UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDINGS RULINGS
Ruling No. 712 / July 13, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14856

In the Matter of	:	
	:	ORDER ON MOTION TO STRIKE
EGAN-JONES RATINGS COMPANY and	:	PRELIMINARY STATEMENT AND
SEAN EGAN	:	AFFIRMATIVE DEFENSES
	:	

The Securities and Exchange Commission (Commission) issued an Order Instituting Administrative and Cease-and-Desist Proceedings (OIP) on April 24, 2012, pursuant to Sections 15E(d) and 21C of the Securities Exchange Act of 1934 (Exchange Act). Respondents filed their Answer on June 1, 2012, which contains a Preliminary Statement and affirmative defenses. The hearing is currently scheduled to commence on September 10, 2012.

Pending before me is the Motion of the Division of Enforcement (Division) to Strike Preliminary Statement and Affirmative Defenses From Answer of Respondents (Motion to Strike).[1] The Motion to Strike is granted in part, denied in part, and deferred in part.

Preliminary Statement

The Division contends that Respondents' Preliminary Statement is irrelevant and should, therefore, be stricken. Div. Memo, p. 5. The OIP alleges that, beginning in July 2008, Respondent Egan-Jones Ratings Company (Egan-Jones) made material misstatements and omissions in its applications filed with the Commission to become a Nationally Recognized Statistical Rating Organization (NRSRO) for issuers of asset-backed securities (ABS) and various government securities. OIP, pp. 1-2. The alleged misstatements and omissions relate to the extent and duration of Respondents' activities issuing ratings on ABS and government securities prior to its applying for NRSRO certification. OIP, p. 2.

The OIP also alleges that Egan-Jones stated in submissions to the Commission that it was unaware whether its subscribers held long or short positions in particular securities, while, in

[1] The parties filed the following: the June 7, 2012 Motion to Strike and Memorandum in Support of Motion to Strike (Div. Memo); Respondents' June 14, 2012 Opposition to Motion to Strike (Opposition) and Memorandum of Law in Opposition (Resp. Memo); and the Division's June 20, 2012 Reply Memorandum in Support of Striking Preliminary Statement and Affirmative Defenses (Reply).

some instances, Egan-Jones salespeople knew whether clients had long or short positions. OIP, p. 2. Finally, the OIP alleges that Egan-Jones failed to enforce its conflict of interest policies and record-keeping requirements. Id.

Respondents' Preliminary Statement makes several points: Egan-Jones's investor-paid model differs from, and is less conflicted than, issuer-paid rating agencies; the Commission's Office of Compliance Inspections and Examinations (OCIE) staff did not fully comprehend this difference, which adversely impacted its examinations; Respondent Sean Egan is an outspoken advocate of investor-paid rating agencies; and that, given its issuer independence, Egan-Jones's ratings are more accurate than the ratings issued by issuer-paid rating agencies. Answer, pp. 2-3.

Because the Preliminary Statement does not directly address the allegations that Egan-Jones's NRSRO applications included misstatements and omissions, the Division argues it is irrelevant and should be stricken. Div. Memo, pp. 3, 5-6. The Division also argues that the Preliminary Statement's allegation that OCIE staff mishandled the examination of Egan-Jones is scandalous and impertinent. Div. Memo, pp. 3-5.

In opposition, Respondents argue that their Preliminary Statement should not be stricken because it is relevant to their defenses. Resp. Memo, p. 5. Specifically, Respondents argue that the statements regarding their independence and high quality ratings and their criticism of OCIE staff behavior are central to certain affirmative defenses. Resp. Memo, pp. 5-7.

Rule 152(f) of the Commission's Rules of Practice provides that "[a]ny scandalous or impertinent matter contained in any brief or pleading . . . may be stricken on order of . . . the hearing officer." 17 C.F.R. § 201.152(f). This Rule permits an ALJ to strike matter which "improperly casts a derogatory light on someone, usually a party to the action," as well as matter that is "not responsive or relevant to the issues involved." Donald T. Sheldon, Administrative Proceedings Release No. 304 (July 22, 1988), 52 S.E.C. Docket 461 (defining "scandalous matter" and "impertinent matter" of Rule 152(f), respectively). Under Sheldon, even when read in combination with Rules 103(a) and 111, Rule 152(f) does not have the same scope as Federal Rule of Civil Procedure 12(f), which permits striking material that is also redundant or immaterial. 17 C.F.R. §§ 201.103(a), .111.

Applying this standard, the Preliminary Statement will not be stricken. To be sure, the OIP does not address the content or quality of Egan-Jones's ratings, and therefore the Preliminary Statement's focus on Egan-Jones's independence and quality of ratings is irrelevant to the Division's allegations. Div. Memo, p. 3. However, first, this does not significantly prejudice the Division. It is not clear that the Division will have to disprove the Preliminary Statement at the hearing, even if all of Respondents' affirmative defenses are litigated. Second, while Respondents' word choice is excessively argumentative for an Answer, it does not rise to the level of "scandalous." Third, and most important, the Preliminary Statement (liberally construed) clarifies and supports some of Respondents' affirmative defenses, as described below.

Affirmative Defenses

The Division moves to strike Respondents' affirmative defenses 1, 2, 9-19, and 23-29. Div. Memo, p. 6. Respondents do not request permission to file an amended Answer, and those

affirmative defenses stricken are therefore stricken with prejudice. I grant in part, deny in part, and defer ruling in part on this portion of the Division's Motion to Strike.

First Defense

The Division argues that Respondents' defense of failure to state a claim should be stricken, because the OIP alleges the required elements for liability and its claims for relief are sufficient. Div. Memo, p. 12. Respondents correctly counter that the substantive merits of the allegations in the OIP, against which this defense is directed, are for resolution at the hearing. Resp. Memo, p. 16. Therefore, the first affirmative defense will not be stricken.

Second Defense

The Division argues that Respondents' lack of particularity defense should be stricken, because Rule 220(d) of the Commission's Rules of Practice implements a specific procedure for requesting more particularity – namely, moving for a more definite statement – with which Respondents have not complied. Div. Memo, p. 11. In opposition, Respondents argue by analogy to Federal Rule 9(b) that the defense of lack of particularity is valid. Resp. Memo, pp. 14-15. Respondents also assert that the word "may" in Commission Rule 220(d) means that a motion for more definite statement need not be filed "with the answer." Id., at 16. Finally, Respondents request permission to file a motion for more definite statement. Id.

The defense of lack of particularity is not provided for in the Commission's Rules of Practice; therefore, it is invalid and is stricken. Where a Commission Rule of Practice mirrors a Federal Rule, the Commission has looked to federal courts' interpretation of the Federal Rule for guidance in interpreting the Commission Rule. See, e.g., Jeffrey L. Gibson, Exchange Act Release No. 57266 (Feb. 4, 2008), 92 S.E.C. Docket 2104, petition for review denied, 561 F.3d 548 (Mar. 11, 2009). That, however, is not the case here. Rule 220(d) is unlike Federal Rule 9(b), and it alone governs.

Neither party has sufficiently briefed the issue of when a motion for more definite statement may be filed. Respondents, therefore, are granted permission to file, no later than July 23, 2012, a motion for a more definite statement, which may well be denied due to lack of timeliness.

Defenses Nine to Eighteen

Respondents raise a number of other defenses, including violations of the First and Fourteenth Amendments. The Division argues that Respondents have not alleged any legal prejudice; therefore, as a threshold matter, these defenses fail and should be stricken. Reply., pp. 4-5. The Division initially argued these defenses were also improper equitable estoppel defenses. Div. Memo., p. 6. The Division did not address this issue in its Reply, and therefore apparently no longer takes that position, and it is meritless in any event. Reply.

The Division cites various cases to support its contention that Respondents must allege legally cognizable prejudice in their constitutional affirmative defenses. However, all such cases deal with equitable defenses of unclean hands and laches, not purely constitutional ones.

Additionally, Respondents have not had the opportunity to fully address the necessity of pleading prejudice because the Division did not raise the issue before filing its Reply.

As specified below, several of these defenses will be stricken, and I defer ruling on all but one of the others. Respondents' defenses, particularly the constitutional ones, are not always clearly pled; some seem duplicative and others incoherent. However, liberally construed, some appear to assert a valid defense. Although lack of clarity alone might provide a basis for striking a defense, the Division has not specifically moved to strike any defense on the ground that it is so poorly pled as to be impossible to respond to.

Accordingly, in lieu of striking such defenses, I will permit motion practice regarding them. For those defenses not currently stricken, the Division is granted permission to renew, before July 23, 2012, their motion to strike, and may assert new grounds for striking, and/or to file a motion for a more definite statement regarding affirmative defenses.[2]

Because defenses nine through eighteen are sometimes very similar, I address them in summary fashion. Respondents' affirmative defense number:

9. Is not stricken, as it goes to the merits of the case, and Respondents may be able to prove this defense at the hearing;

10. Is not currently stricken, because, liberally construed and read in conjunction with the Preliminary Statement, it appears to assert a First Amendment retaliation defense;

11. Is not currently stricken, for the same reason as defense number 10;

12. Is stricken, because there is no citation to a statutory or constitutional provision;

13. Is not currently stricken, although it is unclear what the two mentioned Acts are;

14. Is not currently stricken, because liberally construed and read in conjunction with the Preliminary Statement, it appears to assert an Equal Protection defense;

15. Is not currently stricken, because liberally construed and read in conjunction with the Preliminary Statement, it appears to assert a selective prosecution defense, and there has been insufficient briefing on whether the Commission staff's alleged discriminatory motives are legally sufficient;

16. Is not currently stricken, for the same reason as defense number 15;

17. Is not currently stricken, for the same reason as defense number 15;

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[2] While the Commission Rules do not specifically provide for this type of motion under these circumstances, I have found no prohibition on it (unlike the interpretation of Rule 152(f) urged by the Division, which is precluded by Sheldon, as explained supra), and it is colorably within my authority pursuant to Rule 111. See 17 C.F.R. § 201.111. In reviewing this motion, I will follow the legal standards that apply to a traditional motion for a more definite statement. See 17 C.F.R. § 201. 220(d).

18. Is not currently stricken, for the same reason as defense number 15.

Nineteenth Defense

The Division moves to strike Respondents' laches defense, which is not available against a United States government agency acting in the public interest. Div. Memo, pp. 9-10. Respondents counter that the Division is engaged in selective prosecution and, thus, not acting in the public interest. Resp. Memo, pp. 10-11.

Given the striking lack of specificity of this defense, even read in light of the Preliminary Statement, I find that the defense of laches is not available in this proceeding and strike it from Respondents' Answer. See U.S. v. Summerlin, 310 U.S. 414, 416 (1940). Additionally, whether the Division is acting in the public interest is tantamount to whether sanctions are in the public interest, which has yet to be determined. Finally, if Respondents successfully prove selective prosecution, then laches is irrelevant because, presumably, the case will be dismissed.

Twenty-Third to Twenty-Fifth Defenses

The precise nature of these defenses is unclear. The Division initially interpreted them as estoppel defenses, and argued that estoppel defenses cannot be maintained against the Commission. Div. Memo, p. 7. Respondents argue that they do not assert estoppel defenses, and then argue that many are constitutional (but do not specify which). Resp. Memo, p. 8. Defenses twenty-three to twenty-five, however, do not reference any constitutional provisions. Answer, p. 19. Respondents' Memo also has a section titled "Equitable Affirmative Defenses," which sets out its "laches" and "bad faith and unclean hands" defenses, but not its twenty-third to twenty-fifth defenses. Resp. Memo, pp. 10-12.

Thus, I rule that Respondents' affirmative defense number:

23. Is stricken, as it does not cite any statutory or constitutional provision, and, even broadly construed, it appears to be duplicative of Respondents' selective prosecution defense;

24. Is not currently stricken. Although it does not cite any statutory or constitutional provision, liberally construed and read in conjunction with the Preliminary Statement, it may assert a valid defense, but more briefing is required;

25. Is not currently stricken. Although it does not cite any statutory or constitutional provision, liberally construed and read in conjunction with the Preliminary Statement, it may assert a valid defense, but more briefing is required.

As with the other defenses on which I defer ruling, the Division is granted permission to renew, before July 23, 2012, their motion to strike on different grounds and/or to file a motion for a more definite statement as to those defenses not currently stricken.

Twenty-Sixth Defense

Respondents' affirmative defense of retroactive application of the Dodd–Frank Wall Street Reform and Consumer Protection Act civil monetary provisions is not stricken. While the Division's Motion to Strike includes this defense amongst those it moves to strike, footnote six of its Memo indicates that it does not seek to strike this defense. See Div. Memo, p. 6 n.6. Regardless, the defense is, on its face, valid though apparently incomplete.

Twenty-Seventh and Twenty-Eighth Defenses

The Division moves to strike, due to lack of prejudice, Respondents' affirmative defense that the Division withheld the production of its investigative file, including Brady v. Maryland, 373 U.S. 83, 87 (1963), and Jencks Act, 18 U.S.C. § 3500, material. Div. Memo, p. 11 n.9. The Division concedes that it has been tardy in the production of its investigative file. However, non-compliance with Commission Rule 230's production requirement is not grounds for dismissal and, therefore, not a valid affirmative defense. See 17 C.F.R. § 201.230. Similarly, non-production of Brady or Jencks Act material is not necessarily a Due Process violation, so long as these materials are eventually produced and Respondents are provided with sufficient time to prepare for the hearing. Therefore, affirmative defenses twenty-seven and twenty-eight will be stricken, but Respondents may move for relief on these matters by requesting relief other than dismissal.

Twenty-Ninth Defense

The Division moves to strike Respondents' bad faith and unclean hands defense, arguing it cannot be invoked against a government agency attempting to enforce its congressional mandate in the public interest. Div. Memo, pp. 10-11. Respondents, citing to SEC v. Cuban, 798 F. Supp. 2d 783, 784 (N.D. Tex. 2011), argue that the defense is applicable here because the Division's misconduct was egregious and the misconduct resulted in prejudice to Respondents that rises to a constitutional level. Resp. Memo, p. 12.

Adopting the Cuban standard for purposes of this Order, I find that the defense of unclean hands should be stricken. Cuban concludes that while the affirmative defense of unclean hands is not barred as a matter of law, it is only available in strictly limited circumstances "when the SEC's misconduct is egregious, the misconduct occurs before the SEC files the enforcement action, and the misconduct results in prejudice to the defense of the enforcement action that rises to a constitutional level and is established through a direct nexus between the misconduct and the constitutional injury." 798 F. Supp. 2d at 784. Cuban also stands for the proposition that these elements must be pled, as well as proven. Id. As in Cuban, Respondents failed to adequately plead the prejudice prong of unclean hands under this exacting standard. Moreover, the phrasing of defense twenty-nine suggests that the complained-of misconduct is the institution of this proceeding, not any pre-OIP action. Therefore, Respondents' defense twenty-nine is insufficiently pled.[3]

[3] Cuban deals only with equitable defenses, and I decline to extend its standard to purely constitutional affirmative defenses. See supra p. 4.

Subpoenas

The nature of many of Respondents' affirmative defenses suggests that at least some of the evidence needed to prove them is likely to be in the possession of Commission staff, but absent from the investigative file. It seems likely, therefore, that Respondents will request multiple subpoenas directed to Commission staff. It also seems likely that the Division will object to such subpoenas.

In anticipation of this, and to ensure that any objections to such subpoenas are timely resolved, all subpoena requests directed to Commission staff or requesting materials in the possession, custody, or control of the Commission, and not already produced, must be submitted no later than July 30, 2012.

Order

The Division's Motion to Strike is GRANTED IN PART and DENIED IN PART. Respondents' affirmative defenses 2, 12, 19, 23, 27, 28, and 29 are STRICKEN; the Preliminary Statement and affirmative defenses 1, 9, and 26 are NOT STRICKEN; I defer ruling on affirmative defenses on 10, 11, 13, 14, 15, 16, 17, 18, 24 and 25.

IT IS FURTHER ORDERED that renewal of a motion to strike and motions for more definite statement, as provided for in this Order, are due no later than July 23, 2012.

IT IS FURTHER ORDERED that any subpoena requests from Respondents directed to Commission staff or requesting Commission materials must be submitted to this Office no later than July 30, 2012.

Cameron Elliot
Administrative Law Judge