WILMERHALE

Securities Litigation and Enforcement Update

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SECURITIES

Update: Recent Court Decisions Reveal Litigation Challenges for SEC

Although the US Securities and Exchange Commission may have significant leverage to get what it wants during the course of an investigation and even in settlements, several recent court decisions strongly suggest that the playing field levels once the agency ends up in litigation.

From the US Supreme Court to the federal district courts, litigants are pushing back effectively against the SEC on everything from when the clock starts for the SEC to bring an action for civil monetary penalties to key discovery questions.

What you need to know

- *Gabelli v. SEC*, No. 11-1274, 568 U.S. --, Slip Op. (Feb. 27, 2013): An SEC enforcement action for civil penalties must be brought within five years of when the fraud occurs, not within five years of its discovery.
- *SEC v. Kovzan*, No. 2:11-cv-02017-JWL-KGS (D. Kan. 2013): Where the SEC has voluntarily initiated an enforcement action in federal court, it is not immune from discovery into the agency's internal documents, may not assert deliberative process privilege over documents for which it has not searched, and is not exempt from appearing for a Rule 30(b)(6) deposition, a regular discovery tool used in standard civil litigation.
- *Zelaya v. United States*, No. 11-62644 (S.D. Fla. Feb. 15, 2013): In an FTCA action against the SEC, the SEC could not completely stay discovery pending the district court's decision on its motion to dismiss.
- *SEC v. Sells*, No. 11-cv-04941 (N.D. Cal. Feb. 4, 2013): Defendants litigating against the SEC may be able to obtain information from immunized witness interviews, including information that is only contained in SEC attorneys' memories and notes, if they show that the information is substantially necessary to the case and unavailable through any other means.
- *SEC v. Merkin*, 283 F.R.D. 689 (S.D. Fla. 2012): The SEC is subject to the Federal Rules of Civil Procedure in the same manner as any private litigant is, and cannot preemptively assert privilege and work product to avoid Rule 30(b)(6) depositions.

***Gabelli v. SEC*[1]**

On February 27, 2013, the Supreme Court unanimously held that the SEC must bring an enforcement action for civil monetary penalties within five years of when a securities fraud allegedly occurred—not five years from its discovery or "would-be" discovery.

[1] WilmerHale filed an amicus brief on behalf of the National Association of Criminal Defense Lawyers in this matter.

In 2008, the SEC brought an enforcement action alleging that defendants Bruce Alpert and Marc Gabelli aided and abetted investment adviser fraud from 1999 to 2002. Specifically, the SEC said that the pair allowed certain clients to engage in market timing of Gabelli's mutual fund in exchange for an investment in a hedge fund run by Gabelli—all while prohibiting other clients from engaging in market timing and making public statements that such behavior was prohibited.[2] According to its complaint, the SEC did not discover the alleged wrongdoing until "late 2003, at the earliest."[3]

Alpert and Gabelli moved to dismiss the action as untimely. Under 28 U.S.C. §2462, the SEC must bring an action for civil monetary penalties "within five years from the date when the claim first accrued[.]"[4] Under Alpert and Gabelli's view, the last potential "claim" occurred when they committed their final alleged fraudulent act in 2002. The SEC did not file its complaint until 2008—more than five years later and thus too late.

The district court agreed with Gabelli and Alpert and dismissed the case. The Second Circuit reversed the district court's decision, accepting the SEC's argument that, because the underlying violations "sounded in fraud," the discovery rule applied.[5] Under the discovery rule, the five-year statute of limitations did not start until the SEC discovered or should have discovered the fraud.[6]

The Supreme Court granted certiorari and reversed, finding that the five-year statute of limitations for SEC enforcement actions in §2462 begins when the fraud occurs, not when the fraud is discovered.[7] After conducting a "natural reading" of the statute, the Court noted that the "discovery" rule rarely, if ever, applies where the Government is seeking civil penalties. It reasoned the Government—and the SEC in particular—stands in a different posture than allegedly defrauded private plaintiffs, "who do not know they are injured and who reasonably do not inquire as to any injury"[8] or "spend [their] days looking for evidence that [they] were lied to or defrauded."[9]

To the contrary, the very mission of the SEC is to investigate potential violations of the securities laws.[10] To "root out" this fraud, the SEC can utilize a variety of legal tools, including demanding the submission of trading information, requiring investment advisers to turn over books and records, subpoenaing documents and witnesses it deems relevant and material without filing a lawsuit, and being able to pay monetary awards to whistleblowers and offer cooperation agreements to violators in an effort to gather more information.[11] As the Court explained: "[c]harged with this mission and armed with these weapons, the SEC as enforcer is a far cry from the defrauded victim the discovery rule evolved to protect."[12]

What is more, the Court remarked that the SEC also seeks very different relief than does a private plaintiff. A private plaintiff in a fraud action is the victim of fraud and seeks compensation for a loss. Civil penalties go beyond recompense, as they are "intended to punish, and label defendants wrongdoers."[13]

Implications Going Forward

Defendants should pay careful attention to the dates alleged by the SEC in enforcement actions for civil penalties and, when the SEC files a complaint seeking civil penalties, should move to dismiss on that basis where appropriate. Note that the Court only addressed actions for civil penalties, as the injunctive relief and disgorgement claims were found by the district court to be outside of the scope of §2462. Additionally, the Court did not address what qualifies as a "civil penalty" for purposes of §2462, so the issue of whether an injunction or director and officer bar could qualify as a "penalty" is still an open question.

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[2] *Gabelli v. SEC*, No. 11-1274, 568 U.S. ---, Slip Op. at 2-3 (Feb. 27, 2013).
[3] *SEC v. Gabelli*, No. 08-cv-03868, Dkt. No. 1, Complaint at 16 (S.D.N.Y. Apr. 24, 2008).
[4] 28 U. S. C. §2462, *Gabelli*, 568 U.S. --, Slip Op. at 2.
[5] *Gabelli*, 568 U.S. --, Slip Op. at 3-4.
[6] *Id.* at 4.
[7] *Id.* at 4, 11.
[8] *Id.* at 7.
[9] *Id.*
[10] *Id.* at 8.
[11] *Id.*
[12] *Id.*
[13] *Id.*

The decision also does not affect the ability of the SEC to seek tolling agreements that stop the statute of limitations, and, in the aftermath of *Gabelli*, defendants should expect to see more frequent requests for these agreements. Defendants often sign tolling agreements in the hope of appearing cooperative and receiving leniency from the Government, and it's likely that *Gabelli* will only increase their usage. The decision did not address doctrines that toll the running of the statute of limitations, such as fraudulent concealment, as the SEC did not rely on those doctrines for its arguments. Defendants should also be aware that the SEC may be pressed to complete investigations more quickly if it wishes to seek civil penalties, which may affect counsel's strategic decision-making.

***SEC v. Kovzan*[14]**

In February 2013, a Kansas district court held that the SEC is not immune from discovery into its internal documents, may not assert deliberative process privilege over documents for which it has not yet searched, and is not exempt from appearing for a Rule 30(b)(6) deposition, a regular discovery tool used in standard civil litigation.

In early 2011, the SEC brought an enforcement action against Stephen M. Kovzan, CFO of a Kansas-based technology company, alleging that he committed securities fraud for his role in the company's alleged failure to disclose perquisites paid to the former CEO.[15] The CEO lived in Wyoming and traveled to Kansas and other places as needed to perform his job duties.[16] A key fact issue in the case is whether the CEO's trips between Wyoming and Kansas are ordinary business expenses, or "commuting" expenses, the payment of which would constitute compensation to the CEO and possibly a reportable perquisite under Item 402 of Regulation S-K.[17] Kovzan also has asserted an affirmative defense that he did not have constitutional fair notice of what the regulations required during the relevant time period.[18]

Motion practice has been extensive in this case, with Kovzan filing several motions to compel and the SEC filing one motion to quash Kovzan's Rule 30(b)(6) deposition of the SEC.[19] Kovzan's first motion to compel, filed in February 2012, sought, among other things, SEC internal documents concerning the meaning of perquisite disclosure regulations as well as the definition of internal control over financial reporting.[20] Kovzan argued that this discovery was relevant to whether Kovzan acted with scienter, whether he had constitutional fair notice of what the regulations required, and, to the extent the SEC were to prevail at trial on liability, the appropriateness of the relief sought.[21]

Although the magistrate denied the portion of one of Kovzan's motions to compel seeking the SEC's internal documents, the district court nonetheless granted his motion for review as to a subset of the SEC's internal documents initially requested.[22] Specifically, the court agreed that "industry practice, guidance given to other companies [by the SEC], and confusion within the SEC itself may be relevant" on the issues of scienter, fair notice, and the appropriateness of injunctive relief.[23] The court separately held that the SEC could not assert a blanket claim of deliberative process privilege over documents for which it had not yet searched.[24]

A separate motion to compel brought by Kovzan sought discovery into what he contended is the SEC's "analogous practice of allowing [the SEC's] high-level officials to reside in locations of their choice while the SEC reimburses these individuals for their travel."[25] The court rejected the SEC's objections to this

[14] WilmerHale is currently representing Kovzan in this matter.
[15] *SEC v. Kovzan*, No. 2:11-cv-2017, Dkt. No. 22, Am. Compl. ¶¶ 1-3 (Apr. 8, 2011).
[16] *Id.* ¶ 21.
[17] *Id.* ¶¶ 33-34.
[18] *See SEC v. Kovzan*, No. 2:11-cv-2017, Dkt. No. 38, Answer at 19 (Aug. 26, 2011).
[19] See *SEC v. Kovzan*, No. 2:11-cv-2017, Dkt. Nos. 89 (July 31, 2012), 113 (Oct. 10, 2012), 136 (Dec. 21, 2012), 169-171 (Feb. 21, 2013).
[20] *SEC v. Kovzan*, No. 2:11-cv-2017, Dkt. 61-62, Memorandum in Support of First Motion To Compel, at 8-15 (Feb. 27, 2012).
[21] *Id.* at 8.
[22] *SEC v. Kovzan*, No. 2:11-cv-2017, Dkt. No. 113 (Oct. 10, 2012), Order at 6, 12.
[23] *Id.* at 8, 10-12.
[24] *Id.* at 14.
[25] *SEC v. Kovzan*, No. 2:11-cv-2017, Dkt. No. 170 (Feb. 21, 2013), Order at 1.

discovery on relevance, deliberative process privilege, and Privacy Act grounds, and granted the motion to compel.[26]

The magistrate agreed with Kovzan that the "SEC's approval of certain expense reimbursements for tax and other purposes could conceivably shed light on when similar expenses may be considered ordinary travel costs and not commuting costs."[27] And in what could have positive implications for defendants in other cases, the magistrate rejected the SEC's burden arguments as conclusory in that "the SEC has failed to provide specific details regarding the expense or time it would take to comply with what Kovzan has requested."[28] Moreover, the magistrate rejected the SEC's claims of deliberative process privilege as both overbroad and premature, given that the SEC conceded it had not yet searched for responsive documents.[29]

On similar grounds, and on the same day, the magistrate denied the SEC's motion to quash Kovzan's Rule 30(b)(6) deposition notice.[30] The SEC sought a protective order on multiple bases, arguing that Kovzan effectively sought to depose opposing counsel, that the noticed topics would necessarily intrude on testimony protected by deliberative process privilege or work product protection, and that appearing for a deposition would be unduly burdensome.[31] The magistrate rejected all of these arguments, holding that (1) the notice on its face does not seek the deposition of opposing counsel; (2) that it would be "speculative" to prohibit the deposition on the basis that answers to some questions might be covered by an applicable privilege; and (3) as to burden, "the SEC has failed to come forward with a particular and specific demonstration of fact that would allow the court to conclude that the deposition would result in an undue burden or expense" justifying a protective order.[32] The SEC is contesting both the denial of its motion to quash the Rule 30(b)(6) deposition notice and the grant of Kovzan's motion to compel discovery into the SEC's travel policies and has sought further review by the district court.[33]

Implications Going Forward

The biggest takeaway from the *Kovzan* discovery orders is that defendants should not assume that the deck is stacked in favor of the Government when it comes to discovery disputes. Defendants should not hesitate to seek discovery from the SEC beyond the four corners of the Staff's investigative file. Likewise, given that the SEC often invokes privilege—particularly deliberative process privilege—as a complete bar to discovery of its internal documents, defendants should challenge those claims where they appear overbroad or unsupportable.

Zelaya v. United States

On February 15, 2013, in a case in which the SEC was a defendant, a Southern District of Florida district court denied the SEC's request to stay discovery pending the resolution of its motion to dismiss.

Plaintiffs filed a Federal Tort Claims Act lawsuit in December 2011, alleging that the SEC was liable for plaintiffs' financial losses suffered as the result of a Ponzi scheme operated by financier R. Allen Stanford.[34] Following the partial granting of the SEC's motion to dismiss, plaintiffs filed an amended complaint and served discovery on the SEC.[35] The SEC responded to the discovery, and then filed a second motion to dismiss for lack of subject matter jurisdiction. The SEC subsequently sought an order staying discovery until the court ruled on its second motion to dismiss.[36]

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[26] *Id.* at 2.
[27] Id. at 5.
[28] *Id.* at 5.
[29] *Id.* at 6-9.
[30] *SEC v. Kovzan*, No. 2:11-cv-2017, Dkt. No. 171 (Feb. 21, 2013), Order at 1.
[31] *Id.* at 3.
[32] *Id.* at 3, 6.
[33] *SEC v. Kovzan*, No. 2:11-cv-2017, Dkt. No. 178, SEC's Objections to the Magistrate Judge's Order Compelling Discovery of the SEC's Travel Policies and Order Denying The SEC's Motion To Quash Kovzan's Rule 30(b)(6) Deposition Notice (Mar. 7, 2013).
[34] *Zelaya v. United States*, No. 11-62644, Dkt. No. 66, Order at 1 (Feb. 15, 2013).
[35] *Id.* at 1-2.
[36] *Id.* at 2.

To determine whether to stay discovery pending resolution of the motion to dismiss, the court weighed the potential harm caused by a delay against the possibility that the motion would be granted. [37] The merits of the motion to dismiss must be examined by the court, as a stay may be ordered if there is "an immediate and clear possibility" that the court will grant the motion to dismiss. [38]

The SEC argued that a stay of discovery would not prejudice plaintiffs but that having to produce large amounts of documents or records would amount to a "considerable burden" for the Commission.[39] The magistrate judge ruled that such a burden could be reduced by narrowing the scope of plaintiff's discovery requests pending a ruling on the motion to dismiss.[40] Further, the SEC's motion to dismiss was not "clearly meritorious and truly case dispositive," so the court denied the Commission's motion to stay.[41]

Implications Going Forward

The *Zelaya* case may at first glance appear to be atypical in that the SEC is the defendant and is attempting to stay discovery. However, *Zelaya* demonstrates that, once the SEC is in litigation, it is generally subject to the same rules as is a private party. Here, the court recognized that responding to discovery inherently creates some amount of burden, and the SEC cannot avoid the usual hassles of litigation, just because it is a Government entity. Defendants facing the SEC in litigation may be able to use the decision to extract discovery from the SEC, thus encouraging defendants to go on the offensive to fight back.

SEC v. Sells

On February 4, 2013, a Northern District of California district court issued an order requiring the SEC to provide certain information relating to witness interviews—despite the SEC's objections that the material was protected by the SEC's own attorney work product doctrine.

On January 29, 2013, Timothy Murawski and the SEC filed a joint letter brief in which Murawski asked the district court to compel the SEC to respond to interrogatories asking the SEC "to disclose the dates of its communications" with three immunized witnesses and "to describe the information provided by" the three witnesses during their interviews with the SEC.[42] The interviews were not recorded by a stenographer, and the information from the interviews formed the basis of the complaint against Murawski.[43] The SEC argued that the information sought by the interrogatories was protected attorney work product.[44] On February 4, 2013, the district court granted Murawski's request and ordered the SEC to respond to the interrogatories.[45]

In granting Murawski's request, the court implicitly characterized the requested material as work product, and applied the work product analysis set forth in *Hickman v. Taylor*, 329 U.S. 495 (1947): if relevant and non-privileged facts are contained in an attorney's files and if discovery of the facts "is essential to the preparation of one's case," the court may permit discovery.[46] The party seeking discovery must establish "adequate reasons" to justify discovery, which may include a showing of "substantial need" and "unavailability by other means."[47]

The court concluded that Murawski had established "adequate reasons" to justify discovery of the facts from the SEC's interviews for a number of reasons—including that the content of the interviews formed the basis of the allegations against him and that, because there was no transcript or recording made of

[37] *Id.*, quoting *McCabe v. Foley*, 233 F.R.D. 683, 685 (M.D. Fla. 2006).
[38] *Id.,* quoting *Feldman v. Flood*, 176 F.R.D. 651, 653 (M.D. Fla. 1997).
[39] *Id.* at 3.
[40] *Id.*
[41] *Id.*
[42] *SEC v. Sells*, No. 11-cv-04941, Dkt. No. 91, Order Compelling Responses to Interrogatories 8-10 at 2 (Feb. 4, 2013).
[43] *Id.*
[44] *SEC v. Sells*, No. 11-cv-04941, Dkt. No. 88, Joint Letter Brief at 3 (Jan. 29, 2013).
[45] *SEC v. Sells*, Order Compelling Responses to Interrogatories 8-10 at 3.
[46] *Id.* at 2.
[47] *Id.*, citing *Hickman v. Taylor,* 329 U.S. 495 (1947) and Fed. R. Civ. P. 26(b)(3)(A).

the interviews, Murawski had no other way in which to obtain the information.[48] The court rejected the idea that Murawski could gather the same information simply by deposing the interviewees in the present.[49] Also, in contrast to *Hickman*, where the responding party had already provided information learned from witness interviews, the district court found that the SEC had produced no information from the three interviews and had instead "asserted every possible objection" to such requests.[50] The court added its displeasure with the SEC for "repeatedly withholding relevant information."[51]

Implications Going Forward

It is probably the case that this decision will not require the SEC to produce memories and notes of its witness interviews generally in litigation. What is clear, however, is that the SEC does not stand in any special position when it comes to warding off a request for information that is protected work product. That is to say, the *Hickman* standard applies regardless of whether a party is a private party or a public one, as in the SEC's case. If a party can show that the information is otherwise unavailable and is substantially necessary to the development of the case, the SEC may not be able to protect it from discovery.

SEC v. Merkin

On June 12, 2012, a district court in the Southern District of Florida allowed a defendant to take 30(b)(6) depositions from the SEC, rejecting the argument that the SEC is *de facto* immune from 30(b)(6) depositions and overruling the SEC's objection that none of the topics noticed by the defendant were appropriate for a 30(b)(6) deposition.

The SEC brought a civil lawsuit against Stewart Merkin, alleging that Merkin made false statements in connection with the purchase and sale of stock. The SEC alleged that Merkin failed to disclose that his clients were being investigated by the SEC, despite the fact that Merkin was the attorney representing the client in the SEC investigation.[52] Merkin unsuccessfully attempted to persuade the SEC to allow him to take a 30(b)(6) deposition and was ultimately forced to issue a 30(b)(6) deposition notice to the agency.[53] The SEC objected to the notice on a number of grounds, including that the deposition would implicate various privileges and protections, that the SEC would be required to produce enforcement division attorneys as deposition designees, and that SEC attorneys would have to prepare a non-lawyer for the deposition "by divulging attorney's opinions, strategies and thoughts."[54]

Notwithstanding that the SEC argued at the discovery hearing that it "was not taking the broad position the SEC was exempt from Rule 30(b)(6)," counsel for the SEC conceded that he "had never personally produced a 30(b)(6) designee in his eight years with the agency, was unaware of any instance where another SEC attorney had done so and could not imagine even one issue" in the case that would warrant a 30(b)(6) deposition.[55] In turn, Merkin's counsel argued that the SEC was in fact seeking special treatment under the discovery rules.[56]

Using the terms of Rule 30(b)(6), which state that a "governmental agency" may be named as a deponent,[57] the court rejected "as a threshold matter" the idea that the Government generally, and the SEC in this case, enjoys some type of exemption from Rule 30(b)(6).[58] The court determined that "like any party litigating in federal court, Merkin has the right to take a 30(b)(6) deposition from the SEC," subject to the privileges and protections available to all litigants and the special privileges afforded the Government.[59] Regarding the SEC's claims that the depositions would necessarily involve privileged

[48] *SEC v. Sells*, Order Compelling Responses to Interrogatories 8-10 at 3.
[49] *Id.* at 3.
[50] *Id.* at 2-3.
[51] *Id.* at 3.
[52] *SEC v. Merkin*, 283 F.R.D. 689, 690-91 (S.D. Fla. 2012).
[53] *Id.* at 691.
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *Id.* at 693.
[58] *Id.* at 694
[59] *Id.*

information, the court reasoned that "the concern that a 30(b)(6) deposition would risk disclosure of privileged information" was not unique to cases involving the Government and that these same concerns are often asserted by private litigants and are routinely rejected.[60] The SEC's position that the preparation of the deponent by an SEC attorney would mean any answers were necessarily work product was also rejected, as "[p]ermitting a litigant to use a 30(b)(6) deposition to learn facts would not cause disclosure of work product information merely because a lawyer prepared the witness."[61]

Because the court rejected the SEC's objections, Merkin was permitted to take depositions from the SEC.[62] The court did limit the topics that Merkin could depose witnesses on, finding that eight of the 15 topics noticed were irrelevant or unduly broad, but the ruling was without prejudice.[63]

Implications Going Forward

Defendants in SEC actions should push back when the SEC asserts blanket privilege statements in objections to depositions or other discovery devices. In both *Merkin* and the *Kovzan* discovery orders, the SEC took the position that it is functionally exempt from 30(b)(6) depositions—in *Merkin* because any questions would necessarily implicate privileged information or work product and in *Kovzan* because it had no firsthand knowledge so it would essentially allow the deposition of opposing counsel. The courts outright rejected these arguments and made it clear that the SEC is subject to the Federal Rules of Civil Procedure just as any private litigant is.

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Although there are many factors to consider when deciding whether or not to litigate a case with the SEC, these recent decisions should give some encouragement to the SEC's opponents. No doubt, the SEC has advantages before the start of litigation, but the filing of a complaint helps to level the playing field—and defendants (and possible defendants) should consider the shift before rushing to a settlement.

[60] *Id.* at 696.
[61] *Id.* at 697.
[62] *Id.* at 698.
[63] *Id.*

FOR MORE INFORMATION ON THIS OR OTHER SECURITIES LITIGATION AND ENFORCEMENT MATTERS, CONTACT:

Douglas J. Davison +1 202 663 6690 douglas.davison@wilmerhale.com
Christopher Davies +1 202 663 6187 christopher.davies@wilmerhale.com
Michael Mugmon +1 650 858 6103 michael.mugmon@wilmerhale.com
Kelly S. Shoop +1 202 663 6519 kelly.shoop@wilmerhale.com
Allyson Fortier +1 213 443 5307 allyson.fortier@wilmerhale.com