WILLKIE FARR & GALLAGHER LLP

NEW YORK WASHINGTON HOUSTON PARIS LONDON FRANKFURT BRUSSELS MILAN ROME

CLIENT MEMORANDUM

SEC Proposes Amended Rules to Govern Administrative Proceedings

September 28, 2015

AUTHORS

Elizabeth P. Gray | Amelia A. Cottrell | Michael S. Schachter | William J. Stellmach | Julie A. Smith

On September 24, 2015, the Securities and Exchange Commission ("SEC" or "Commission") proposed amendments to its Rules of Practice governing the SEC's internal administrative proceedings. In announcing the proposed amendments, SEC Chair White stated, "The proposed amendments seek to modernize our rules of practice for administrative proceedings, including provisions for additional time and prescribed discovery for the parties."[1]

The proposals, which were unanimously approved by the Commission, include three primary categories of changes to the Commission's Rules of Practice:

(1) They permit parties to take a limited number of depositions of witnesses as part of discovery;

(2) They adjust the timing of administrative proceedings, including by extending the time before a hearing occurs in appropriate cases;

(3) They require parties in administrative proceedings to submit filings and serve each other electronically, and to redact certain sensitive personal information from those filings.

[1] SEC Press Release, "SEC Proposes to Amend Rules Governing Administrative Proceedings," Sept. 24, 2015; *available here*.

Challenges to the SEC's Use of Administrative Proceedings

The SEC is currently facing widespread criticism for its increased use of administrative proceedings rather than federal court proceedings to enforce the federal securities laws.[2] Constitutional challenges to the process for appointing SEC administrative law judges ("ALJs") have significantly raised the stakes for the Commission.[3]

Critics have argued that SEC administrative proceedings effectively bypass the judiciary, in that they are overseen by administrative law judges – employees of the SEC – rather than Article III judges. There is also concern about the procedural limitations respondents face in administrative proceedings and the concomitant advantage the SEC has in the administrative forum.[4] The proposed amendments address only some of these concerns.

As recently as 2005, civil court cases brought by the SEC outnumbered administrative proceedings. In contrast, by 2012 there were nearly twice as many administrative proceedings as civil actions brought by the Commission.[5] This trend is attributable in part to the broadened reach of administrative proceedings provided by Dodd-Frank, which enables the SEC to impose financial penalties on any offender, rather than only those it directly regulated, such as broker-dealers and investment advisers. The trend may also be affected by SEC's favorable track record in administrative proceedings. In the year prior to September 29, 2014, the Division of Enforcement won all six litigated administrative proceedings, but only 11 out of 18 federal court trials.[6] And despite the procedural limitations noted above, the SEC's Division of Enforcement has said it would try cases administratively if they give the Commission a chance to define a complex or unsettled area of the law.[7]

---

2 *See, e.g.*, Center for Capital Markets Competitiveness, "Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices," at July 19, 2015 (recommending a procedure to enable respondents to challenge the choice of forum, and noting concerns that the Commission may be "usurp[ing]…a defendant's right to request a jury." *Id.* at 17).

3 *See Duka v. SEC*, 15-Civ-357 (RMB), Decision & Order Granting Preliminary Injunction at 4 (S.D.N.Y. Aug. 12, 2015) (enjoining an SEC administrative proceeding on constitutional grounds).

4 For instance, there is no discovery and no right to a jury under the SEC's current Rules of Practice. In addition, the timeline for administrative cases is condensed compared to civil trials: administrative hearings must be completed within 270 days of the SEC's order instituting proceedings. At the same time, the Enforcement Division has the opportunity to build the investigative record for years, which is then used in the proceeding.

5 Sonia Steinway, SEC "Monetary Penalties Speak Very Loudly," But What Do They Say? A Critical Analysis of the SEC's New Enforcement Approach, YALE LAW JOURNAL, 124:209 (2014).

6 Jean Eaglesham, "SEC Is Steering More Trials to Judges It Appoints," THE WALL STREET JOURNAL, Oct. 21, 2014.

7 "Division of Enforcement Approach to Forum Selection in Contested Actions," May 8, 2015, *available here*.

Key Components of the Proposed Amendments

The most significant proposed rules change the current rules in the following respects:

- Amending the time for discovery and extending the time before hearing: Currently, Rule 360 provides that a hearing should occur in the most complex matters within four months of the Enforcement Division initiating proceedings. The proposed amended Rule 360 provides that a hearing can be scheduled up to eight months after the Enforcement Division initiates proceedings, and provides similar expansions for less complex matters. The Commission's discussion explaining this change notes that the added months will allow time for deposition discovery, described below.

- Deposition discovery: Currently, depositions are only permitted in administrative proceedings if a witness will be unavailable to testify at the hearing. The proposed amendments to Rule 233 provide that in matters with one respondent, each side can subpoena for deposition a maximum of **three** people; and in matters where there are multiple respondents, each side (i.e., the Enforcement Division on one hand, and the group of all respondents on the other) can depose up to **five** people. Each deposition is limited to one day of six hours which includes "a reasonable amount of time for cross-examination" by the other side. The ALJ or Commission can expand the time allotted upon a showing, among other reasons, that more time is needed to "fairly examine the deponent." Also, proposed Rule 233(h)(ii) provides that an objection to evidence during the deposition must be noted on the record.

- Motions to quash: Currently, the standard to quash a subpoena (for a trial witness or documents) is if compliance with it would be "unreasonable, oppressive, or unduly burdensome." The proposed amendment to Rule 232 adds that a subpoena (for depositions, trial witnesses, or documents) can be quashed if it would "unduly delay the hearing."

- Admissibility of Evidence: Currently, all evidence is admissible in administrative proceedings under Rule 320 unless it is "irrelevant, immaterial, or unduly repetitious." The proposed amendments to Rule 320 adds "unreliable" to that list, but do not exclude hearsay. Instead, new Rule 320(b) would specifically state that hearsay is admissible if it is "relevant, material, and bears satisfactory indicia of reliability so that its use is fair." The Commission noted, in the discussion concerning these changes, that these amendments are consistent with the Administrative Procedure Act.

- Experts: As the proposed amendments do not provide separately for expert witness depositions, the deposition of any expert is one of the three or five depositions allowed in Rule 233. The proposed amendments to Rule 222 concerning expert disclosures and reports would bring these practices in line with those in the Federal Rules of Civil Procedures, according the Commission.

The proposed rules also amend other timing touchpoints and revised the appeal process in a noteworthy respect:

- Settlement talks toll the clock: Under current Rule 161, settlement discussions do not toll the required deadlines for the hearing and the ALJ's initial decision. Under proposed Rule 161, an ALJ may stay a proceeding pending the Commission's consideration of offers of settlement, and the stay will toll these deadlines.

- Timing of ALJ decision: Under the current rule, the clock for the ALJ's initial decision begins to run from the time the order instituting proceedings is served on the respondent. Under the proposed rule, the deadline for the ALJ to file his initial decision would run from the time that the post-hearing briefing or briefing of dispositive motions is completed.

- Three-page limit on notice of appeal: Currently, under Rule 410, appealing respondents must set forth all specific findings and conclusions of the initial decision to which they take exception in their petition for review within 21 days of the ALJ's decision. Proposed Rule 410(b) would instead require a three-page "summary statement of the issues presented for review," which the Commission noted would be consistent with the Federal Rules of Appellate Procedure.

The proposed changes to Rules 151 and 152 would also modernize the filing procedures so that documents filed and served in connection with administrative proceedings would be filed and served electronically, rather than in paper form. The rule release contemplates a 90-day "phase-in" period, where parties would file and serve documents in both paper and electronic form.

Conclusion

The proposed amendments leave many unanswered questions as to how the new rules would work, and address only some of the limitations to the administrative process. Broadly speaking, the proposed rules appear to attempt to align the process of an administrative proceeding with the Administrative Procedure Act, and provide for some discovery with references to the Federal Rules of Civil Procedure, in order to insulate the Commission from recent constitutional challenges to the forum and format of the proceeding. Nevertheless, the changes do not eliminate the due process concerns that have been raised. For instance, the proposed rules only provide for extremely limited deposition discovery (especially in the case of multi-respondent proceedings), and explicitly do not disallow hearsay in administrative proceedings.

Among the many unknowns with the proposed changes is how the new discovery rules will actually work in practice, including the mechanics of how and when the parties will notice their limited depositions and how expert discovery will fit into the still-compressed discovery schedule. This is especially true given the need in many cases for respondents to first digest the voluminous investigatory file from the Enforcement Division, and the absence of explicit procedures such as those set forth in the Federal Rules of Civil Procedure for identifying witnesses. However, these changes do provide an

opportunity for respondents to develop a meaningful defense and challenge to the Enforcement Division's case in an administrative proceeding.

If you have any questions regarding this memorandum, please contact Elizabeth P. Gray (202-303-1207; egray@willkie.com), Amelia A. Cottrell (212-728-8281; acottrell@willkie.com), Michael S. Schachter (212-728-8102; mschachter@willkie.com), William J. Stellmach (202-303-1130; wstellmach@willkie.com), Julie A. Smith (202-303-1209; jasmith@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

September 28, 2015