

Professional Perspective

Navigating a Litigated SEC Administrative Proceeding

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Navigating a Litigated SEC Administrative Proceeding

Contributed by *John J. Carney, Jimmy Fokas, and Bari R. Nadworny, BakerHostetler*

The Securities and Exchange Commission has determined it will bring charges in its administrative forum against an individual, the respondent, for violations of the federal securities laws. The respondent has decided settlement is not an option and the charges must be challenged. The Division of Enforcement has already conducted a lengthy multiyear investigation and formed its view of the facts before the litigation has commenced.

The charging document—the Order Instituting Proceedings (OIP)—is drafted with the benefit of those facts and a developed view of the case. The SEC seeks significant penalties, including a six-figure civil monetary penalty and a career-ending bar. The matter is assigned to an administrative law judge (ALJ) in the SEC's home court. Now what?

Successfully navigating a litigated SEC administrative proceeding requires an in-depth knowledge of the SEC Rules of Practice and a litigation strategy that is targeted to develop the strengths and themes of the defense through the limited motion practice, discovery, and prehearing preparation provided by the Rules. This article describes the stages of the proceeding and discusses key areas of the administrative process where defense counsel can take advantage of the limited tools the Rules permit to craft a successful litigation strategy.

Background

Potential violations of the securities laws, enforced by the Division, run the gamut from accounting and disclosure frauds, books and records violations, Ponzi schemes, and compliance failures associated with Bank Secrecy Act requirements.

Unlike a typical litigant or even the Department of Justice, the SEC can choose at its whim to bypass federal court and sue individuals and corporations for such violations in its administrative forum, thereby denying parties the right to a trial by a jury of their peers. In the SEC's administrative forum, the ALJ acts as judge and jury, with the five SEC commissioners making the ultimate decision on findings of fact and sanctions despite not having heard a single witness testify.

SEC administrative proceedings operate under a specific set of procedural rules that greatly limit discovery, provide little in the way of procedural safeguards typical in federal court, and call for an expedited prehearing and hearing schedule greatly constraining a party's ability to prepare its defense. The target of an SEC administrative proceeding reaches federal court only after the case has been decided by the ALJ and appealed to the Commission.

SEC Administrative Proceedings

The SEC can [authorize](#) the staff to file a case in federal court or to bring an administrative action. Administrative proceedings differ from civil court actions in that they are before an ALJ rather than a federal court judge. The ALJ presides over the case in much the same way a federal court judge does—deciding motions; resolving discovery, evidentiary, and other disputes between the parties; and ultimately presiding over the hearing.

At the hearing, the ALJ considers the evidence presented by the Division as well as any evidence put forth by the respondent, makes credibility determinations, and then issues an initial decision with findings of fact and conclusions of law. The SEC can seek virtually the same sanctions through the administrative proceeding process as it can seek in federal court.

These include cease and desist orders, suspension or revocation of broker-dealer and investment advisor registrations, censures, bars from association with the securities industry or from appearing or practicing as an attorney or an accountant before the Commission, civil monetary penalties, and disgorgement. The ALJ determines the appropriate sanction just as it determines the facts and law.

Phase One: Beginning the Proceeding

Order Instituting Proceedings

The litigated action officially begins when the SEC files its OIP, which sets forth the Division's factual allegations, the alleged violations of the securities laws, and the potential sanctions. The OIP is akin to a complaint in federal court. Within the OIP, the Commission also sets the timing for the ALJ to issue its initial decision. There are three potential time periods—30 days, 75 days, and 120 days—and the clock starts ticking for the ALJ following either: the completion of post-hearing briefing, the completion of briefing of a summary disposition motion (similar to a summary judgment motion) if it has been determined no hearing is necessary, or in the event of default. These three potential time periods determine much about the proceeding, including its overall length. The 120-day timing for the initial decision requires the hearing to commence between four to 10 months from the date of service of the OIP. The time is shortened to two-and-a-half to six months under the 75-day timing, and one to four months under the 30-day timing.

In other words, 10 months is the longest possible time period for when the hearing must commence, leaving little time for prehearing motion practice, discovery, and trial preparation. The 120-day time frame is usually reserved for complex cases and allows the parties to take limited depositions and impacts the motion for summary disposition, discussed more fully below. Respondents are not permitted to depose witnesses before the hearing in cases that proceed on the shorter timelines. This article focuses on the rules governing proceedings under the 120-day time period.

The Division's Investigative File

The Division is required to make available for inspection and copying documents it obtained prior to instituting the proceedings in connection with its investigation. Documents in the investigative file include, among others, each subpoena issued, other written requests to provide documents or to be interviewed, documents turned over in response to the subpoenas or other written requests, transcripts and exhibits, and other documents obtained by the Division.

Depending on the length of the Division's investigation, the investigative file can be voluminous and may include thousands of documents not particularly relevant to the proceeding or respondent at issue. Creating a strategy to sift through these materials and to identify those that are relevant to the defense is critical, especially when the Division has had years to work through these documents and form its view of the facts, and the respondent has only a matter of weeks before the next phase of the proceeding will be underway.

While tackling the materials in the investigative file may be time-consuming, it provides a respondent invaluable insight into the Division's investigation early in the proceeding and permits counsel to make more informed discovery decisions.

Scheduling Order

In addition to getting a handle on the Division's investigative file, devising a workable scheduling order is a top priority at the outset of the case. Within the time allotted under the Rules, it is crucial to bear in mind how much needs to be accomplished before the hearing commences only a few months after the Division has filed the OIP.

The scheduling order includes dates for motion practice, fact discovery, expert discovery, and hearing preparation. The turnaround time on motion practice is also quick, with just three days between opposition and reply briefs. The most effective way to create the schedule is to work backward from the hearing, leaving sufficient time to prepare for the hearing itself, being mindful of any timing imposed by the Rules, and ensuring that there is adequate time for each phase of the case without too many conflicting deadlines.

Motions for More Definite Statement and a Ruling on the Pleadings

Two motions may be made early in the case that can be advantageous for the defense: a motion for more definite statement and a motion for a ruling on the pleadings. Along with the answer, due 20 days from service of the OIP, a respondent may choose to file a motion for more definite statement of specified matters of fact or law to be considered or determined.

The motion must state the respects in which and the reasons why the identified matters of fact or law should be required to be made more definite. The motion for more definite statement is an early opportunity in the proceeding to challenge information that is unclear in the OIP or is missing entirely.

While the OIP is not directly subject to the pleading requirements under rules 8 and 9 of the Federal Rules of Civil Procedure (FRCP), the SEC is still held to a pleading standard. Commission precedent dictates that a respondent is entitled to notice of the charges against it but not to the disclosure of evidence. *David Pruitt, CPA*, Admin. Proc. Rulings Release No. 6528 (ALJ Mar. 28, 2019). The Rules require that the OIP contain a short and plain statement of the matters of fact and law to be considered and determined, unless the OIP requires an answer, in which case the OIP must “set forth the factual and legal basis alleged therefor in such detail as will permit a specific response thereto.” 17 C.F.R. § 201.200(b)(3).

One ALJ, in considering why the Rules make a distinction between OIPs requiring an answer and those that do not, concluded that OIPs requiring an answer must, at a minimum, provide more information—“more detail allowing more specificity”—than what is required under [FRCP 8\(a\)\(2\)](#), the “short and plain statement” standard. *David Pruitt, CPA*, Admin. Proc. Rulings Release No. 6528. Thus, a motion for more definite statement may be a very helpful tool for the defense at the start of the proceeding to argue that the OIP lacks the necessary information and should be required to be made more definite.

Not long after the briefing for a motion for more definite statement wraps up, a respondent may move for a ruling on the pleadings, which is similar to a motion to dismiss in federal court. A motion for a ruling on the pleadings must be made no later than 14 days after a respondent's answer has been filed.

In the motion, the respondent asserts that, even accepting all of the Division's factual allegations as true and drawing all reasonable inferences in the Division's favor, the respondent is entitled to a ruling as a matter of law. As is often the case in federal court, succeeding on such a motion is a high hurdle. A motion for a ruling on the pleadings may have a limited chance of success when the Division had the benefit of a full investigation and unfettered access to witnesses before drafting the OIP.

Despite this, a motion for a ruling on the pleadings can still be worthwhile, as it can help clarify the Division's position and legal theories and provide the respondent an opportunity to counter the one-sided narrative in the OIP.

Phase Two: Discovery and Summary Disposition

Document Discovery

Discovery is limited under the Rules, and effectively maximizing the tools available is one of the more critical aspects of the defense strategy that will require thoughtful planning. Fortunately, the Rules do not limit the number of document subpoenas that may be served. This allows a respondent to cast a wide net to seek documents from third parties that may be helpful to the defense—especially documents the Division did not focus on during its investigation and that were not a part of the investigative file.

Given the availability of the materials in the investigative file, document discovery should be used strategically during this phase of the proceeding to supplement the universe of documents. While taking a broad approach to document discovery can be useful, it should be balanced against the risk of distracting discovery motions during the limited prehearing period.

Depositions

Unlike document discovery, the number of depositions is strictly limited in SEC administrative proceedings. Before relatively recent amendments to the Rules, depositions were permitted in very limited circumstances. Depositions are now available in cases under the 120-day time frame, and in those cases, each side may take—as of right—three depositions in proceedings with a single respondent or five depositions in proceedings with multiple respondents. Each side is permitted to file a motion seeking leave to notice up to two additional depositions; however, the Rules prescribe very specific procedures for this motion.

The motion for additional depositions must be filed no later than 90 days prior to the hearing date, reply briefs are not permitted, and the motion cannot exceed seven pages in length. There are also specific grounds and standards for the motion for additional depositions. The movant must demonstrate a compelling need for the additional depositions by:

- Identifying each of the witnesses the movant plans to depose as of right as well as the additional witnesses the movant seeks to depose
- Describing the role of each witness and proposed additional witness
- Describing the matters concerning which each witness and proposed additional witness is expected to be questioned, and why the deposition of each witness and proposed additional witness is necessary for the movant's arguments, claims, or defenses
- Demonstrating that the additional depositions requested will not be unreasonably cumulative or duplicative

The information required for this motion must be laid out methodically for the ALJ, and it is not permissible for the parties to stipulate to the additional depositions. *Adrian D. Beamish, CPA*, Admin. Proc. Ruling Release No. 4581 (ALJ Feb. 3, 2017). The respondent is therefore forced to walk a thin line between demonstrating to the ALJ the compelling need for the depositions and not providing the Division with too much insight into the defense strategy. Nevertheless, careful attention must be paid to the content of this motion, as securing the two additional depositions could prove critical in preparing for the hearing or pursuing a more favorable prehearing resolution.

Expert Witnesses

Expert witnesses are permitted in SEC administrative proceedings, and they can be a useful resource for the defense, depending on the nature of the case. The submission disclosing testifying expert witnesses—required by the Rules—must include a statement of the expert's qualifications, a listing of other proceedings in which the expert has given expert testimony during the previous four years, and a list of publications authored or co-authored by the expert in the previous 10 years.

The expert's report must contain:

- A complete statement of all opinions the expert will express and the basis and reasons for them
- The facts or data considered by the expert in forming them
- Any exhibits that will be used to summarize or support them
- A statement of the compensation to be paid for the study and testimony in the case

Communications with expert witnesses are not protected by the attorney-client privilege, but the Rules afford certain protections that should be guarded closely. Drafts of any expert report or other disclosure need not be furnished, regardless of the form in which the draft is recorded.

Similarly, communications between a party's attorney and the party's expert witness need not be furnished, regardless of the form of the communications, except if the communications relate to compensation for the expert's study or testimony, identify facts or data that the party's attorney provided and that the expert considered in forming his or her opinions, or identify assumptions that the party's attorney provided and that the expert relied upon in forming those opinions.

An expert witness should be provided access to a document portal to share drafts of the report and documents for the expert's review and consideration. This will save time and resources when the expert prepares a documents considered list, and will help ensure the lines of communication stay streamlined and protected.

Though the number of depositions is limited, the depositions of expert witnesses do not count against the deposition limits. *David Pruitt, CPA*, Admin. Proc. Rulings Release No. 5219 (ALJ Nov. 3, 2017). A respondent should aim, if the tight timing allows, to focus on the fact witness depositions, followed by the expert witness deposition or depositions in cases with more than one testifying expert.

During the expert's deposition, the respondent should be sure to maintain the protection of the communications and drafts and object to any questioning that goes beyond the bounds of the Rules. Expert testimony and reports can be extremely useful tools for the defense to ensure the ALJ has a complete understanding of the complex issues that will be presented at the hearing.

Summary Disposition and the Prehearing Brief

After discovery is closed, the parties may consider making motions for summary disposition, which is similar to making a motion for summary judgment in federal court. A party may make a motion for summary disposition on one or more claims or defenses, asserting that the undisputed pleaded facts, declarations, affidavits, deposition transcripts, documentary evidence, or facts officially noted demonstrate that there is no genuine issue with regard to any material fact and that the movant is entitled to summary disposition as a matter of law.

Under the 120-day time frame, unlike in a proceeding in federal court, a motion for summary disposition can be made only with leave of the ALJ, and leave will be granted only for good cause shown and if consideration of the motion will not delay the start of the hearing. Given this requirement, it is advantageous to make the motion for leave well in advance of the deadlines for summary disposition briefing.

A respondent does not want to be caught in the position of having drafted an entire summary disposition motion only to learn the ALJ will not hear the motion. A respondent should also consider the utility of this motion under the circumstances of the case and in light of the issues of material fact that exist. A motion for summary disposition is time-consuming, especially with other deadlines looming in the not-too-distant future, and may preview what would be better saved for the hearing.

Most ALJs will also allow prehearing briefs. The prehearing brief functions more like an opening statement, and for some ALJs, it may serve as the opening statement in lieu of a traditional opening statement at the commencement of the hearing. The prehearing brief typically sets forth the respondent's positions on the facts and law. A respondent must walk the same fine line here as throughout the proceeding—presenting persuasive arguments to the ALJ about the merits of the case and framing the issues for the ALJ to decide, while not giving away too much of the defense strategy in advance of the hearing.

Phase Three: The Hearing

Motions in Limine

Once discovery has closed and the dispositive motions all have been filed, the hearing is likely only a few weeks away, but there is still plenty of ground to cover. The respondent should consider filing motions in limine to challenge or limit certain evidence in advance of the hearing. However, because there is no jury and no chance of juror prejudice, an ALJ may exercise a more relaxed standard and liberally permit challenged evidence and determine what weight, if any, to give it during the hearing.

The Rules are also far more lenient than the Federal Rules of Evidence regarding hearsay. Evidence that constitutes hearsay may be admitted if it is relevant, material, and bears satisfactory indicia of reliability so that its use is fair.

It is very likely that hearsay will be admitted, and counsel should plan accordingly. Nevertheless, motions in limine are still a worthwhile exercise, especially in connection with expert witnesses where the ALJ might be more inclined to rein in testimony that strays into questions of fact not appropriate for experts. *David Pruitt, CPA*, Admin. Proc. Ruling Release No. 6678 (ALJ Sept. 17, 2019).

The respondent should balance the resources and time available to focus on witness preparation, the technical and logistical pressures of trial, and the time remaining in the schedule when thinking through which and how many motions in limine to make, particularly since there is no jury whose members would be prejudiced by receiving improper testimony or documentary evidence.

Witness Preparation

When analyzing the list of potential hearing witnesses, the respondent should think of the principle of *primum non nocere*—first, do no harm. A party in federal court is unlikely to call to the stand a witness who was not deposed during discovery. In SEC administrative proceedings, however, a respondent may not have that luxury because of the limit of three or maybe five depositions.

If a particular witness provided sworn testimony during the Division's investigation, counsel will have a copy of that transcript to determine what the witness might say at the hearing. Where appropriate, the respondent should try to interview witnesses in advance of the hearing. Surprises at trial are best left for the movies, and hearing witnesses should be limited to those who are critical to the defense and will cause it no harm.

The Hearing

The hearing proceeds much like a bench trial in federal court. The hearing must be “conducted in a fair, impartial, expeditious and orderly manner.” 17 C.F.R. § 201.300. The ALJ can receive relevant evidence and will exclude all evidence that is irrelevant, immaterial, unduly repetitious, or unreliable. Witnesses testify under oath or affirmation. ALJs may have individual rules setting forth additional requirements apart from the Rules for exhibits, the order of witnesses, and the presentation of evidence. As there may be significant penalties at stake and complex legal issues to present, counsel should prepare for the hearing with the same diligence and strategy that would be typical for any trial.

Phase Four: After the Hearing

Post-Hearing Briefing

Before the ALJ issues its initial decision, each party has the opportunity to file proposed findings of fact and conclusions of law with or as a part of its brief. The proposed findings of fact must be supported by citations to specific portions of the record from the hearing. A reply brief may be filed by the party assigned to file first, or, where simultaneous filings are directed, reply briefs may be filed by each party.

At the end of the hearing, the ALJ, after consultation with the parties, will prescribe the time period within which the proposed findings and conclusions and supporting briefs are to be filed. The party directed to file first, if any, must make its initial filing within 30 days of the end of the hearing unless the ALJ, for good cause shown, permits a different period.

And unless the ALJ, for good cause shown, permits a different period, the total period within which all of the post-hearing briefing must conclude is no more than 90 days after the close of the hearing. Unfortunately, this leaves little time to deal with post-hearing fatigue. The post-hearing briefing, just as in federal court, provides the respondent with one last critical opportunity to advocate for findings of fact and conclusions of law prior to the issuance of the initial decision.

Appeals

Once the ALJ has issued an initial decision, both the Division and the respondent **may appeal** all or any portion of the initial decision to the Commission. An ALJ's initial decision is subject to de novo review by the Commission, **which may** affirm, reverse, modify, set aside, or remand for further proceedings.

On appeal, the Commission may make any findings or conclusions that in its judgment are proper and on the basis of the record. Indeed, “[o]nce the Commission grant[s] the parties’ petitions for review, the initial decision cease[s] to have any force or effect. On review, the Commission [is] vested with all of the powers which it would have had in making the initial decision.” *Steven Altman, Esq.*, [Exchange Act](#) Release No. 63665 (Jan. 6, 2011); 5 U.S.C. § 557(b) (“On appeal from or review of the initial decision, the agency has all the powers which it would have in making the initial decision except as it may limit the issues on notice or by rule.”).

This includes the ability to make credibility determinations that differ from the ALJ's determinations despite not having heard the live testimony of any witness. The Commission has stated that it does not accept an ALJ's credibility determinations “blindly” and “there are circumstances where, in the exercise of [its] review function, [it] must disregard explicit determinations of credibility.” *Irfan Mohammed Amanat*, [Exchange Act](#) Release No. 54708 (Nov. 3, 2006).

The Commission **may also choose** to review an initial decision on its own initiative. If a party does not petition for review and the Commission does not order review on its own initiative, the Commission will issue an order stating that the initial decision has become final. Accordingly, an ALJ's initial decision—including factual findings, legal conclusions, and sanctions—does not take effect until the Commission by order adopts the decision as its own.

A respondent does not reach the circuit court until the action has first been appealed to the Commission. On appeal to the circuit, “[t]he findings of the Commission as to the facts, if supported by substantial evidence, are conclusive.” [15 U.S.C. § 78y\(a\)\(4\)](#). “Under the Administrative Procedure Act, [the circuit court] will set aside the SEC’s actions, findings, or conclusions of law only if they are ‘arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.’” *Gonnella v. SEC*, [954 F.3d 536](#), 543 (2d Cir. 2020); *Koch v. SEC*, [793 F.3d 147](#), 152 (D.C. Cir. 2015). The circuit court also will not disturb the Commission’s choice of sanction unless it is “unwarranted in law or without justification in fact.”

Conclusion

Finding justice in an SEC administrative proceeding can feel unlikely when you are faced with the prospect of no jury, limited depositions, and a forum housed inside the very agency that is prosecuting your client, but defense victories can be secured by zealous advocacy. That advocacy starts with a focused understanding of the Rules and a litigation strategy that maximizes the available discovery and hearing preparation unique to the forum.

That advocacy continues with challenging every aspect of the Division’s case—concede nothing—and insisting that the Division establish each and every aspect of its case. Finally, that advocacy concludes with an acknowledgment that victory might be achieved only after the matter is appealed to the federal courts, so the creation of a clear evidentiary and procedural record is essential. Winning in an SEC administrative forum is not an impossible task; it’s just more difficult for those unprepared for the fight.