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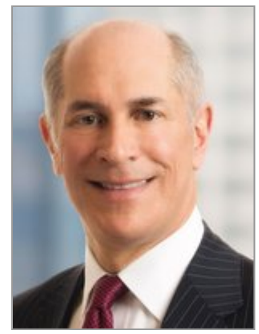
Ex-Informant Ruling Guides On Challenging SEC Enforcement

By **Jay Dubow, Mary Grace Metcalfe and Ghillaine Reid** (November 18, 2020, 5:26 PM EST)

On Sept. 29, the U.S. District Court for the District of New Jersey issued an order in the matter U.S. Securities and Exchange Commission v. Gentile **dismissing** the amended complaint filed by the SEC seeking an injunction against former government informant Guy Gentile.



Jay Dubow

This decision, which is the most recent in several matters over many years involving both Gentile and the SEC, offers useful guidance to those facing an SEC enforcement action. Particularly, when compared to the recent U.S. Court of Appeals for the Third Circuit **decision** in Gentile v. SEC, another matter involving the same parties, the District of New Jersey's opinion in SEC v. Gentile highlights the protections afforded to the certain subjects of SEC investigations once the investigation results in litigation.

Mary Grace Metcalfe

On Sept. 10, the Third Circuit issued its decision in Gentile v. SEC, in which it determined that the authority to investigate had been committed to the SEC's discretion by law, without any meaningful standard of review, and thus that the SEC's decision to investigate is exempt from the waiver of sovereign immunity that might otherwise apply under the Administrative Procedure Act.[1]

Ghillaine Reid

In contrast to the challenges raised in Gentile v. SEC, which focused on the SEC's exercise of its unique authority, Gentile's challenges in this matter focused on the SEC's conduct as a litigant. The recent ruling by the District of New Jersey focused on the remedy sought by the SEC's action, rather than the conduct at issue, and thus provides guidance on how certain defendants can challenge SEC enforcement actions, once they are in the court system.

After the SEC commenced the litigation seeking an injunction against future violations of the federal securities laws against Gentile, Gentile moved to dismiss the SEC's amended complaint for failure to state a claim upon which relief can be granted.

The SEC's counterarguments effectively sought to avoid the application of the Federal Rules of Civil Procedure by excusing it both from pleading all the elements of its claim and doing so within the four corners of the complaint.

The SEC argued that, despite the existence of a securities law violation within the relevant time period being a necessary element of the injunction at issue, the evaluation of such element could not be made by the district court at the motion to dismiss stage. Such a determination, it argued, could only be made upon review of "a full evidentiary record."[2]

These arguments, in effect, sought to excuse the SEC from meeting the applicable pleading standards imposed by the Federal Rules of Civil Procedure.

The District of New Jersey rejected each of the SEC's arguments and instead focused on the deficiency of the SEC's pleadings, in light of the requested relief. The district court declined to take judicial notice of the new facts pled in opposition to the motion to dismiss.

In so declining, the district court drew attention to the SEC's past pleadings in the case, noting that "the Court is compelled to highlight that this is not the first time the SEC has attempted to rely on factual assertions not contained in the operative complaint" and "such an effort was not previously permitted by the Court, nor will it be permitted now."[3]

Like any other litigant, should the SEC wish to bring additional factual allegations to the court's attention, it would need to do so by amending its complaint.[4]

The district court similarly rejected the SEC's argument regarding its claim for an injunction, reminding the agency of its obligations as a litigant in federal court:

> The SEC argues the Court cannot make a determination as to the propriety of the sought injunctions at this stage because it can only make such a decision upon consideration of a developed factual record. While this is an accurate statement of the general standard governing the issuance of injunctions, the SEC omits, or at least fails to acknowledge, that their complaint must still state a plausible claim for relief.

The district court accordingly reviewed the applicable standards for issuing an injunction, including the requirement that "the SEC must plausibly allege Defendant will engage in future securities violations absent an injunction" and evaluated the allegations contained in the amended complaint in light of those requirements.[5]

In particular, the district court noted the disconnect between the conduct pled by the SEC, which was decades old, and the requested relief, which sought to curtail future acts by Gentile.

The district court ultimately found that the "specific facts alleged by the SEC to support this conclusion ... are somewhat feeble" and even "suspect," especially in light of the parties' agreement that Gentile had "not engaged in illegal securities activity for over a decade."[6]

Contrasting this pleading deficiency with the impact that such an injunction would have on a member of the securities industry, the court held:

> While the SEC is not required to make an evidentiary showing to survive a motion to dismiss, they must still include sufficient allegations to plausibly state an entitlement to relief. Here, even with all inferences drawn in the SEC's favor, the allegations of the Amended Complaint are insufficient to state a plausible claim for relief. The Court, accordingly cannot even consider whether to impose the "securities industry equivalent of capital punishment."[7]

The district court then granted Gentile's motion to dismiss.

The interplay between the Third Circuit's decision in early September and the District of New Jersey's decision a few weeks later is clear: While the judiciary may not have the ability to review the decisions of the SEC regarding the initiation or continuation of an investigation, once that investigation results in an enforcement action in federal court, the SEC is subject to the federal rules and judicial review.

As a result, and as seen here, the SEC is obligated to adhere to the same procedural standards as any other litigant, including with regard to the initiation of a case and the sufficiency of its pleadings.

Thus, while the subject of an SEC investigation may be limited in his or her recourse with regard to an investigation's existence or continuance, should the SEC proceed to use the fruits of its investigation against the subject in a court of law, that subject has full access to the various rights and protections afforded by our legal system in challenging the agency.

Other recent U.S. Supreme Court and appellate court decisions have put restrictions on the SEC's ability to obtain an injunction. Combined with the District of New Jersey's holding in Gentile, these decisions show that when the SEC files suit, defendants may be able to get the case dismissed on a motion early in the case, under the right circumstances.

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[1] Gentile v. Sec. & Exch. Comm'n, No. 19-2252, 2020 WL 5416297 (3d Cir. Sept. 10, 2020).

[2] Sec. & Exch. Comm'n v. Gentile, 16-cv-01619-BRM-JAD, Doc. 84 at 9.

[3] Sec. & Exch. Comm'n v. Gentile, 16-cv-01619-BRM-JAD, Doc. 108 at 24.

[4] The district court, in dismissing the amended complaint, noted that it would permit the SEC "one final opportunity to amend their complaint." Sec. & Exch. Comm'n v. Gentile, 16-cv-01619-BRM-JAD, Doc. 108 at 31. On Oct. 19, 2020, the SEC filed a letter to the court confirming that it would "not file a further amended complaint in this matter." Id., Doc. 113. The case was ordered closed on Oct. 21, 2020. Id., Doc. 114.

[5] Sec. & Exch. Comm'n v. Gentile, 16-cv-01619-BRM-JAD, Doc. 108 at 29.

[6] Sec. & Exch. Comm'n v. Gentile, 16-cv-01619-BRM-JAD, Doc. 108 at 29-30.

[7] Sec. & Exch. Comm'n v. Gentile, 16-cv-01619-BRM-JAD, Doc. 108 at 31 (quoting Saad v. S.E.C., 718 F.3d 904, 906 (D.C. Cir. 2013).
