary disposition.<sup>47</sup> A respondent may file such a motion before the hearing only with "leave" from the ALJ.<sup>48</sup> The ALJ's determination of whether to grant or deny this leave is unreviewable.<sup>49</sup> Indeed, even the Division itself has observed that the summary disposition apparatus is less effective than its federal court counterpart.<sup>50</sup> It appears that out of all of the motions for summary disposition that respondents have filed since 1995, ALJs have only granted a handful.<sup>51</sup>

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<sup>45</sup> *Id.*

<sup>46</sup> A respondent should be able to take advantage of the conditional plea without admitting to facts included in the OIP that are unnecessary to establish his liability.

<sup>47</sup> See 17 C.F.R. § 201.250.

<sup>48</sup> 17 C.F.R. § 201.250(a).

<sup>49</sup> 17 C.F.R. § 201.250(b).

<sup>50</sup> See Division of Enforcement Approach to Forum Selection, *supra* note 14 ("There may be potential efficiencies if the case can be decided on, or the disputed issues narrowed by, a motion for summary judgment in federal court (which generally addresses a broad range of claims and issues) or a motion for summary disposition in the administrative forum (which

(Cont'd on next page)

December 4, 2015

Page 15

The Rules should be changed to allow for such motions to be filed before the hearing as of right—whether in conjunction with a conditional plea or not. ALJs should be required to rule promptly on motions so that respondents are not needlessly subjected to hearings.

### C. Interlocutory Review

The Rules currently provide a limited method to appeal legal determinations to the Commission before trial via interlocutory review.<sup>52</sup> Such appeals are “disfavored” and granted “only in extraordinary circumstances.”<sup>53</sup>

The Rules should be amended to require the Commission to promptly hear and resolve all appeals from ALJ denials of pre-hearing motions for summary disposition that attack the statutory or regulatory basis for the proceeding, or that challenge the constitutionality of the same.

### D. Stays

The Rules currently provide that the proceedings will ordinarily continue to move forward toward the hearing even as a respondent challenges the legality of that proceeding before the ALJ or the Commission.<sup>54</sup>

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generally requires leave from the Administrative Law Judge to file and typically addresses a narrower range of claims and issues). For example, district courts more frequently address and resolve elements of claims (such as whether a statement is false or whether an instrument is a ‘security’) on summary judgment.”).

<sup>51</sup> See, e.g., *In re Salvatore F. Sodano*, 91 S.E.C. Dkt. 1199, S.E.C. Release No. 333, 2007 WL 2362701 (Aug. 20, 2007) (granting respondent’s motion for summary disposition), *rev’d*, 94 S.E.C. Dkt. 2968, S.E.C. Release No. 34-59141, 2008 WL 5328801 (Dec. 22, 2008).

<sup>52</sup> 17 C.F.R. § 201.400.

<sup>53</sup> 17 C.F.R. § 201.400(a).

<sup>54</sup> 17 C.F.R. § 201.400(d).

December 4, 2015

Page 16

The Rules should be amended to require that the hearing be stayed pending final resolution of the legal challenge.

#### E. Judicial Review

The Rules should also be amended to provide a more efficient route for respondents to litigate legal challenges. In cases involving the proposed conditional stipulation, once the Commission rejects a legal challenge, the respondent's liability would be firmly established. The only outstanding issue would be the penalty. In some cases, a respondent who enters a conditional stipulation may choose to negotiate a penalty with the Division, leaving no outstanding issue regarding finality, exhaustion, or ripeness. The Rules should be further amended to require the Commission to promptly certify as a "final order" any decision rejecting a respondent's motion for summary disposition challenging the Enforcement Division's legal theories where the respondent has already entered a conditional stipulation, even where no penalty has been imposed. Finally, if necessary to facilitate judicial review over cases in which the respondent has not yet been assigned any penalty, the Rules should be amended to require ALJs to impose a nominal penalty (e.g., a fine of \$1.00, a suspension of one day) on respondents who have entered conditional pleas and lost motions for summary disposition at the ALJ level.<sup>55</sup>

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As the Commission is aware, the system of administrative proceedings has become the subject of substantial criticism, and is currently facing a lack of public confidence.<sup>56</sup> To enhance accountability and trust in its system of adjudication, the SEC should look beyond the current proposals and consider broader reforms. In addition to the changes proposed, the SEC should consider appointing a Task Force, comprising current staff, former Commissioners, members of the private bar, and academics, to consider and propose comprehensive reforms to the Rules of Practice. Such an effort would mirror the Commission's appointment, in the early 1970s, of a committee led by John A. Wells to

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<sup>55</sup> Cf., e.g., *Prairie State Generating Co. v. Sec'y of Labor*, 792 F.3d 82, 87 (D.C. Cir. 2015) (discussing Secretary of Labor's practice of issuing "technical citations," including a "nominal monetary penalty," in order to facilitate judicial review of certain disputes regarding mine safety plans).

<sup>56</sup> See, e.g., Rakoff, *supra* note 3; Eaglesham, *supra* note 2; *Hill v. SEC*, No. 15-cv-492, 2015 WL 4307088 (N.D. Ga. June 8, 2015); *Duka v. SEC*, No. 15-cv-357, 2015 WL 4940057 (S.D.N.Y. Aug. 3, 2015).

December 4, 2015

Page 17

review its enforcement policies and practice. Among other recommendations, the committee's 1972 report included an important discussion of what is now known (after the committee's chairman) as the "Wells Process."<sup>57</sup> Similarly, in the early 1990s, the Commission appointed a task force, led by then-Commissioner Mary Schapiro, to consider and propose amendments to the Rules of Practice. The 1993 Report, entitled "Fair and Efficient Administrative Proceedings," included many key recommendations that were subsequently adopted by the Commission via notice and comment rulemaking in 1995.<sup>58</sup> Given the meaningful changes to the scope of administrative proceedings over the past two decades, the Commission would be well-served by a comprehensive, rather than piecemeal, approach to reforming its procedures.

## V. Conclusion

We thank the Commission for the opportunity to provide comments on the Proposed Amendments. We would welcome the opportunity to discuss our views in greater detail.

Sincerely,

/s/ Theodore B. Olson

Theodore B. Olson

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<sup>57</sup> See Securities and Exchange Commission, Report of the Advisory Committee on Enforcement Policies and Practices 32 (June 1, 1972).

<sup>58</sup> See Securities and Exchange Commission, Report of the Task Force on Administrative Proceedings: Fair and Efficient Administrative Proceedings (Feb. 1993).