

INITIAL DECISION RELEASE NO. 241
ADMINISTRATIVE PROCEEDING
FILE NO. 3-9784-EAJA

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :
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MICHAEL FLANAGAN, : INITIAL DECISION
RONALD KINDSCHI, and : November 24, 2003
SPECTRUM ADMINISTRATION, INC. :

APPEARANCES: William S. Dixon, William P. Hicks, and William A. Rees for the Division of Enforcement, Securities and Exchange Commission.

Laura J. Sauriol and Michael K. Wolensky for Respondents.

BEFORE: James T. Kelly, Administrative Law Judge.

Summary

This initial decision denies an application for fees and other expenses filed pursuant to the Equal Access to Justice Act (EAJA), 5 U.S.C. § 504. It concludes that the position of the Division of Enforcement (Division) in the underlying proceeding was, on the whole, substantially justified. The decision further concludes that, even if an award were warranted, the level of fees and expenses sought in the application far exceeds the amounts allowable under the EAJA.

The Underlying Enforcement Proceeding

The United States Securities and Exchange Commission (SEC or Commission) instituted this proceeding on December 9, 1998, pursuant to Section 8A of the Securities Act of 1933 (Securities Act), Sections 15(b), 19(h), and 21C of the Securities Exchange Act of 1934 (Exchange Act), and Sections 203(e), (f), and (k) of the Investment Advisers Act of 1940 (Advisers Act). The Order Instituting Proceedings (OIP) alleged that, between June 1, 1993, and December 31, 1995, Michael Flanagan (Flanagan), Ronald Kindschi (Kindschi), and Spectrum Administration, Inc. (SAI) (collectively, Applicants), engaged in a course of business that operated as a fraud and deceit on their customers and clients and, as part of that course of

business, omitted to disclose and misrepresented material facts in connection with the purchase of mutual funds.

The OIP charged that Flanagan and Kindschi willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5. It further asserted that SAI willfully violated Sections 206(1) and 206(2) of the Advisers Act, and that Kindschi willfully aided and abetted SAI's violations.

The matter was initially assigned to another Administrative Law Judge; it was reassigned to my docket on April 12, 1999. I held a public hearing on April 27-30, 1999, in Atlanta, Georgia. Posthearing briefing was concluded on September 15, 1999, and I issued an initial decision on January 31, 2000. Michael Flanagan, 71 SEC Docket 1709 (Jan. 31, 2000) (hereafter, "ID at ____"). The initial decision sustained four charges in part, dismissed four other charges in full, and imposed sanctions for the violations found.

Applicants appealed to the Commission, seeking reversal of the liability findings and sanctions. The Division also applied for review, seeking increased sanctions for the violations found in the initial decision. The Division did not seek review of those portions of the initial decision that dismissed the other charges in the OIP.

The Commission issued its unanimous Opinion on July 30, 2003. The three-page Opinion stated in relevant part:

The [OIP] charged the [Applicants] with committing fraud by steering certain customers to purchase Class B shares in various mutual funds without disclosing all material facts regarding the costs associated with those purchases. Cases involving breakpoints and the sale of Class B mutual fund shares involve important issues, and the Commission will continue to pursue cases on appropriate facts. We have conducted a de novo review of the record before us in this case, however, and find that the evidence does not support a finding of liability on the charges before us on appeal. We accordingly dismiss this proceeding.

Michael Flanagan, 80 SEC Docket 2766, 2767-68 (July 30, 2003).

The Fee Application

On August 29, 2003, Applicants sought an award of \$352,521.81 in fees and other expenses under the EAJA and the Commission's implementing regulations, 17 C.F.R. §§ 201.31-.59. Applicants argued that they reasonably incurred these fees and expenses, which were necessary to defend the proceeding against them. Applicants tendered supporting affidavits and itemized statements, broadly summarizing the services performed by their attorneys and their expert witness (hereafter, "Fee Application at ____" and "Itemized Statement at ____,"

respectively). Applicants also alleged that the position of the Division in the underlying proceeding was not substantially justified.¹

On September 2, 2003, the Chief Administrative Law Judge assigned the Fee Application to me for determination. See 17 C.F.R. § 201.37(b).

On September 26, 2003, the Division filed its opposition to an EAJA award, arguing that its position in the underlying proceeding was substantially justified (hereafter, “Div. Answer at ___”). See 17 C.F.R. § 201.52. The Division also argued that, if fees and expenses were to be granted, the award should conform to the Commission’s EAJA rules. On October 14, 2003, Applicants submitted their Reply. See 17 C.F.R. § 201.53.

Preliminary Issues

As a partial waiver of sovereign immunity, the EAJA must be strictly construed in favor of the government. Ardestani v. INS, 502 U.S. 129, 137 (1991) (citing Library of Congress v. Shaw, 478 U.S. 310, 318 (1986); Ruckelshaus v. Sierra Club, 463 U.S. 680, 685-86 (1983)).

EAJA awards may only be made to eligible applicants who are prevailing parties in covered adjudicatory proceedings. In establishing such threshold matters, the fee applicants bear the burden of proof. SEC v. Comserv Corp., 908 F.2d 1407, 1412 (8th Cir. 1990); Ramos v. Haig, 716 F.2d 471, 473 n.3 (7th Cir. 1983).

The initial decision of January 31, 2000, dismissed certain charges against Applicants for lack of evidence and the Division elected not to seek Commission review of the dismissal. The Commission subsequently dismissed the remaining charges that the initial decision sustained for lack of evidence. Under the circumstances, it is beyond dispute that Applicants are “prevailing parties” for EAJA purposes. It is also clear that the underlying proceeding was a covered adversary adjudication under 5 U.S.C. § 504(b)(1)(C) and 17 C.F.R. § 201.33(a). The fee application was timely filed within thirty days of the final disposition of the underlying proceeding. See 5 U.S.C. § 504(a)(2); 17 C.F.R. § 201.44(a). There is no question as to whether Applicants “incurred” the fees and expenses for which they now seek reimbursement. See Kirk Montgomery, 76 SEC Docket 1394, 1412-15 (Dec. 18, 2001).

Finally, Applicants have shown that they are eligible to pursue EAJA relief. Flanagan and Kindschi have each presented sworn financial statements demonstrating a net worth of less than \$2 million when the underlying enforcement action commenced. See 5 U.S.C. § 504(b)(1)(B); 17 C.F.R. §§ 201.34(b)(1), .41(b). SAI, a corporation, has shown through the sworn financial statement of an officer and the declaration of counsel that it had fewer than 500 employees and a net worth of less than \$7 million when the underlying enforcement action

¹ Applicants reserved the right to submit supplemental papers documenting the additional time their attorneys spent in preparing the Fee Application (Fee Application, Exhibit G at 2 n.1). However, as of this date, Applicants have not made any supplemental filing.

commenced. See 5 U.S.C. § 504(b)(1)(B); 17 C.F.R. §§ 201.34(b)(5), .41(b). The Division has not contested this evidence, and I conclude that it has waived the opportunity to do so.²

Special Circumstances; Protracted Proceeding

The EAJA provides that a fee award may be denied if “special circumstances make an award unjust.” 5 U.S.C. § 504(a)(1). The government has the burden of proving such special circumstances. See Perez-Arellano v. Smith, 279 F.3d 791, 793 (9th Cir. 2002); Gutierrez v. Barnhart, 274 F.3d 1255, 1258 (9th Cir. 2001); Herman v. Schwent, 177 F.3d 1063, 1065 (8th Cir. 1999). Because the Division’s Answer did not raise this potential defense, I conclude that the opportunity to do so has been waived. In addition, an adjudicative officer may reduce or deny an EAJA award if the applicants “unduly and unreasonably protracted the final resolution of the matter in controversy.” 5 U.S.C. § 504(a)(3) (emphasis added); cf. 17 C.F.R. § 201.35(b) (“unduly or unreasonably protracted the proceeding”) (emphasis added). The Division’s Answer did not allege that Applicants protracted the resolution of the underlying adversary adjudication. I conclude that the Division has waived its opportunity to make that argument, as well.

Substantial Justification

In relevant part, the EAJA provides for a fee award unless the government’s position was “substantially justified.” 5 U.S.C. § 504(a)(1). The burden of demonstrating substantial justification rests with the Division. 17 C.F.R. § 201.35(a).

The EAJA is not intended to be an automatic fee-shifting device in cases where an applicant prevailed. Pisoni v. United States, 837 F.2d 465, 467 (Fed. Cir. 1988). Stated another way, an agency’s position can be substantially justified even if the trier of fact finds the evidence insufficient to prove the violations alleged. In evaluating the Division’s allegations of fraud in the underlying adversary adjudication, a “preponderance of the evidence” standard applied. See Steadman v. SEC, 450 U.S. 91, 97-104 (1981). In contrast, under the EAJA, the decision maker must determine whether the Division’s case had “a reasonable basis in law and in fact,” i.e., whether the allegations were “justified in substance or in the main . . . to a degree that could satisfy a reasonable person.” Pierce v. Underwood, 487 U.S. 552, 565 (1988); SEC v. Fox, 855 F.2d 247, 251 (5th Cir. 1988); see 17 C.F.R. § 201.35(a). The substantial justification determination must be made “on the basis of the administrative record, as a whole, which is

² Flanagan’s net worth exhibit contains little more than rough approximations, i.e., figures rounded off to thousands of dollars (Fee Application, Exhibit D). Because his net worth at the relevant time was well below the \$2 million statutory cutoff and the Division does not contest his eligibility, the issue does not warrant detailed examination. See D’Amico v. Indus. Union of Marine and Shipbuilding Workers of Am., AFL-CIO, 630 F. Supp. 919, 922 (D. Md. 1986) (holding that, absent a factual argument by the government that the applicant is not eligible for an EAJA award, the applicant’s affidavit indicating such eligibility is sufficient); SEC v. Switzer, 590 F. Supp. 756, 767 n.1 (W.D. Okla. 1984) (denying an EAJA claim on substantial justification grounds and declining to pursue the eligibility question).

made in the adversary adjudication for which fees and other expenses are sought.” 5 U.S.C. § 504(a)(1).

The position of the Division in the underlying proceeding was that, between June 1, 1993, and December 31, 1995, Applicants engaged in a course of business that operated as a fraud and deceit on their customers and clients, and, as part of that course of business, omitted to disclose and misrepresented material facts in connection with the purchase of mutual funds.

Objective indicia. In Underwood, 487 U.S. at 568-69, the Supreme Court found that certain “objective indicia” might be relevant in determining whether the government’s position was substantially justified. The Court observed, “While we do not disagree that objective indicia can be relevant, we do not think they provide a conclusive answer, in either direction, for the present case.” Id. at 568; see also United States v. Hallmark Constr. Co., 200 F.3d 1076, 1080 (7th Cir. 2000) (cautioning that such objective factors are rarely conclusive).

In the present proceeding, only two objective indicia warrant discussion—the fact that the Division’s case-in-chief survived two motions for partial summary disposition, and the fact that the initial decision found merit to about half of the charges in the OIP. Neither fact lends much support to the Division’s efforts to demonstrate substantial justification.

First, Applicants moved for partial summary disposition at the close of the Division’s direct case, and again, at the close of their defense (Transcript pages 534-44, 801-05) (hereafter, “Tr. ___”). I denied both motions (Tr. 554-55, 806-07). My rulings were consistent with the Commission’s policy disfavoring such bench decisions, as articulated in Rita Villa, 53 S.E.C. 399, 404 (1998). Thus, the fact that I did not grant Applicants’ motions for partial summary disposition is not conclusive proof that the Division’s position in the underlying proceeding was substantially justified.³

Second, the initial decision partially sustained four of the eight charges in the OIP (¶¶ III.B.1, III.B.2, III.C.1, III.C.2). Because the Commission ultimately disagreed and dismissed the charges the initial decision had sustained, the fact that the Division was able to persuade an Administrative Law Judge to endorse approximately half of its case is entitled to limited weight in the EAJA analysis. See Underwood, 487 U.S. at 569 (“Obviously, the fact that one other court agreed or disagreed with the government does not establish whether its position was substantially justified.”); Sierra Club v. Sec’y of Army, 820 F.2d 513, 519 (1st Cir. 1987) (“We readily acknowledge that when the United States wins several rounds but ultimately loses on

³ The present case is distinguishable from Richard J. Adams, 80 SEC Docket 2145, 2152 (July 9, 2003), appeal dismissed per stipulation, D.C. Cir., No. 03-1267 (Sept. 26, 2003). In Adams, the Commission found an inconsistency between an ALJ’s denial of the applicant’s motion to dismiss during the merits phase of the case and the ALJ’s later determination to make an EAJA award on the grounds that the Division’s case had not been substantially justified. The ALJ denied the motion to dismiss the Adams case before the Commission issued its Villa opinion. In denying the motion in Adams, the ALJ stated that the Division had made a prima facie case. In denying Applicants’ motions here, I did not express the view that the Division had made a prima facie case.

points, its early success is some evidence of justification which the court should factor into the EAJA analysis. . . . But, that is a far cry from saying that, once the government has prevailed below, its position must be deemed to have been substantially justified irrespective of what eventuates on reconsideration or on appeal.”).

Because the “objective indicia” are not conclusive on the issue of substantial justification, the next step is to analyze the reasonableness of the Division’s legal and factual positions. “[F]avorable facts will not rescue the government from a substantially unjustified position on the law; likewise, an accurate recital of law cannot excuse a substantially unjustified position on the facts.” Thompson v. Sullivan, 980 F.2d 280, 281 (4th Cir. 1992).

Reasonableness in law. The OIP charged Applicants with committing fraud by steering customers and clients to purchase Class B shares in various mutual funds through misrepresentations and omissions of material facts. Some of the allegedly misrepresented and undisclosed information—the availability of breakpoints on large investments in Class A shares and the availability of letters of intent and rights of accumulation—have been the topic of Commission opinions finding NASD rule violations and violations of the antifraud provisions of the federal securities laws. See Kenneth C. Krull, 53 SEC 1101, 1105 n.10 (1998) (NASD rule violation), aff’d, 248 F.3d 907 (9th Cir. 2001); Robert L. Den Herder, 53 SEC 329, 331-32 (1997) (same); Shearson, Hammill & Co., 42 SEC 811, 849-51 (1965) (antifraud violations); Russell L. Irish, 42 S.E.C. 735, 740-42 (1965), aff’d, 367 F.2d 637 (9th Cir. 1966) (antifraud violations). Another alleged violation—the failure to disclose the advantages and disadvantages of Class B shares when compared to Class A shares—has also been the subject of a recent Commission opinion. See Wendell D. Belden, 80 SEC Docket 699, 700-06 (May 14, 2003) (finding NASD rule violations in the recommendation of Class B mutual fund shares and the structuring of transactions to avoid mutual fund company limits on purchases of Class B shares). Obviously, Flanagan and Kindschi cannot be charged with knowledge in 1993-95 of what the Commission would later decide in Krull, Den Herder, and Belden. However, these recent opinions did not state that the Commission was creating new law. Nor does a fair reading of the opinions suggest that the Commission was doing so. Under the circumstances, these opinions support a conclusion that the Division’s legal argument was reasonable when the underlying proceeding commenced.

The Commission has also held that a registered representative who is a fiduciary may not discharge his responsibility to disclose all material information by simply delivering a prospectus to the customer. See Irish, 42 S.E.C. at 742 n.15; Mason, Moran & Co., 35 S.E.C. 84, 90 (1953). If the misrepresentations and omissions alleged in the OIP had been supported by adequate facts, the Division could have made a plausible argument that Applicants had violated the antifraud provisions of the federal securities laws. As noted in the initial decision on the merits, Irish and Mason, Moran came from an era when proof of scienter was not required to establish fraud in administrative enforcement proceedings (ID at 32). Those opinions did not discuss materiality, and were premised on the existence of a fiduciary duty. While the Division’s ultimate success in the underlying proceeding was not assured, its legal arguments on these matters were still reasonable.

The OIP also charged that Flanagan misrepresented that a customer had to purchase Class B shares of particular mutual funds to use a timing service, and that he fraudulently induced a switch between mutual funds with similar objectives by misrepresenting that a particular market-timing service would not provide its services in the absence of a switch (OIP ¶¶ III.C.3, III.C.4). It was reasonable in law for the Division to argue that such misrepresentations, if they occurred, involved material information. Although the one alleged switching violation at issue in OIP ¶ III.C.4 did not involve a pattern of switches, the charge was otherwise comparable to the allegations of misconduct that have led to findings of NASD rule violations in the past. See Krull, 53 SEC at 1104-05 & n.8 (collecting cases). I conclude that these allegations in the OIP were also reasonable in law.

The only close case for an unreasonable legal position is presented by OIP ¶ III.B.3, which alleged that Applicants failed to disclose to customers and clients that investments in Class B shares as opposed to Class A shares of the same mutual funds significantly increased the commissions paid to the registered broker-dealer, Flanagan, and Kindschi; increased the compensation paid to SAI and Kindschi; and created a conflict of interest for Kindschi.

It is beyond question that conflicts of interest are material information, so that industry professionals like Kindschi are obliged to disclose them. See Arleen W. Hughes, 27 S.E.C. 629 (1948), aff'd, 174 F.2d 969 (D.C. Cir. 1949). The arguably unreasonable legal position here is narrower: was it reasonable in law for the Division to argue that a fiduciary duty rooted in the Advisers Act created an obligation for Kindschi to disclose comparative gross commission credits accruing to the broker-dealer from the sale of different class shares on a transaction-by-transaction basis? According to the Division, Kindschi had a duty to disclose such information to supplement the prospectus disclosure made by the mutual fund of gross commission credit percentages and the confirmation disclosure made by the broker-dealer of actual commission charges and estimated contingent deferred sales charges (CDSCs). The breach of that disclosure duty was said to be fraud.

The Division found support for the asserted duty to disclose in the language of two Supreme Court decisions to the effect that investment advisers have a fiduciary obligation to eliminate, or at least expose, conflicts of interest. See Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979); SEC v. Capital Gains Research Bureau, 375 U.S. 180, 191-201 (1963). The Division also relied on a release issued by the NASD that reminded its members of their obligation to ensure that communications with customers about mutual fund transactions were accurate and complete, and to discuss with customers the impact of CDSCs on the anticipated return on investments. See NASD Notice to Members 94-16 (Mar. 1994).

Applicants contended that the Commission had never clearly articulated the alleged disclosure duty prior to the period at issue. They also noted that sales practices and disclosures involving multi-class shares of mutual funds continued to evolve throughout the 1990s. During the hearing, Applicants cited to several more recent and specific pronouncements, none of which the Division even attempted to rebut. The initial decision found for Applicants on this point, and dismissed the charge (ID at 36-39). The Division elected not to appeal the adverse ruling to the Commission.

In light of the two broadly worded Supreme Court opinions and the NASD Notice to Members, as well as the absence of any judicial or Commission opinions directly adverse to the Division's legal position, I conclude that the Division's position on this issue was reasonable in law. In so ruling, I rely on the fact that the issue was one of first impression in the case before me. However, my conclusion here is not intended to suggest that the Division's position on this issue will continue to be reasonable in law in future cases if the Division simply recycles the same legal argument, without offering significantly more legal support than it provided here.

In concluding that the Division's theories in the underlying proceeding were reasonable in law, I am mindful of NLRB v. Bell Aerospace Co., 416 U.S. 267, 292-95 (1974), and SEC v. Chenery, 332 U.S. 194, 202-03 (1947). Those opinions make plain that, while rulemaking is the preferred mechanism by which to announce new principles and policies, an agency is also afforded the discretion to proceed via adjudication.

Finally, I note that the Commission has recently brought an unrelated administrative proceeding that repeats, practically verbatim, five of the eight allegations in the Flanagan OIP. Compare Flanagan (OIP ¶¶ III.B, III.C) with the OIP in Admin. Proc. No. 3-11179, IFG Network Secs., Inc., filed July 15, 2003, at ¶¶ III.D, III.E (official notice). IFG is pending before another Administrative Law Judge. The fact that the Commission issued the OIP in IFG so closely in time to its decision to dismiss Flanagan hinders any finding, at the Administrative Law Judge level, that the Division's legal theory in Flanagan was unreasonable. If Applicants wish to contend that the OIP in IFG merely shows that the Division still insists on advancing the same unreasonable legal theories, and is twice guiding the Commission to the shoals of EAJA liability, they may present that argument to the Commission.

Reasonableness in fact. After reviewing the entire record through the EAJA prism, I conclude that most of the Division's factual allegations were reasonably supported by the testimony of its lay witnesses, its exhibits, and the opinion testimony of its expert. This includes all of the factual allegations sustained in the initial decision and a majority of the factual allegations dismissed in the initial decision.

As to the factual matters sustained in the initial decision, the Division's position was reasonable in fact for the reasons stated in the initial decision. I decline Applicants' invitation to speculate about why the Commission's Opinion found the Division's factual presentation inadequate to meet the "preponderance of the evidence" standard. The Commission did not determine that the Division's factual presentation was unreasonable in fact. In arguing to the contrary, Applicants have relied on pre-Underwood case law that is no longer valid.

As to the factual allegations dismissed in the initial decision, most had reasonable record support.⁴ However, I conclude that there were four specific issues on which the Division's case lacked a reasonable factual basis. Based on the judicial precedent discussed below, the absence

⁴ I refer to the initial decision on the merits for the sake of brevity, and because the evidence and rationale discussed therein adequately demonstrates the reasonableness of most of the Division's factual allegations. Of course, this does not include the four allegations discussed immediately below.

of reasonable factual support on these four issues does not mean that the Division's position, viewed as a whole, was substantially unjustified.

First, the Division alleged that Flanagan's violations involved several different accounts maintained by John and Esther Holloway and other members of their extended family (OIP ¶¶ III.B, III.C; Division's Response to Motion for a More Definite Statement, filed Feb. 8, 1999, Exhibits 1-2). Evidence introduced at the hearing showed that John Holloway made investment decisions for his Individual Retirement Accounts (IRAs), as well as for the joint account he shared with his wife, Esther Holloway, and for the account held by his mother, Nell Holloway, before she died in 1995. The evidence also showed that Esther Holloway was responsible for making investment decisions for her individual and IRA accounts, as well as for the trust account she held for her father, Alex Williams, as trustee (Tr. 244-45). John Holloway never controlled the latter accounts, and he was not always present when Esther Holloway discussed them with Flanagan (Tr. 244-45, 567-68, 615-17).

The Division offered the testimony of John Holloway, but it did not call Esther Holloway as a witness. Consequently, there was no evidence in the record to support the charge that Flanagan misled Esther Holloway about any investment in her individual or IRA accounts, or in the Alex Williams Trust account. At the close of its case, Division counsel stated: "[I]n its previous conversations with Mr. Holloway, [the Division] had been informed that he as the patriarch of the family was the one who handled all the investments. His testimony in the record . . . did not support that, so the evidence is not there" (Tr. 550). In its post-hearing filings, the Division expressly abandoned all charges relating to Flanagan's dealings with the Alex Williams Trust Account. The initial decision did not sustain any of the charges in the Division's More Definite Statement concerning the accounts controlled by Esther Holloway. The Division elected not to appeal that adverse ruling to the Commission.

These were significant concessions on the Division's part. In short order, one of the two customers, three of the accounts, and several of the transactions relating to Flanagan's alleged fraud had vanished from the case. Yet, surprisingly, the Division offered nothing to demonstrate its due diligence in bringing these charges or to explain exactly how it came to be misinformed about the facts on which it based its More Definite Statement.

If the Division could show that it relied on John Holloway's sworn investigative testimony in bringing these specific charges, then John Holloway's unexpected hearing testimony would not necessarily render the Division's factual position on the charges unreasonable. In another EAJA case, the Commission argued unsuccessfully that a fee applicant's changed testimony constituted a special circumstance that made an award unjust. See SEC v. Kluesner, 834 F.2d 1438, 1440 (8th Cir. 1987). Although the Kluesner majority did not accept the Commission's argument, there was a persuasive dissent. Here, of course, the unexpected testimony came from the victim of the alleged fraud, not from the fee applicant, and the Division elected not to raise a special circumstances defense. The record is otherwise silent as to the reason for the Division's surprise. I thus find that the Division has failed to show that it had a reasonable factual basis for charging Flanagan with fraud for the accounts that Esther Holloway controlled.

Second, Paragraph III.C.3 of the OIP alleged that Flanagan misrepresented that customers had to purchase Class B shares of particular mutual funds to take advantage of a particular market-timing service. The Division's More Definite Statement established that this charge related to a single customer, John Holloway. Holloway's testimony on this point was unambiguous: Flanagan never said any such thing (Tr. 238). The initial decision dismissed the charge (ID at 41), and the Division elected not to appeal that adverse ruling to the Commission. In its opposition to the Fee Application, the Division fails to offer any factual justification whatsoever for bringing the charge. After reviewing the record, I find that this charge also lacked a reasonable factual basis.

Third, Paragraph III.C.4 of the OIP alleged that Flanagan fraudulently induced a customer to switch from one mutual fund to a fund with similar objectives by misrepresenting that a particular market-timing service would not provide its services in the absence of a switch. The initial decision dismissed this charge, finding that the Division had not shown that Flanagan had made the alleged misrepresentation (ID at 41-43). The Division elected not to appeal that adverse ruling to the Commission.

The Division now argues that its position on this issue was reasonable in fact (Div. Answer at 21 n.11). It relies on three points: a switch occurred; the fund to which the investment was switched was similar to the one from which it was switched; and the explanation for the switch was dubious. All these points are true; however, they are insufficient to demonstrate that there was any factual basis for the charge that Flanagan made the alleged misrepresentation that induced the switch. After reviewing the record, I find that this charge also lacked a reasonable factual basis.

Fourth, Paragraph III.B.4 of the OIP alleged that Kindschi failed to inform his customers and clients that there were ways to structure their investments in mutual funds using Class A shares in the same fund family, letters of intent, and rights of accumulation which would have: (a) provided the diversification the customers and clients desired; (b) qualified such investments for breakpoints; and (c) produced materially higher returns for long term investors than Class B shares of the same, or similar, mutual funds.

The initial decision dismissed this charge, after finding that the Division had presented no evidence on the issue with respect to the Long Beach Plywood Company Profit Sharing Plan, the only customer/client that Kindschi was accused of defrauding (ID at 40). The Division elected not to appeal that adverse ruling to the Commission.

The Division now argues that its position on this issue as to Kindschi was reasonable in fact (Div. Answer at 20-21). In support, it cites three facts: its expert witness explained letters of intent and rights of accumulation in her report; the prospectus of the Putnam fund at issue in the case allowed the aggregation of purchases of Class A shares; and there was evidence in the case that Kindschi's customer invested \$249,999.99 in Class B shares of a Putnam fund one day and \$30,876 in another Putnam fund approximately ten days later.

None of the Division's evidence demonstrates that Kindschi omitted the disclosure of information about letters of intent and rights of accumulation to his customer. As for the expert

witness, the Division fails to mention that her discussion of letters of intent and rights of accumulation was confined to the portion of her report that addressed Flanagan's alleged violations, not Kindschi's. The other evidence cited by the Division is similarly inadequate. In effect, the Division was hoping that the initial decision would draw an adverse inference from the customer's failure to purchase Class A shares. The apparent chain of logic was as follows: if Kindschi had made the appropriate disclosure, then the customer would have chosen Class A shares; because the customer did not choose Class A shares, then Kindschi could not have made the disclosure. An adverse inference may be employed to complete a chain of reasoning on a point partially established by direct evidence, but it cannot be used to fill a void where there is otherwise no evidence. See Stanojev v. Ebasco Servs. Inc., 643 F.2d 914, 923-24 n.7 (2d Cir. 1981) (concluding that an adverse inference cannot supply the missing element of a prima facie case). Accordingly, this charge lacked a reasonable factual basis as to Kindschi.

I conclude that, as to these four charges, the Division's case lacked a reasonable factual basis. These were not situations where the record contains contradictory evidence, and where Applicants' evidence simply outweighed the Division's evidence. Such situations would provide no basis for an EAJA award. See Jackson v. Chater, 94 F.3d 274, 279-80 (7th Cir. 1996). Rather, as to these four charges, the Division lacked direct evidence and did not offer any plausible circumstantial evidence to fill the gaps left by the absence of direct evidence. The Division should have known of these factual gaps when it recommended that the Commission authorize the OIP.

The Division's case as a whole. The Division's position in the underlying proceeding was reasonable in law. For the most part, it was also reasonable in fact. In Comm'r, INS v. Jean, 496 U.S. 154, 159-62 (1990), the Supreme Court held that there should be only one substantial justification determination for an entire proceeding, and that it should be made by looking at the government's case in its entirety. The Court concluded: "While the parties' postures on individual matters may be more or less justified, the EAJA—like other fee-shifting statutes—favors treating a case as an inclusive whole, rather than as atomized line-items." Id. at 161-62.

Several lower courts have cited this broad language in Jean to deny awards of fees and expenses in situations in which only a portion of the government's position was not substantially justified. See, e.g., Roanoke River Basin Ass'n v. Hudson, 991 F.2d 132, 138-39 (4th Cir. 1993) (holding that, under Jean, an issue-by-issue analysis regarding substantial justification is inappropriate, and rejecting the view that "any unreasonable position taken by the government in the course of the litigation automatically opens the door to an EAJA fee award"); United States v. An Undetermined Number of Defendants, 869 F. Supp. 906, 910 (D. Kan. 1994) ("the EAJA requires the government's position to be substantially justified, not that each theory advanced in support of that position be substantially justified"); Ututu Gwaitu Paiute Tribe v. Dept. of Interior, 773 F. Supp. 1383, 1387-88 (E.D. Cal. 1991) (holding that the EAJA contemplates a view of the entire proceeding rather than an issue-by-issue analysis and concluding that a "line item" or issue-by-issue analysis for purposes of fee computations would invite speculative and inherently inaccurate fee awards); see also Lane v. Apfel, 2001 U.S. Dist. LEXIS 6387, at *11-12 (N.D. Ill. May 15, 2001) ("the 'position' of the government encompasses the entire civil action—and not any one individual argument"); FDIC v. Fleischer, 1996 U.S. Dist. LEXIS

18228, at *6-7 (D. Kan. Oct. 16, 1996) (“[Applicant] is mistaken . . . in considering the government’s case piecemeal in applying the ‘substantially justified’ standard. Rather, fees are precluded if the overall position of the government with respect to the entire action was reasonable”). I acknowledge that other courts have reached a different result.⁵ However, in the absence of a clear directive regarding the proper approach to this issue, I have followed the guidance of Roanoke River, An Undetermined Number of Defendants, Utu Utu, Lane, and Fleischer in applying Jean here.

After examining the totality of the circumstances, including the Division’s legal theories, the factual proof the Division presented at the hearing, and the remainder of the administrative record, I conclude that the portion of the Division’s case that was substantially justified outweighs the portion that was not. I further conclude that the Division’s case, as a whole, was substantially justified. On that basis, I deny the Fee Application.

Unwarranted Fee And Expense Requests

Even if the Division’s position had not been substantially justified, the Fee Application still could not be granted in its entirety. Immediately below, I offer illustrations, but not an exhaustive list, of the sort of fees and expenses that Applicants seek but may not recover under the EAJA.

Fees and expenses incurred for services before December 9, 1998. Applicants seek recovery of \$4,131.25 for 28 hours of attorney time and \$189.94 in expenses during November 1998 and another \$4,375 for 25 hours of attorney time between December 1 and December 7, 1998 (Itemized Statement, Tabs A, B). However, no adversary adjudication was then pending. Staff investigations that precede the filing of OIPs in administrative proceedings are not adversary adjudications under the EAJA. See Proposed EAJA Rules, 43 SEC Docket 672, 672 n.5 (Mar. 15, 1989) (citing Family Television, Inc. v. SEC, 608 F. Supp. 882, 883-84 (D.D.C. 1985)); EAJA Rules, 24 SEC Docket 436, 436 (Dec. 18, 1981); cf. Rowell v. Sullivan, 813 F. Supp. 78, 79-81 (D.D.C. 1993).

Fees and expenses incurred in connection with collateral matters. Applicants also seek reimbursement of fees and expenses for preparing and submitting materials to state securities regulators in Maryland and Connecticut, the NASD, and the Certified Financial Planner Board of Standards, Inc., during March 2000 and March 2001 (Itemized Statement, Tabs C, D). Such fees and expenses were not incurred “in connection with” the Commission’s adversary adjudication. Rather, such filings reflect the fact that other financial regulators, in addition to the Commission, exercise oversight of Applicants’ professional conduct. Such fees and expenses are not recoverable from the Commission under the EAJA. Because of the block-billing format of the Itemized Statement, it is impossible to be precise in calculating the dollar amount of the fees and expenses that should be disallowed.

⁵ See United States v. Jones, 125 F.3d 1418, 1427-29 (11th Cir. 1997); Hanover Potato Products, Inc. v. Shalala, 989 F.2d 123, 131 (3d Cir. 1993); SEC v. Morelli, 1995 U.S. Dist. LEXIS 141, at *14-29 (S.D.N.Y. Jan. 11, 1995).

Fees and expenses incurred for the preparation of pleadings not authorized by the Rules of Practice or by Order. At the close of the hearing, the parties agreed that the Division would file its posthearing pleadings first, with Applicants filing their posthearing pleadings a month later (Tr. 808). Because the Division had the burden of proof, the parties further agreed that the Division would have the last word in a reply brief (Tr. 808). Rule 340(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.340(b), does not contemplate the filing of any additional posthearing pleadings, "except with leave of the hearing officer." I did not grant such leave at the hearing, in my Order of July 1, 1999, or at any other time.

Nonetheless, after the Division filed its Reply Brief, Applicants tendered a two-and-one-half page "Posthearing Sur-Reply Brief" on September 24, 1999. Applicants now seek to recover for 10.25 hours of billable time their attorneys devoted to this task (Itemized Statement, Tab B). The request for reimbursement is inappropriate, because I did not authorize the pleading.

Applicants engaged in a similar tactic after the Commission granted review of the initial decision. In the last appellate pleading they filed with the Commission, Applicants argued that the sanctions imposed in the initial decision should be set aside because the Commission's procedure for appointing Administrative Law Judges violated the Appointments Clause of the United States Constitution, Article II, Section 2, Clause 2 (Opposition Brief to the Brief Supporting the Petition for Review of the Division of Enforcement, filed May 31, 2000, at 22-24). As support, they cited Freytag v. Commissioner, 501 U.S. 868 (1991). Applicants also raised this issue at oral argument before the Commission in July 2003. They now seek recovery for approximately 12.20 hours of attorney and paralegal time devoted to researching the issue between May 17 and May 22, 2000 (Itemized Statement, Tab C).

Inasmuch as the Supreme Court issued its Freytag opinion in 1991, one must initially wonder why Applicants waited until the final pages of their last appellate pleading to raise their Appointments Clause challenge—a juncture at which the Division had no opportunity to reply.

Some light may be shed on Applicants' timing if one recognizes that the May 17, 2000, issue of the Fulton County Daily Report, a legal publication in the Atlanta area, featured an article by Martha Coyle entitled "High Court May Hear Challenge To Selecting Administrative Law Judges" (official notice). The article explained how the U.S. Court of Appeals for the District of Columbia Circuit had rejected an Appointments Clause challenge under Freytag, and how the unsuccessful party in that case was preparing a petition for a writ of certiorari. See Landry v. FDIC, 204 F.3d 1125, 1130-34 (D.C. Cir.), cert. denied, 531 U.S. 924 (2000). Fees and expenses incurred in connection with this issue are not recoverable. Applicants did not identify the Freytag issue in their application for Commission review, nor did they discuss it in their opening brief to the Commission. Rule 411(d) of the Commission's Rules of Practice, 17 C.F.R. § 201.411(d), provides that Commission review of an initial decision "shall be limited to the issues specified in the petition for review."

Attorney fees billed at market rates that exceed the EAJA's \$125 per hour fee cap. Applicants urge that the statutory fee cap of \$125 per hour should be "disregarded," and that fees

should be awarded to them based on prevailing market rates in line with those in the community for similar services of lawyers of reasonably comparable skill and reputation (Fee Application at 15). The hourly rates charged to Applicants for the services of the law firm partner who represented them throughout this case ranged from \$250 in 1998 to \$325 in 2003. The hourly rates of the attorneys who assisted him ranged from \$115 in 1998 to \$225 in 2003 (Fee Application, Exhibit G). Applicants presented evidence that the prevailing market rate for lawyers specializing in Commission enforcement matters in the Atlanta area ranged from \$275 to \$400 per hour during 1998 and 1999, and from \$350 to \$500 per hour from 2000 to 2003 (Fee Application, Exhibit H).

The EAJA, 5 U.S.C. § 504(b)(1)(A), provides that “reasonable” attorney fees are recoverable, and it further states that the amount of fees awarded “shall be based upon prevailing market rates for the kind and quality of the services furnished.” However, these provisions are subject to an exception that “attorney . . . fees shall not be awarded in excess of \$125 per hour unless the agency determines by regulation that an increase in the cost of living or a special factor, such as the limited availability of qualified attorneys . . . for the proceedings involved, justifies a higher fee.” 5 U.S.C. § 504(b)(1)(A)(ii).

The Supreme Court has held that the clause of the EAJA permitting an increased hourly rate for special factors must be read narrowly and cannot be read to encompass situations in which normally skilled and qualified attorneys are simply in short supply. *See Underwood*, 487 U.S. at 571-73. One district court has determined that specialization in securities law is not a special factor justifying an increase in the EAJA’s hourly fee cap. *See Morelli*, 1995 U.S. Dist. LEXIS 141, at *35.⁶

At no time since 1981, when the EAJA became effective, has the Commission instituted a rulemaking proceeding leading to the adoption of a formula for cost of living adjustments to the statutory cap on hourly fees.⁷ Nor have Applicants requested the Commission, by petition for

⁶ In *Morelli*, the court stopped short of saying that a specialty in securities law could never constitute grounds for exceeding the statutory cap. The court also granted the applicant’s alternative request for a cost of living adjustment to the statutory cap.

⁷ When Congress enacted the EAJA in 1980, it directed agencies to consult with the Chairman of the Administrative Conference of the United States (ACUS) and then to establish uniform procedures for the submission and consideration of fee applications in their administrative proceedings. *See* Pub. L. No. 96-481, Title II, § 203, 94 Stat. 2326 (Oct. 21, 1980). To facilitate that process, ACUS developed Model EAJA Rules to guide the individual agencies in drafting their own EAJA rules. *See* 46 Fed. Reg. 32,900 (June 25, 1981). The Model EAJA Rules were not binding on the individual agencies because ACUS’s statutory role was consultative only, and EAJA did not empower ACUS to compel other agencies to adopt specific procedures or interpretations.

Model EAJA Rule 0.107(a) explained how agencies might award attorney fees at a rate higher than the statutory cap, if warranted by an increase in the cost of living or by special factors. Model EAJA Rule 0.107(b) provided that any person might file with an agency a

rulemaking or otherwise, for an increase in the allowable hourly rate. Absent such a request and a favorable ruling by the Commission, I am without authority to consider Applicants' request for attorney fees at rates higher than the maximum rate allowed by the EAJA.

**Whether The Commission Has Been Arbitrary
And Capricious In Failing To Increase The Hourly
Fee Cap In Its EAJA Regulations To Match
The Increased Hourly Fee Cap In The Statute**

The Commission's EAJA regulations have capped attorney fees at \$75 per hour since 1981. See 17 C.F.R. § 201.36(b). Congress amended the EAJA in March 1996 to raise the maximum attorney fees recoverable from \$75 per hour to \$125 per hour for adversary adjudications commenced on or after the effective date of that legislation. See Contract With America Advancement Act of 1996, Pub. L. No. 104-121, Title II, §§ 231-33; 110 Stat. 862 (Mar. 29, 1996). This adversary adjudication was commenced after the effective date of the legislation.

Because Congress raised the EAJA's hourly fee cap from \$75 to \$125, Applicants argue that the Commission's failure to amend its EAJA regulations during the intervening seven-and-one-half years to make the regulations consistent with 5 U.S.C. § 504(b)(1)(A) is unreasonable, arbitrary, and capricious (Fee Application at 16-17).

Two days before Congress revised the EAJA in 1996, former Commission Chairman Arthur Levitt wrote to Congressman John D. Dingell, expressing the Commission's opposition to the EAJA provisions of the legislation. See 142 Cong. Rec. H2984-85 (Mar. 28, 1996). In his March 27, 1996, letter, former Chairman Levitt stated that "the Commission is very supportive of fostering small business endeavors, [but] it has serious concerns that the bill could have a negative impact on the Commission's enforcement program." Id. at H2984. Attached to former Chairman Levitt's letter was an analysis of the legislation by the Commission's staff. Footnote 5 of the staff's analysis specifically objected that the proposed amendments to the EAJA "would further increase the burden on the Commission by increasing the fee rate for attorney's fees from \$75 per hour to \$125 per hour." Id. at H2985. Former Chairman Levitt concluded his letter by stating: "We believe that the Commission's concerns can be easily met through appropriate exemptive provisions for the SEC." Id. at H2984. Congress enacted the legislation without an SEC carve-out.

Over the intervening seven-and-one-half years, numerous federal agencies have revised their EAJA regulations to raise the hourly fee cap for their adversary adjudications from \$75 to \$125. These include:

petition for rulemaking to increase the maximum allowable rate for attorney fees. It also urged the individual agencies to commit themselves to responding to such a petition for rulemaking within sixty days after it was filed. See 46 Fed. Reg. at 32,913. The Commission explicitly declined to adopt Model EAJA Rule 0.107, as recommended by ACUS. See EAJA Rules, 24 SEC Docket at 436-37.

<u>Regulation</u>	<u>Agency</u>	<u>Effective Date</u>
5 C.F.R. § 2430.4(a)	Federal Labor Relations Authority	March 29, 2000
5 C.F.R. § 2610.107(b)	Office of Government Ethics	March 18, 1998
7 C.F.R. § 1.186(b)	Agriculture Department	October 11, 2002
12 C.F.R. § 308.175(a)	Federal Deposit Insurance Corp.	November 16, 1999
12 C.F.R. § 1705.5(a)	Housing and Urban Development	December 26, 2000
14 C.F.R. § 14.05(b)	Federal Aviation Administration	June 28, 1999
29 C.F.R. § 2204.107(b)	Occ. Safety & Health Rev. Comm.	July 3, 1997
29 C.F.R. § 2704.106(b)	Mine Safety & Health Rev. Comm.	December 14, 1998
39 C.F.R. § 960.6(b)	Postal Service	November 2, 2001
46 C.F.R. § 502.501(f)(2)	Federal Maritime Comm.	May 1, 1999
47 C.F.R. § 1.1506(b)	Federal Communications Comm.	July 31, 1996
49 C.F.R. § 6.11(b)	Transportation Department	May 21, 1997

The Commission has not updated the hourly fee cap in its EAJA regulations, and it has not attempted to hide that fact. See Russo Secs., Inc., 71 SEC Docket 74, 77 n.10 (Nov. 10, 1999) (“Rule 36(b) of our EAJA regulations (17 C.F.R. § 201.36(b)) still imposes a ceiling of \$75 per hour on attorneys’ fees.”). In essence, Applicants’ objection is that the Commission has granted itself part of the carve-out that Congress declined to enact.

At about the same time that Congress revised the EAJA, it also passed the Debt Collection Improvement Act of 1996, Pub. L. No. 104-134, 110 Stat. 1321 (Apr. 26, 1996). That statute requires the Commission to make inflation adjustments to civil monetary penalty sanctions imposed for violations of the federal securities laws. The Commission has twice made upward adjustments for such civil monetary penalty sanctions since 1996. See 17 C.F.R. §§ 201.1001, .1002.

The Commission has also moved with dispatch to make periodic adjustments to the fee rates it collects from issuers on the registration of securities under Section 6(b) of the Securities Act, on specified repurchases of securities under Section 13(e) of the Exchange Act, on proxy solicitations and statements in corporate control transactions under Section 14(g) of the Exchange Act, and from national securities exchanges and national securities associations on transaction fees under Section 31 of the Exchange Act. See Investor and Capital Market Fee Relief Act, Pub. L. No. 107-123, 115 Stat. 2390 (Jan. 16, 2002).

Statutes always take precedence over conflicting administrative regulations. See, e.g., Ellis v. Gen. Motors Acceptance Corp., 160 F.3d 703, 709 (11th Cir. 1998); Caldera v. J.S. Alberici Constr. Co., 153 F.3d 1381, 1383 note ** (Fed. Cir. 1998); Wolf Creek Collieries v. Robinson, 872 F.2d 1264, 1268 (6th Cir. 1989); Pacific Gas and Elec. Co. v. United States, 664 F.2d 1133, 1136 (9th Cir. 1981). Because the EAJA is a statute of general applicability and the Commission’s EAJA regulations purport to interpret 5 U.S.C. § 504, the usual deference accorded to an agency’s interpretation of its own regulations does not apply in the event of judicial review. See Adams v. SEC, 287 F.3d 183, 190 (D.C. Cir. 2002).

Applicants have not established that there is a conflict between 17 C.F.R. § 201.36(b) (which, after twenty-two years, still caps fees at \$75 per hour) and the revised statute (which provides that agencies may not award fees in excess of \$125 per hour). The revised EAJA generally prohibits agency awards above the \$125 per hour maximum, but it does not require agencies to award fees at the maximum or even above the previous maximum of \$75 per hour.

The Commission's regulatory inaction since March 1996 is not an inadvertent oversight, but rather, appears to be a conscious policy choice. As such, Applicants' claim that the Commission has acted unreasonably, arbitrarily, and capriciously is more appropriately addressed to the Commission itself, rather than to the undersigned.

RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), it is certified that the record includes the items set forth in the record index issued by the Secretary of the Commission on October 18, 1999, as supplemented on November 21, 2003.

ORDER

IT IS ORDERED THAT the Application for Fees and Other Expenses filed by Michael Flanagan, Ronald Kindschi, and Spectrum Administration, Inc., is denied.

This initial decision shall become effective in accordance with and subject to the provisions of 17 C.F.R. § 201.57. Pursuant to that Rule, a petition for review of this initial decision may be filed within twenty-one days after service of the decision, in accordance with the procedures set forth in 17 C.F.R. §§ 201.410-411. If the parties do not seek review and the Commission does not take review on its own initiative, this initial decision shall become a final decision of the Commission thirty days after it is issued. See 17 C.F.R. § 201.57.

James T. Kelly
Administrative Law Judge