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Securities Litigation & Enforcement News

Current Legal Developments in the Broker-Dealer Arena

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Court Rules SEC Cannot Invoke Its Investigatory Powers to Circumvent Discovery Rules

A Texas federal district court recently refused to reconsider its order imposing sanctions on the U.S. Securities and Exchange Commission ("SEC") for conducting an "extra-judicial deposition" of a third party without providing notice to defendants in a pending civil action to which the third party's testimony was relevant. Order on reconsideration, *SEC v. Life Partners Holdings, Inc. et al.*, Case No. 1:12-CV-00033-JRN, in the United States District Court for the Western District of Texas, Austin Division (Sept. 27, 2012)[Doc. 56]; original order dated Aug. 17, 2012 [Doc. 47]. The court determined that the SEC obtained the testimony for use in the pending case and could not invoke its investigatory powers to do an end-run around the governing discovery rules.

The orders were entered in a case brought by the SEC against financial services firm Life Partners Holdings, Inc. and three of its executives, Brian Pardo, R. Scott Penden, and David M. Martin. The SEC alleged that defendants systematically underestimated life expectancy estimates the company used to price life settlement transactions so as to create a false appearance of a steady stream of earnings.

After the SEC complaint was filed but before the parties' Rule 26(f) conference, the SEC deposed a non-party witness, the auditor for Life Partners. The SEC did not seek the court's permission to depose a witness prior to the conference and did not give notice to defendants. Defendants sought to preclude the SEC from using any documents or testimony obtained by the witness for any purpose relating to the litigation. The SEC argued that the deposition was a valid exercise of its regulatory authority to investigate potential violations of federal securities laws and was not an attempt to obtain ex parte discovery.

Although the filing of a civil action "does not inhibit the SEC's broad authority to investigate securities-law violations," administrative agencies are bound by the Federal Rules of Civil Procedure ("FRCP") when they are parties in a civil action. The rules require leave of court to take a deposition before the Rule 26(f) conference, and notice to all parties must be provided. The question for the court was whether the deposition was taken as part of a regulatory investigation unrelated to the civil action.

The SEC claimed it was investigating the auditor to ensure he had fulfilled his professional obligations, but District Judge James R. Nowlin found the deposition was not taken solely to investigate matters outside the complaint. The auditor was examined regarding Life Partners' revenue recognition and other practices, "as well as Defendants Pardo, Peden, and Martin's knowledge of the same — all of which form the very bases of Plaintiff's Complaint in this case." The court also rejected the SEC's assertion that testimony relating to the civil suit "inadvertently came out." The SEC relied on *SEC v. O'Brien*, 467 U.S. 735 (1984) for the proposition that the target of an SEC investigation is not entitled to notice of investigative subpoenas issued to third parties. The court held that *O'Brien* did not apply because the subpoena was issued after the Complaint was filed "and with the intention of obtaining evidence against the named Defendants."

The court also rejected the claim that there was no prejudice because the SEC provided the deposition transcript to defendants, who were free to depose the auditor themselves. The court determined that the lack of notice deprived defendants of their ability to cross-examine the auditor and object to the testimony elicited.

The court asserted, "Plaintiff cannot administer an extra-judicial deposition regarding an investigation, elicit testimony during that deposition regarding allegations made in the Complaint for use against defendants, and then claim immunity from the FRCP by labeling the deposition as 'investigative.'" The multiple violations of the FRCP warranted sanctions because the deposition without notice to opposing counsel "frustrated the fair examination" of the witness. In addition to awarding Defendants $5,000 in attorney's fees, the court prohibited the SEC from using the deposition testimony in the civil case.

In a motion for reconsideration, the SEC claimed that the court had "introduced a new rule of law" that "upon the filing of a civil suit, the Commission may not use its investigatory powers to investigate any related violations." The court rejected this interpretation of its order. It noted that the SEC Enforcement Manual itself cautioned staff about issuing investigative subpoenas after commencement of a civil action because "[a] court might conclude that the use of investigative subpoenas to conduct discovery is a misuse of the SEC's investigative powers and circumvents the court's authority and limits on discovery in the Federal Rules of Civil Procedure."

While the deposition in this case appears to have been a fairly transparent effort to circumvent the FRCP to gain discovery for use in the civil case, the court's order reinforces important limits on the SEC's investigatory powers. The court sent a clear signal that it would not tolerate abuses of those powers to gain an advantage over civil litigants. Defendants in an SEC proceeding should be alert for the possibility of such abuses. They will find strong support in this order should the SEC take non-party depositions without notice that could be relevant to the civil suit.

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