

# Financial Services & Securities Litigation

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## SEC Announces “Refined and Expanded” Policy Prohibiting Defendants in Follow-On Agency Proceedings From Contesting Facts Underlying Consent Injunctions, Despite Settlement Language to the Contrary

In a recent opinion, the Securities and Exchange Commission (“SEC” or “Commission”) announced a “refined and expanded” policy for administrative disciplinary proceedings based on consent injunctions, and, in particular, consent injunctions involving fraud. The new policy will apply prospectively to consent injunctions that are “both agreed to and entered by a court” after the *Melton* decision.<sup>1</sup> The new policy has serious implications for defendants considering settlement with the agency.

As mandated by the securities laws, in a disciplinary action based on an injunction, the Commission determines what remedial action, if any, is appropriate in the public interest.<sup>2</sup>

This determination is based on the circumstances of each particular case, including:

- the seriousness of the violation;
- the isolated or recurrent nature of the violation;
- the defendant’s state of mind;

- the sincerity of the defendant’s assurances against future violations;
- the defendant’s recognition of the wrongful nature of the misconduct;
- the defendant’s opportunity to commit future violations;
- the age of the violation; and
- the degree of harm to investors and the marketplace resulting from the violation.<sup>3</sup>

In cases in which the injunctive complaint has been settled by consent, the Commission has traditionally considered the allegations in the complaint and given them “considerable weight.”<sup>4</sup> However, the injunctive allegations

<sup>1</sup> *In the Matter of Marshall E. Melton and Asset Management & Research, Inc.*, 2003 SEC LEXIS 1767 (July 25, 2003), Investment Advisers Act Rel. No. 2151; Exchange Act Rel. No. 48228; Admin. Proc. File No. 3-9865.

<sup>2</sup> This authority is granted to the Commission by Sections 203(e)(4) and 203(f) of the Investment Advisers Act of 1940 and Sections 15(b)(4)(C) and 15(b)(6)(A)(iii) of the Exchange Act of 1934. See also Sections 9(a)(2), 9(b), and 9(c) of the Investment Company Act of 1940; Section 201.102(e) of the SEC Rules of Practice, particularly Section 201.102(e)(3)(i)(A).

<sup>3</sup> *Melton*, 2003 SEC LEXIS at \*4.

<sup>4</sup> *Id.* at \*6.

have not been dispositive, due to language in consent orders to the effect that the defendant has neither admitted nor denied the allegations in the complaint. This is apparently no longer the case.

The Commission's newly broadened policy provides that a defendant who has consented to the entry of an injunctive order against him will be precluded from challenging any of the facts underlying the order.<sup>5</sup> Citing efficiency and resource issues, the Commission contends that, "... it would be illogical and a waste of resources ... not to rely on the factual allegations of the injunctive complaint in a civil action settled on consent in determining the appropriate remedial action in the public interest."<sup>6</sup> Thus, where a defendant agrees to a consent injunction against him, the Commission "will construe the 'neither admit nor deny' language as precluding [the defendant] ... from denying the factual allegations of the injunctive complaint in a follow-on proceeding before [the SEC]."<sup>7</sup> More bluntly, *Melton* decrees that, "those allegations potentially can be dispositive of what remedial action is appropriate in the public interest."

In the absence of evidence to the contrary, the Commission now views consent injunctions as indicating sufficiently serious implications for the public interest to justify:

- registration revocation;
- suspension or bar from participation in the securities industry; and/or
- prohibition from participation in an offering of penny stocks.<sup>8</sup>

## Considerations Going Forward for Defendants

*Melton* has served notice that clients ought to be on heightened alert within their organizations to any potential exposure points. Although the Commission ostensibly will continue to base its disciplinary decisions on considerations of the

particular circumstances of each case, arguably, it has limited a consenting defendant's ability to put on any meaningful defense in a follow-on disciplinary proceeding. It is, therefore, more important than ever that in reaching a settlement with the staff, the defendant pay close attention to the factual allegations in the proposed complaint and suggest revisions to the complaint, rather than merely accepting what the staff has proposed.<sup>9</sup> Moreover, in negotiating a settlement, the consenting defendant should endeavor to reach an agreement upfront on any resulting disciplinary terms.

It remains to be seen whether the Commission's "refined and expanded" policy will maximize agency efficiency. The agency has created a disincentive for defendants, particularly those alleged to have acted fraudulently, to settle by consent. Facing the prospect of almost automatic disciplinary action, defendants may have no other choice but to take their cases to trial. Although defendants will "have the opportunity to demonstrate that, notwithstanding the antifraud injunction, the public interest does not support revocation, suspension, or a bar," the substantial hurdle posed by the Commission's new policy is made clear only a few paragraphs later, wherein the Commission opines that where a person has been enjoined from violating the antifraud provisions of the securities laws (e.g., Section 17(a) of the Securities Act of 1933 or Section 10(b) of the Exchange Act of 1934), such an injunction has "especially serious implications for the public interest."<sup>10</sup>

<sup>5</sup> *Id.* at \*27.

<sup>6</sup> *Id.* at \*28.

<sup>7</sup> *Id.* at \*27.

<sup>8</sup> *Id.* at \*30.

<sup>9</sup> The SEC has indicated that it will begin requiring language in its settlement agreements that the consenting defendant understands that in any follow-on disciplinary proceeding before the Commission based on the entry of the injunction, the defendant will not be permitted to contest the factual allegations of the injunctive complaint.

<sup>10</sup> *Melton*, 2003 SEC LEXIS at \*29-\*30.

It also remains to be seen what impact this new policy will have on private suits. Plaintiffs will certainly argue that because consent orders are essentially to be treated as dispositive evidence of wrongdoing for Commission purposes, then a court might also treat the consent order as an admission of liability. This may be yet another incentive for defendants to take their cases to trial rather than settle with the Commission.

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