

Discovery Outside of the Federal Rules of Civil Procedure: The SEC's Hidden Hammer

New York Law Journal Online

April 7, 2025

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1. The SEC's Far-Reaching Investigative Tools

Most market participants are keenly aware that SEC investigatory powers are broad. However, the breadth of Staff's powers, especially when it comes to fact gathering abroad, can surprise even the most experienced regulatory defense lawyer.

SEC investigations typically feature Staff issuing subpoenas demanding a target (or witness) to testify under oath and produce relevant documents. If the subpoena's target refuses to comply, then the SEC can compel compliance through the courts.

And "[o]nce the SEC has complied with the statutory prerequisites for enforcement, the opponent has a heavy burden of proving that the subpoena is sought for an invalid purpose, and a meaningful and substantial factual showing must be made even to receive an evidentiary hearing" – all "without the aid of discovery." *Sprecher v. Graber*, 716 F.2d 968, 972 (2d Cir. 1983) (internal quotations omitted).

The SEC also regularly employs other methods that do not directly coerce parties to comply with its investigation, though they nevertheless carry the underlying threat

For instance, the SEC can request informal assistance from relevant parties, who may volunteer to sit for an interview or hand over documents, perhaps in the hope that their compliance may help them avoid enforcement litigation.

Interestingly, where the investigation involves people or entities in other countries, the SEC can request that the foreign country's securities regulator pass along the SEC's demands for testimony or documents through one of several methods (e.g., a Memorandum of Understanding with the other country, Hague Convention letters, or letters rogatory).

Depending on the country, the foreign regulator may be able to choose to decline the SEC's request. Where the foreign regulator agrees to forward the SEC's request, however, it may also enforce compliance, even though the SEC itself may not. *Compare* 15 U.S.C. 78u(a)(2) (SEC may *request* assistance from foreign regulators) (emphasis added) *with* FCA Enforcement Guide §2.16 (UK securities regulator may "*require* the production of documents, the provision of information or the answering of questions" "to assist overseas regulators") (emphasis added).

Regardless of whether the investigation remains entirely within the US or involves foreign entities and regulators, SEC investigations and subpoenas are generally confidential, meaning that the existence of an investigation (the corresponding subpoenas and the precise nature of the investigation) are not disclosed to investigation targets until after – and only if – the SEC determines it will pursue civil litigation.

2. The SEC's Continued Use of Investigatory Powers After Litigation Commences

Counsel might expect that once litigation begins, the SEC's investigation ends, meaning that any further discovery must proceed according to the Federal Rules of Civil Procedure (FRCP). That assumption would be only partially correct.

Although once a case is commenced, courts have curtailed the SEC's use of investigative subpoenas to take discovery of US domiciled parties in aid of the pending litigation, courts have permitted the SEC to take foreign discovery, via cooperative arrangements which the SEC has with foreign regulators, outside of the confines of the FRCP.

In other words, the SEC can obtain documents and witness testimony without the participation of defendants in the litigation, even if such discovery is intended for use in the litigation.

For example, the Southern District of New York has twice affirmed the SEC's use of requests for assistance to foreign securities regulators for the production of documents or testimony without notice to defendants.

In *Securities and Exchange Commission v. Badian*, Case No. 1:06-cv-2621-LTS (S.D.N.Y. 2009), a defendant learned that the commission had requested assistance from the U.K.'s Financial Services Authority to obtain, during the pendency of the publicly filed litigation and without notice to defendant, a trove of documents from a British accounting firm previously engaged by the defendant's company.

The accounting firm claimed a "duty to report" to its clients that its documents were being sought and produced, but the FSA insisted that the SEC's request be kept "confidential" and warned that, though the documents were "being sought on a voluntary basis," "the FSA does have statutory powers to compel production of information and documents." *Securities and Exchange Commission v. Badian*, Case No. 1:06-cv-2621-LTS, ECF No. 112 at Exs. 4, 6-7.

The defendant eventually learned of the SEC's request (and FSA demand) and complained to the court that the SEC's request for "secret assistance" "for use in this litigation only and not in connection with any . . . open separate investigation" violated the FRCP, the SEC's own enforcement manual, and the court's scheduling order.

But the court was not concerned, finding that "nothing in [the] Rules prohibits an attorney from investigating an action and gathering evidence outside of the Rules' discovery provisions." Further, "[t]he fact that the SEC enjoys recourse to a particular method of *ex parte* investigation that has legal force in a foreign tribunal under foreign law is immaterial."

Defendant's protest that the issuance of the subpoenas violated the SEC's own rules and the court's scheduling order was also not well-taken because "[t]he SEC's internal manual does not have the force of law" nor did the scheduling order prohibit the SEC from using "other means of obtaining evidence located abroad."

A similar scenario occurred in *Securities and Exchange Commission v. Ripple Labs, Inc.*, 540 F. Supp. 3d 409 (S.D.N.Y. 2021), where the SEC requested the same documents from multiple foreign entities under both a Request for Assistance sent to each country's securities regulator and a Rule 45 subpoena sent to the parties themselves.

Defendants argued that the SEC's use of its investigative powers concurrent with discovery violated the federal rules, and that "[h]aving chosen to bring its case in federal court, the SEC should seek foreign discovery through established processes . . . like every other litigant, rather than utilizing a procedure available only to the SEC."

The court disagreed, finding that “the fact that this discovery tool is one-sided does not render it unlawful” because “parties to litigation routinely experience imbalances in resources or otherwise.” 540 F. Supp. 3d at 411.

Courts also approve the SEC’s investigatory powers without notice to defendants in other scenarios. In *S.E.C. v. Honig*, 18-cv-8175, at ECF No. 184 (S.D.N.Y. Sept. 30, 2019), the court permitted the SEC to issue investigative subpoenas and conduct civil litigation on the same defendants simultaneously where the investigation was focused solely on conduct post-dating the allegations in the complaint.

Defendants had raised concerns that the SEC would use information from its investigation in the pending civil litigation in violation of the FRCP. The SEC briefed the court in camera and ex parte on the contents of its investigation, and the court determined that because neither party identified “any specific discovery that the SEC intends to use in this case at this time,” it permitted the investigation to continue.

It noted, however, that “if and when any party becomes aware of a subpoena, deposition, interrogatory, or other manner of discovery related to this case and taken in a manner violating the Federal Rules, the party may file an appropriate motion for relief.”

The Southern District of New York issued a similar ruling in *S.E.C. v. F.N. Wolf & Co., Inc.*, No. 93 Civ. 0379 (LLS), 1993 WL 568717 (S.D.N.Y. Dec. 14, 1993), holding that the SEC’s “institution of civil litigation did not shrink the scope of the investigative resources available to the SEC, nor limit its use of information obtained from those resources to purposes *other than the litigation*.”

Seemingly, the only occurrences where litigants have successfully challenged the SEC’s extrajudicial discovery is where both the target of, and the information sought, reside domestically. In *Securities and Exchange Commission v. Life Partners Holding, Inc.*, Cause No. 1:12-CV-00033-JRN, 2012 WL 12850253 (W.D. Tex. Aug. 17, 2012), the SEC alleged that public company Life Partners fraudulently misled its shareholders about its financial strength. After commencement of the action, the SEC took the investigative deposition of the company’s auditor, who was a non-party.

The deposition, taken without notice to the defendants, focused in part on the allegations of the complaint. When the defendants discovered that the SEC had used its subpoena power after commencement of the lawsuit without their knowledge, they filed a motion to prohibit use of the subpoenaed testimony.

Although the SEC contended that it took the deposition to determine whether to bring an enforcement action against the auditor, the court disagreed, explaining that the SEC “cannot administer an extra-judicial deposition regarding an investigation, elicit testimony during that deposition regarding allegations made in the complaint for use against defendants, and then claim immunity from the FRCP by labeling the deposition as ‘investigative.’”

The court further found that the deposition was subject to the FRCP which requires notice, and because the SEC never sought leave of court to take a pre-Rule 26(f) conference deposition or give notice to plaintiffs, the SEC violated Rule 30(b)(1).

In sum, the SEC can and often does use its investigatory powers to covertly conduct discovery in aid of ongoing active federal court litigation in instances where it seeks information that is abroad or from foreign domiciled parties.

Even though such discovery could impact the pending court action, notice is not given to defendants. And the SEC has at times used its investigative powers to take post-litigation unilateral testimony from even domestic parties.

Not only does the use of these powers grant the SEC a unilateral advantage, but because this fact-finding occurs outside the litigation itself, defendants cannot use the Federal Rules to oppose or object to the discovery sought, nor does the court overseeing a parallel, filed litigation exercise its authority in the normal course to supervise this special discovery.

3. Strategic Considerations for Counsel

Counsel for defendants in cases against the SEC should remain mindful that the SEC retains its broad and unique investigative powers, especially when it comes to foreign discovery.

Foremost, the SEC can often coax U.S. based witnesses to produce information and sit for interviews voluntarily and thus also take covert domestic discovery during pending actions. Knowing that defense counsel is on this uneven playing field, discovery and litigation strategies must be devised accordingly.

Discovery demands to the SEC should be continuing in nature and should be drafted to learn of all related document requests.

In the event that counsel for a defendant learns that the SEC has taken post-litigation investigative testimony without the participation of counsel for the defendants in the litigation, counsel should challenge the SEC's use of the testimony as was successfully done in *Life Partners*.

To stay abreast of developments, and to quickly identify any discovery sought outside of the normal course, counsel for defendants in SEC enforcement actions should also contemplate continuing to liaise with any lawyers who may have been a part of any common interest agreements that might have been in place prior to the commencement of an action, but whose clients ultimately were not named as defendants in pleadings filed by the SEC.

These lawyers, especially if they represent a party that is abroad, might have more insight into the SEC's discovery tactics than would otherwise be apparent. Ultimately, a proactive, well-prepared and aggressive approach to discovery will make a significant difference in how cases against the SEC unfold.

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