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First Circuit Overturns SEC Commissioners' Sanctions Order

December 15, 2015| Blog | By Chip Phinney

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As we have **discussed before**, the SEC's increased use of in-house administrative proceedings in enforcement actions involving allegations of fraud has been a subject of considerable debate. Commentators have questioned the fairness of proceedings where the SEC gains an automatic home field advantage by bringing claims before its own administrative law judges (ALJs), with appeals being heard by the SEC's own commissioners. But a determined defense can still defeat the SEC by ensuring that it plays by the rules, as demonstrated by a **decision issued last week by the U.S. Court of Appeals for First Circuit** in a case where Mintz Levin attorneys **Jack Sylvia**, **Andy Nathanson**, **Jess Sergi**, McKenzie Webster, and **Geoff Friedman** represented one of the petitioners.

The First Circuit vindicated two former employees of State Street Global Advisors (SSgA) who had been targeted by the SEC for alleged securities violations during the 2007 subprime mortgage crisis. Despite applying the highly deferential "substantial evidence" standard of review for agency factfinding, the First Circuit concluded that the SEC abused its discretion in holding Mintz Levin's client, former SSgA Vice President James Hopkins, liable under Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5. The First Circuit also vacated the Commission's order holding Mr. Hopkins' co-defendant, SSgA CIO John Flannery, liable under Section 17(a)(3) of the Securities Act.

A long and tortured path led to the First Circuit's **widely-reported** decision. It began in September 2010, when the Commission issued an Order Instituting Proceedings against Mr. Hopkins and Mr. Flannery, alleging that they each made several material misrepresentations and omissions that misled investors about the SSgA Limited Duration Bond Fund (LDBF) and its exposure to subprime securities. The case was initially tried before the SEC's Chief Administrative Law Judge. After an eleven-day hearing, involving nineteen witnesses (generating thousands of pages of transcripts), the **ALJ issued a 58-page decision** finding that neither Mr. Hopkins nor Mr. Flannery made any false or misleading statements. In light of the **SEC's 90% success rate before its own ALJs**, this was a truly rare defeat for the SEC on its home turf.

Undeterred, the SEC's Division of Enforcement appealed the ALJ's decision to the five-member Commission. Three more years passed. Finally, in December 2014, the **commissioners issued a 3-2 decision** effectively reversing the ALJ. In Mr. Hopkins' case, the majority focused on a single slide that he had allegedly used at a presentation to a group of investors. This slide described LDBF's "typical portfolio exposures" in several broad categories including asset-backed securities, commercial mortgage-backed securities, and mortgage-backed securities. A majority of the commissioners took the position that this slide was materially misleading because it represented that typically only 55% of the fund was invested in asset-backed securities when its actual investment in asset-backed securities in September 2006 through June 2007 was substantially higher. Based on this single slide, the Commission suspended Mr. Hopkins for one year from association with any investment adviser or company and assessed a civil monetary penalty of $65,000. With regard to Mr. Hopkins' co-defendant, John Flannery, the Commission found he was liable for alleged misstatements in two letters concerning LDBF and similarly imposed a one-year suspension and a civil fine.

On a petition for review to the First Circuit, Judges Lynch, Stahl, and Kayatta vacated the Commission's order in its entirety. With regard to Mr. Hopkins, the Court concluded that the SEC's purported showing of materiality was "marginal" and that the SEC had failed to demonstrate that he had acted with scienter. "Context," the court emphasized, "makes a difference." The court noted that the single slide cited by the Commission was clearly labeled "typical," and it was only one slide in a deck of at least twenty. Moreover, investors had access to specific information about LDBF's actual investments through quarterly fact sheets and the fund's audited financial statements. "[W]hen a slide is labeled 'typical,' and where a reasonable investor would not rely on one slide but instead would conduct due diligence when making an investment decision, the availability of actual and accurate information is relevant," the court reasoned. Further, based in part on this "thin materiality showing," the court held that scienter, even in the form of recklessness, also was lacking. The court took note of Mr. Hopkins' testimony that he did not recall ever discussing the typical portfolio slide or being asked a question about actual sector breakdowns during a presentation and that he did not update the slide's breakdowns because he did not think they were important to investors. Moreover, when making an investor presentation, he would prepare notes with specific current information about the LDBF's sector investments. The court therefore concluded that Mr. Hopkins' presentation of this single slide did not rise to the level of recklessness required to show scienter for a securities fraud claim, i.e., "an extreme departure from the standards of ordinary care" that is either known to the defendant or so obvious that he must have been aware of it. As for Mr. Flannery, the court concluded that one of the two letters cited by the Commission was not misleading, and that even assuming that the other might have been, that single alleged misstatement would not suffice to hold him liable under the Commission's interpretation of Section 17(a)(3).

Two aspects of the court's decision merit particular mention.

First, while the court applied the deferential "substantial evidence" test in reviewing the Commission's decision, the court emphasized the more searching aspects of that test. The court observed that in determining whether the Commission's decision was supported by substantial evidence, "[t]he substantiality of the evidence must take into account whatever in the record fairly detracts from its weight," noting in particular that "evidence supporting a conclusion may be less substantial when an impartial, experienced examiner who has observed the witnesses and lived with the case" – in this case the ALJ who initially heard the evidence – "has drawn conclusions different from the Commission's." In that situation, the First Circuit said, "our review is slightly less deferential than it would be otherwise." Following this less deferential standard of review, the court cited aspects of the record the ALJ credited but the Commission did not. For example, the court noted the ALJ's finding that Hopkins had "worked in the securities industry for thirty-five years with an unblemished record"—a fact conspicuously absent from the Commission's opinion. The court also cited expert testimony that a typical investor would not have relied on the information contained in a single, pre-prepared slide in performing diligence, testimony that was also cited favorably by the ALJ but not the Commission. Building this evidentiary record in the administrative proceeding proved crucial to obtaining a reversal in federal court.

Second, the First Circuit's discussion of materiality and scienter provides useful guidance as to when a single, allegedly misleading statement may be non-actionable. While the court made it clear that it was "not suggest[ing] that the mere availability of accurate information negates an inaccurate statement," the court also indicated that the materiality of the alleged misstatement and the maker's scienter must be considered in the context of its presentation and the other information available to investors.

This striking defense victory will feature prominently in the ongoing debate about the SEC's use of administrative tribunals to prosecute securities law violations.

Authors

Chip Phinney