BSF | BOIES SCHILLER FLEXNER

MICHAEL D. ROTH
mroth@bsfllp.com

September 1, 2017

Hon. Jason S. Patil
Administrative Law Judge
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: *In the Matter of RD Legal Capital, LLC, et al.*
Administrative Proceeding No. 3-17342

Dear Judge Patil:

Respondents RD Legal Capital, LLC and Roni Dersovitz ("Respondents") submit this letter in accordance with paragraph 8 of the Court's May 2, 2017 Post-Hearing Order permitting Respondents to memorialize their constitutional objections to this Administrative Proceeding.

I. Respondents Incorporate by Reference their Prior Facial Challenges to this Administrative Proceeding

Respondents previously raised several facial constitutional challenges to this Administrative Proceeding, and now renew the following arguments: (1) the appointment of the administrative law judges ("ALJs") who preside over SEC administrative proceedings violates the Appointments Clause in Article II of the United States Constitution; (2) the tenure protection afforded to ALJs violates the Vesting Clause in Article II of the Constitution; and (3) SEC administrative proceedings violate the Due Process Clause of the Fifth Amendment to the Constitution.

Respondents have previously briefed these issues and recognize that this Court has noted that it lacks the authority to address the Appointments Clause issue (TR6814:13-16 (Patil)), the Commission has previously rejected Appointments Clause challenges, *see, e.g., In the Matter of Lynn Tilton*, Release No. 3885, 2017 WL 3214456 (July 28, 2017) (declining to follow *Bandimere v. SEC*, 844 F.3d 1168 (10th Cir. 2016)), and this Court recently rejected similar facial challenges to SEC administrative proceedings, *see In the Matter of Donald F. ("Jay") Lathen, Jr., et al.*, Release No. 1161 at 4 (Aug. 16, 2017). Accordingly, Respondents do not repeat those arguments here but instead incorporate them by reference and attach as Exhibit A their prior brief addressing the constitutional infirmities of SEC

administrative proceedings. In addition, as discussed below, Respondents also bring an as-applied due process challenge to the way the Division's case has been presented throughout this proceeding.

II. The Division's Vague Allegations and Shifting Theories of Liability Denied Respondents a Meaningful Opportunity to Understand the Issues and Meet the Charges During the Course of the Proceeding

"It is a well established principle that procedural due process is required in administrative proceedings when adjudications of fact are made which operate to deprive a person of a constitutionally protected interest." *McDonald v. McLucas*, 371 F. Supp. 831, 834 (S.D.N.Y.), *aff'd*, 419 U.S. 987 (1974). "'Administrative due process is satisfied where the party against whom the proceeding is brought understands the issues and is afforded a full opportunity to meet the charges during the course of the proceeding.'" *In the Matter of Donald F. ("Jay") Lathen, Jr., et al.*, Release No. 1161 at 5 (quoting *Application of Jonathan Feins*, Exchange Act Release No. 41943, 1999 WL 770236, at *7 (Sept. 29, 1999)); *see also Savina Home Indus., Inc. v. Sec'y of Labor*, 594 F.2d 1358, 1365 (10th Cir. 1979) (finding that respondents in administrative proceedings have a basic due process right to be reasonably appraised of the issues in controversy).

Prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the Division would have had no choice but to bring a case against unregistered individuals, such as Respondents, in an Article III court.[1] Moreover, because it alleges that Respondents committed fraud, had the Division brought this case in federal court, it would have been subject to the heightened pleading requirements set forth in Rule 9(b) of the Federal Rules of Civil Procedure. *See* Fed. R. Civ. P. 9(b) ("In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake.").

"The primary purpose of Rule 9(b) is to afford defendant fair notice of the plaintiff's claim and the factual ground upon which it is based." *Ross v. Bolton*, 904 F.2d 819, 823 (2d Cir. 1990) (citing *Denny v. Barber*, 576 F.2d 465, 469 (2d Cir.1978)); *cf.* TR6827:21-25 (Patil) ("I mean, the purpose of specificity, to the extent it's required in a complaint under the federal rules or in an OIP subject to a motion for more definite statement, is to provide notice to enable discovery and the preparation of a defense."). By circumventing these particularity requirements, the Division was permitted to file a vague, "kitchen-sink" complaint that failed

[1] *See, e.g.*, *Tilton v. SEC*, 824 F.3d 276, 279 (2d Cir. 2016), *cert. denied*, 137 S. Ct. 2187 (2017) ("Until 2010, the SEC's authority to impose monetary penalties through administrative proceedings was relatively limited. The agency could not, for example, penalize a non-regulated person such as Tilton through administrative channels. The Dodd-Frank Act dramatically expanded the SEC's authority to impose penalties administratively, making it essentially 'coextensive with [the SEC's] authority to seek penalties in Federal court.'") (quoting H.R. Rep. No. 111-687, at 78 (2010)).

to identify the particular alleged misstatements or omissions on which the Division based its securities fraud claims against Respondents. While Respondents strongly believe and reiterate that they did not violate the securities laws, the vague and overbroad allegations in the OIP materially prejudiced Respondents' ability to prepare and present their defense, and impermissibly undercut Respondents' opportunity to understand the issues and meet the charges during the course of the proceeding. The Division's refusal to clearly articulate its claims, moreover, was particularly prejudicial given the limited discovery rights available in administrative proceedings.

Specifically, Respondents were unable to discern from the OIP exactly what theory of liability the Division intended to pursue at the proceeding, and which particular representations the Division claimed were inaccurate. Indeed, the OIP includes statements suggesting that the Division's fraud claims were based on alleged statements and/or omissions by Respondents to the effect that the Funds' strategy did not involve investment in default judgments such as the *Peterson* judgment. *See* OIP ¶¶ 10 ("The Funds' stated strategy was to invest in the legal receivables of attorneys in connection with *settlements* those attorneys have obtained on behalf of their clients.") (emphasis added), 3 ("By December 2013, over 60% of the [F]unds' assets were invested in a default judgment relating to litigation associated with the Iranian terrorist bombing of the United States Marine Barracks in Beirut.").[2] Respondents accordingly prepared their defense based on these supposed misrepresentations or omissions about default judgments, and were shocked when the Division completely abandoned the supposedly "significant distinction" between settlements and judgments in its opening statement at the administrative hearing:

> Now, in their [pre-hearing] brief, [R]espondents seek to highlight that some of their documents in some places included the words "judgments," that there were settlements and judgments, but that, of course, misses the point, and it is the essence of how Roni Dersovitz deceived his investors.
> The Court will hear from investors, many of whom weren't lawyers. They didn't focus on the legal niceties of when a case is technically settled, when a judgment is technically a judgment or a default judgment or final or otherwise. They understood the world in the two buckets Roni Dersovitz described: Resolved cases, settled beyond the point of dispute, beyond any litigation risk, beyond the point of appeal; and

[2] *See* also OIP ¶ 16 ("The modification [to the Offering Documents clarifying that the Funds invested in judgments] also failed to capture the significant distinction between a judgment obtained after full litigation and a default judgment—an important failure given that the Funds had invested the majority of their assets in receivables associated with a single default judgment, as discussed below.").

> other cases where you still have some fight going on, cases where a party like Iran might say, "I don't want to pay," cases where a drug company might say, "I'm going to fight you in court." It's not a settlements/judgment issue, it's a resolved/unresolved issue because that's how Mr. Dersovitz explained his fund to investors, just like we saw the FAQ did.

TR49:20-50:15 (Birnbaum).

By the end of the hearing, there was no longer any question that the Division's theory of the case had evolved from the supposed distinction between settlements and default judgments, to the difference between investments that did or did not have "litigation risk." Indeed, on the very first page of its post-hearing brief, the Division proclaimed that "[a]t *the core of this case* is the chasm between the 'post-settlement,' 'no litigation risk' strategy Dersovitz sold to investors, and the Flagship Funds' actual investments." (Div. Post-Hearing Br. at 1) (emphasis added). However, after Respondents demonstrated in their post-hearing brief that the *Peterson* and Cohen investments did not have any material litigation risk (and that the Osborn investments were indisputably part of a workout *outside* of the Funds' primary strategy), the Division pivoted once again in its post-hearing reply brief, claiming, incredibly, that the distinction between litigation risk and collection risk "does not matter." (Div. Reply Br. at 1-2 ("Now, having constructed a portfolio so dependent on disputed litigations, Respondents quibble over which cases involved 'litigation risk' and which involved the supposedly distinct 'collection risk.' The answer, of course, is that it does not matter."))[3]

The moving target that has resulted from the Division's constantly shifting theory of liability[4] has substantially interfered with Respondents' constitutional due process rights in at

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[3] Having abandoned the distinction between settlements and judgments, and acknowledged that Respondents disclosed their investments "in settled cases and non-appealable judgments" (Div. Reply Br. at 1), the Division's newest theory leads to an absurd result: Respondents could invest in a judgment *only* if (1) the judgment could not be overturned (*i.e.*, there was no litigation risk), and (2) if there were collection proceedings, they would be uncontested (*i.e.*, there was no collection risk). This theory is not grounded in reality or the evidence, and in fact would eliminate any need for legal funding, let alone funding that yields a 13.5% return. Accordingly, even if some investor had testified to such an understanding—which none did—that investor could not be considered reasonable. (Resp. Post-Hearing Br. at 22 ("There is no such thing as a risk-free investment, however, and certainly not one that delivers a 13.5% compounded return."))

[4] Respondents' ability to prepare their defense against the surviving misrepresentation claims was further hampered by the Division's decision first to pursue, then obstinately refuse to dismiss, valuation claims that the Court recently dismissed summarily on the ground that they

least two ways. First, because the Division has persisted since the filing of the OIP in its refusal to specifically and consistently identify Respondents' allegedly fraudulent statements, Respondents have been deprived of a full opportunity to understand the issues and meet the charges during the course of the proceeding. *See Lathen,* Release No. 1161 at 5. This is particularly true with respect to the Division's dramatic about-face in its reply brief regarding the purported insignificance of the concept of litigation risk to its fraud claims against Respondents. Indeed, at the hearing this Court noted that any lack of notice in the OIP was essentially cured by the notice provided in the Division's pre-hearing brief. *See* TR6826:12-6827:1 (Patil). The Division's pre-hearing brief, however, asserted that the case was based on the distinction between "'post-settlement' financing" and "'pre-settlement' funding strategies that exposed investors to litigation risks." (Div. Pre-Hearing Br. at 1.) In other words, the pre-hearing brief provided notice that the crux of the Division's case was "the chasm between the 'post-settlement,' 'no litigation risk' strategy" and the Funds' investments in *Peterson*, Osborn, and Cohen.[5] At this point, evidence has already closed, and Respondents are left with no opportunity at all, let alone a "full opportunity," to defend themselves against the Division's newest (and incorrect) theory of liability—that the meaning and existence of "litigation risk" does not matter.[6]

Second, the Division's failure to establish or identify specific misstatements or omissions makes it impossible for Respondents to understand or adequately challenge the number of individual violations the Division is alleging for purposes of calculating the statutory civil penalties it seeks in this proceeding. To the extent any penalties are appropriate here (which Respondents strongly dispute), the Court must determine what "each act or omission" or "each violation" means in the context of violations that may involve arguably many acts or omissions. *See, e.g., Rapoport v. SEC*, 682 F.3d 98, 108 (D.C. Cir.

"amount to nothing." (August 16, 2017 Order Granting Respondents' Rule 250(d) Motion on Valuation Allegations at 15 ("Having carefully scrutinized the Division's recitation of all evidence on this issue, I find that, as a matter of law, its allegations on valuation amount to nothing."))

[5] Of course, the additional notice of the Division's then-current theory of liability in the pre-hearing brief occurred *after* the close of discovery, and less than two weeks prior to the start of the hearing, severely disadvantaging Respondents' ability to prepare for the hearing—especially in a factually intensive case such as this, where the Division's preliminary witness list included more than 50 witnesses, pre-hearing document productions included millions of pages, and the actual hearing involved more than 40 witnesses and thousands of exhibits.

[6] The evidence at trial did establish, however, that Respondents believed correctly that the risks of collecting on the *Peterson* judgment were the same as the risks involved in any other asset in the Funds' portfolio—duration and collection risk. (*See* Respondents' Post-Hearing Brief, at Section I.B.1.(b)) ("Investments in the *Peterson* Judgment Were Consistent with the Funds' Primary Strategy.")

2012) ("These calculations do not follow the formula set by the statute. To impose second-tier penalties, the commission must determine how many violations occurred and how many violations are attributable to each person, as the statute instructs.") Here, the Division has *never* articulated how it believes these civil penalties should be calculated in any of its pre-hearing documents, opening or closing statements, or post-hearing briefs. The Division's omission is not surprising given that it has remained vague and repeatedly changed its position on the specific alleged statements and omissions that it contends were both fraudulent and material. Accordingly, the assessment of any significant penalty here raises issues both under the Due Process Clause and, depending on how this Court rules, the Excessive Fines Clause of the Eighth Amendment. *See* U.S. Const. amend. VIII ("Excessive bail shall not be required, *nor excessive fines imposed*, nor cruel and unusual punishments inflicted.") (emphasis added); *see also United States v. Bajakajian*, 524 U.S. 321, 334 (1998) ("The touchstone of the constitutional inquiry under the Excessive Fines Clause is the principle of proportionality: The amount of [a monetary penalty] must bear some relationship to the gravity of the offense that it is designed to punish.").

III. Conclusion

Given the severe consequences to Respondents that could result from an adverse determination, due process demands appropriate protections to ensure the fairness of the proceedings. *See Mathews v Eldridge*, 424 U.S. 319, 334 (1976) ("[R]esolution of the issue whether the administrative procedures provided here are constitutionally sufficient requires analysis of the governmental and *private* interests that are affected.") (emphasis added). At a minimum, due process must require that the Division clearly articulate its theory of liability *prior to the hearing* so that Respondents have a fair opportunity to respond to the allegations asserted against them. Here, for the reasons stated above and in the brief attached as Exhibit A, the procedures generally in place for administrative proceedings do not sufficiently ensure that the Division meets minimum standards of due process and, at each stage of this specific proceeding, the Division improperly obfuscated and modified its theory in a manner that denied Respondents fair notice of the charges that have now been asserted.

Sincerely,

MICHAEL D. ROTH

Attachment – Exhibit A

cc: David K. Willingham (email only)
Terence M. Healy (email only)
Michael Birnbaum (email only)
Jorge Tenreiro (email only)
Victor Suthammanont (email only)

EXHIBIT A

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-17342

In the Matter of

RD LEGAL CAPITAL, LLC and
RONI DERSOVITZ

RESPONDENTS' MOTION TO DISMISS UNCONSTITUTIONAL PROCEEDING

Roel C. Campos
Terence M. Healy
Hughes Hubbard & Reed LLP
1775 I Street, N.W.
Washington, D.C. 20006-2401
202-721-4600
www.hugheshubbard.com

Counsel for RD Legal Capital, LLC and Roni Dersovitz

David K. Willingham
Michael D. Roth
Caldwell Leslie & Proctor, PC
725 South Figueroa Street, 31st Floor
Los Angeles, CA 90017-5524
213- 629-9040
www.caldwell-leslie.com

Counsel for Roni Dersovitz

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I. INTRODUCTION

The Securities and Exchange Commission (the "SEC" or "Commission") seeks in this administrative proceeding to impose crippling monetary penalties against Respondents Roni Dersovitz and RD Legal Capital, LLC ("Respondents") based on claims that Respondents defrauded their investors (despite not a single investor losing any money). The Commission's actions, however, run afoul of core American principles of democratic accountability and procedural due process that are firmly embedded in the United States Constitution. The SEC's action against Respondents must therefore be dismissed.

First, because they exercise "significant authority," SEC administrative law judges ("ALJs") are "inferior Officers" who must be appointed in the manner required by the Appointments Clause in Article II of the United States Constitution. *See Bandimere v. U.S. Sec. & Exch. Comm'n*, 844 F.3d 1168, 1185-86 (10th Cir. 2016). The Commission, however, erroneously maintains that SEC ALJs are merely regular SEC employees exempt from the Appointments Clause. Several federal district courts and the Court of Appeals for the Tenth Circuit have unanimously agreed with Respondents' position on this issue, and an *en banc* panel of the Court of Appeals for the District of Columbia Circuit recently vacated the only judicial decision supporting the Commission's contrary view. This Court should likewise recognize the significant authority it wields over this proceeding and Respondents' fate, and hold that SEC ALJs are "inferior Officers" subject to the Appointments Clause.

Second, SEC ALJs have two layers of tenure protection, which is an independent violation of Article II of the Constitution. This insulation of SEC ALJs prevents the President from "tak[ing] Care that the Laws be faithfully executed" (U.S. Const. art. II, § 3), thereby impeding democratic accountability. Indeed, the Supreme Court has held that inferior Officers—

like SEC ALJs—charged with executing federal law may not be separated from Presidential supervision and removal by more than one layer of tenure protection. *See Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 483-84 (2010). Like the Appointments Clause, this constitutional requirement is not some historical quirk or mere technicality, but rather a direct manifestation of the Founders' bedrock commitment to representative government.

Third, the Commission's decision to bring this case as an administrative proceeding rather than a federal court action has resulted in violations of the Due Process Clause of the Fifth Amendment. Unlike SEC-registered entities, who consent to have matters within the Commission's jurisdiction adjudicated in an in-house forum, Respondents have been dragged against their will into a proceeding where the rules governing civil procedure and evidence in the federal courts do not apply, Respondents' ability to obtain discovery and prepare for trial is substantially curtailed, and Respondents are not entitled to have the SEC's claims decided by a jury of their peers. In fact, prior to the passage in 2010 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank"), the Commission was statutorily prohibited from bringing administrative proceedings seeking financial penalties against unregistered entities such as Respondents. While Dodd-Frank may have lifted that legislative restriction, it did not and could not eliminate the constitutional due process rights that undergird it.

The difficulties Respondents have faced while attempting to defend themselves in this administrative proceeding illustrate the practical impact that the selection of this forum has had on Respondents' procedural due process rights. In particular, Respondents: (a) were unable to obtain a more definite statement regarding the Commission's fraud claims, which were not pled with the particularity that would have been required under Rule 9 of the Federal Rules of Civil

Procedure; (b) were only permitted to take five depositions even though the SEC identified more than fifty witnesses on its preliminary witness list (and more than two dozen on its final witness list); and (c) were unable because of the expedited hearing schedule to file a timely motion for summary disposition establishing that the SEC has no evidence to support one of its two primary theories of liability. These impediments and others that will inevitably arise at the hearing as a result of the Commission's selection of this forum are particularly problematic considering the severity of the penalties being sought against Respondents. The difference between the procedural protections afforded in SEC administrative proceedings and those mandated in federal courts is not simply of degree but of kind.

Recognizing the appropriate and vitally important role that this Court and other SEC ALJs play in the Commission's regulatory enforcement regime, Respondents nonetheless respectfully submit that the Court should dismiss this administrative proceeding because it violates constitutional requirements of democratic accountability and procedural due process. While the Commission may believe that its claims against Respondents have merit (a proposition Respondents vigorously dispute), it has an obligation to pursue those claims in a constitutionally permissible manner (*i.e.*, in federal court).

II. PROCEDURAL BACKGROUND

The Commission initiated this administrative proceeding against Respondents by filing an Order Instituting Administrative and Cease-and-Desist Proceedings ("OIP") on July 14, 2016. Despite bringing a multi-million dollar securities fraud case against Respondents that sought massive and crippling Tier-III penalties, the SEC elected not to prosecute its claims in federal court, where Respondents would have the protections of the Federal Rules of Civil Procedure and the Federal Rules of Evidence, broad discovery rights, and the opportunity to present their

defenses to a jury of their peers. Instead, the Commission brought its claims in this forum, where those procedural and evidentiary protections do not apply, and where Respondents have significantly narrower rights to discovery and a much shorter time to prepare their defense.

Because the Commission failed to plead its fraud claims in the OIP with the particularity that would have been required by Rule 9 of Federal Rules of Civil Procedure, Respondents filed a motion for a more definite statement on August 5, 2016. After ordering the parties to meet and confer, however, this Court ultimately declined to rule on the motion. Respondents' inability to obtain a sufficiently definite statement of the SEC's fraud claims has forced Respondents to try to defend themselves without notice of key details, including the specific allegedly fraudulent activity at issue and the audience, time, and location of that activity.

The preliminary witness list the SEC served on October 18, 2016, unfortunately did not provide any further clarity regarding the specific factual bases for the fraud claims in the OIP. Indeed, the Commission's preliminary witness list identified more than fifty witnesses—many of whom appeared to have no connection to the case. Under 17 C.F.R. § 201.233(a)(2) (Rule 233(a)(2)), however, Respondents collectively were permitted in this administrative proceeding to depose just five percipient witnesses. When Respondents requested the maximum number of two additional depositions under 17 C.F.R. § 201.233(a)(3) (Rule 233(a)(3)), this Court initially granted leave for the depositions (*see* Admin. Proc. Rulings Release No. 4499/Jan. 4, 2017), but later quashed one of those supplemental deposition subpoenas to accommodate the witness' vacation schedule (*see* Admin. Proc. Rulings Release No. 4526/Jan. 13, 2017). Because the Court had earlier quashed one of Respondents' original deposition subpoenas (*see* Admin. Proc. Rulings Release No. 4474/Dec. 20, 2016), Respondents were limited to five total non-expert depositions in connection with their preparation for the hearing.

Respondents completed the deposition of the Commission's sole designated expert, Professor Anthony Sebok, on February 15, 2017, two days before the close of expert discovery. On that same day—*i.e.*, the very first opportunity for filing a dispositive motion based on lack of evidence—Respondents sought leave from this Court to file a dispositive motion on the ground that the SEC had no evidence in support of one of its two primary theories of liability. In light of the expedited pre-hearing schedule, Respondents voluntarily agreed to waive their right to file a reply so that the motion could be heard before the March 20, 2017 hearing date. This Court, however, still determined that the motion was untimely, and refused Respondents' request that it be heard. As a result, Respondents have had to devote (and divert) significant amounts of their limited time and resources to prepare to defend against a theory that lacks evidentiary support.

III. THE ADMINISTRATIVE PROCEEDING IS UNCONSTITUTIONAL

Respondents are aware that the Commission has faced numerous challenges to the constitutionality of its administrative proceedings, including that: (1) the appointment of SEC ALJs presiding over the proceedings violates the Appointments Clause in Article II of the United States Constitution; (2) the tenure protection afforded to SEC ALJs violates the Vesting Clause in Article II of the Constitution; and (3) SEC administrative proceedings violate the Due Process Clause of the Fifth Amendment to the Constitution. Respondents previously raised these issues in an action they filed in federal court, but were ordered to raise them first in this administrative proceeding, and, accordingly, do so now.

A. The SEC's ALJ Program Violates the Appointments Clause

The Appointments Clause provides that:

> [The President] shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the supreme Court, and all other Officers of the United States, whose Appointments are not herein

> otherwise provided for, and which shall be established by Law: *but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper*, in the President alone, in the Courts of Law, or *in the Heads of Departments*.

U.S. Const. art. II, § 2, cl. 2 (emphasis added).

As such, inferior Officers can only be appointed by a limited set of Executive Branch officials, including the SEC Commissioners—who, for purposes of the Appointments Clause, collectively function as the "Head" of the Department with authority to appoint "inferior Officers." *See Free Enterprise*, 561 U.S. at 511-13.

The SEC previously has conceded that SEC ALJs are not appointed by the Commissioners, and has taken the position that compliance with the requirements of the Appointments Clause is unnecessary because SEC ALJs are not "inferior Officers" as defined in the Constitution, but instead are mere employees of the SEC. Federal courts, however, have disagreed. Indeed, every court to consider the merits of Article II challenges to the SEC ALJ program, save one, has concluded that SEC ALJs *are* inferior Officers subject to the Appointments Clause. *See Bandimere*, 844 F.3d at 1185-86; *Duka v. SEC*, 124 F. Supp. 3d 287, 289 (S.D.N.Y. 2015), *vacated on other grounds*, (2d Cir. No. 15-2732) (June 13, 2016); *Hill v. SEC*, 114 F. Supp. 3d 1297, 1316-19 (N.D. Ga. 2015), *rev'd on other grounds*, 825 F.3d 1236 (11th Cir. 2016); *Ironridge Glob. IV, Ltd. v. SEC*, 146 F. Supp. 3d 1294 (N.D. Ga. 2015), *appeal dismissed*, No. 16-10205 (11th Cir. Sept. 27, 2016); *Gray Fin. Grp., Inc. v. SEC*, 166 F. Supp. 3d 1335 (N.D. Ga. Aug. 4, 2015), *vacated on other grounds sub nom. Hill v. SEC*, 825 F.3d 1236 (11th Cir. 2016).

The one exception to this unanimous rejection of the Commission's position is a decision by a panel of the D.C. Circuit, but that decision has been vacated and is scheduled to be reheard *en banc*. *See Raymond J. Lucia Cos., Inc. v. Sec. & Exch. Comm'n*, 832 F.3d 277, 285 (D.C. Cir.

2016), *vacated and reh'g en banc granted* (D.C. Cir. Feb. 16, 2017). The *Lucia* panel departed from the decisions of other courts based on D.C. Circuit precedent and concluded that SEC ALJs are not inferior Officers but rather are mere employees. *See Lucia*, 832 F.3d at 283 (relying on *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000)). The vacated *Lucia* panel decision is inconsistent with binding Supreme Court precedent, however, and should not be given weight. *See Freytag v. Comm'r of Internal Revenue*, 501 U.S. 868, 910 (1991).[1]

1. The Broad Powers Exercised by SEC ALJs Demonstrate that they Exercise "Significant Authority"

Where an "appointee exercis[es] significant authority pursuant to the laws of the United States," that person "is an 'Officer of the United States'" and must be appointed in the manner prescribed by the Appointments Clause. *Freytag*, 501 U.S. at 881 (citation omitted).

The Commission's own description of the role played by its ALJs in administrative proceedings illustrates the broad range and scope of responsibilities of SEC ALJs and easily meets the "significant authority" test:

> Just as a federal judge can do, an ALJ issues subpoenas, rules on motions, and rules on the admissibility of evidence. At the conclusion of the hearing, the parties submit proposed findings of fact and conclusions of law. The ALJ prepares an initial decision that includes factual findings and legal conclusions that are matters of public record.

https://www.sec.gov/about/whatwedo.shtml; *see also* Office of Administrative Law Judges, *available at* www.sec.gov/ALJ (analogizing SEC ALJs to Article III judges presiding over a bench trial).

[1] Half of the eight current members of the Supreme Court have written or joined opinions expressing the view that, as a general matter, all ALJs are inferior Officers of the United States subject to the Appointments Clause. *See Free Enterprise*, 561 U.S. at 542 (Breyer, J., joined by Stevens, Ginsburg, and Sotomayor, JJ., dissenting); *Freytag*, 501 U.S. at 910 (1991) (Scalia, J., joined by O'Connor, Kennedy, and Souter, JJ., concurring in part and concurring in judgment).

As the *Bandimere* court found:

> The SEC has authority to delegate "any of its functions" except rulemaking to its ALJs. 15 U.S.C. § 78d-1(a). And SEC regulations task ALJs with "conduct[ing] hearings" and make them "responsible for the fair and orderly conduct of the proceedings." 17 C.F.R. § 200.14. SEC ALJs "have the authority to do all things necessary and appropriate to discharge [their] duties." 17 C.F.R. § 201.111.12.

Bandimere, 844 F.3d at 1177-78. The *Bandimere* court identified examples of the SEC ALJs' duties as follows:

Duty	Provision(s)
Administer oaths and affirmations	5 U.S.C. § 556(c)(1) 17 C.F.R. § 200.14(a)(1) 17 C.F.R. § 201.111(a)
Consolidate "proceedings involving a common question of law or fact"	17 C.F.R. § 201.201(a)
"Determin[e]" the "scope and form of evidence, rebuttal evidence, if any, and cross-examination, if any"	17 C.F.R. § 201.326
Enter default judgment	17 C.F.R. § 201.155
Examine witnesses	17 C.F.R. § 200.14(a)(4)
Grant extensions of time or stays	17 C.F.R. § 201.161
Hold prehearing conferences	17 C.F.R. § 200.14(a)(6)
Hold settlement conferences and require attendance of the parties	5 U.S.C. § 556(c)(6) 5 U.S.C. § 556(c)(8) 17 C.F.R. § 201.111(e)
Inform the parties about alternative means of dispute resolution	5 U.S.C. § 556(c)(7) 17 C.F.R. § 201.111(k)
Issue protective orders	17 C.F.R. § 201.322
Issue, revoke, quash, or modify subpoenas	5 U.S.C. § 556(c)(2) 17 C.F.R. § 200.14(a)(2) 17 C.F.R. § 201.111(b) 17 C.F.R. § 201.232(e)
Order and regulate depositions	17 C.F.R. § 201.233
Order and regulate document production	17 C.F.R. § 201.230
Prepare an initial decision containing factual findings and legal conclusions, along with an appropriate order	5 U.S.C. § 556(c)(10) 17 C.F.R. § 200.14(a)(8) 17 C.F.R. § 200.30-9(a) 17 C.F.R. § 201.111(i) 17 C.F.R. § 201.360

Punish contemptuous conduct by excluding a person from a deposition, hearing, or conference or by suspending a person from representing others in the proceeding	17 C.F.R. § 201.180(a)
Regulate the course of the hearing and the conduct of the parties and counsel	5 U.S.C. § 556(c)(5) 17 C.F.R. § 200.14(a)(5) 17 C.F.R. § 201.111(d)
Reject deficient filings, order a party to cure deficiencies, and enter default judgment for failure to cure deficiencies	17 C.F.R. § 201.180(b). (c)
Reopen any hearing prior to filing an initial decision or prior to the fixed time for the parties to file final briefs with the SEC	17 C.F.R. § 201.111(j)
Rule on all motions, including dispositive and procedural motions	5 U.S.C. § 556(c)(9) 17 C.F.R. § 200.14(a)(7) 17 C.F.R. § 201.111(h) 17 C.F.R. § 201.220 17 C.F.R. § 201.250
Rule on offers of proof and receive relevant evidence	5 U.S.C. § 556(c)(3) 17 C.F.R. § 200.14(a)(3) 17 C.F.R. § 201.111(c)
Set aside, make permanent, limit, or suspend temporary sanctions the SEC issues	17 C.F.R. § 200.30-9(b) 17 C.F.R. § 201.531
Take depositions or have depositions taken	5 U.S.C. § 556(c)(4)

Id., at 1178.

Moreover, the Securities Exchange Act of 1934 ("Exchange Act") itself recognizes the distinction between administrative law judges and mere "employees." *See* 15 U.S.C. § 78d-1(a) (noting that the SEC may delegate its authority to, among others, "an administrative law judge, or an employee or employee board"). The Exchange Act also strictly limits who may preside over an SEC hearing to [1] the Commission, [2] "any member or members thereof, or [3] any *officer or officers* of the Commission designated by it." 15 U.S.C. § 78v (emphasis added). In other words, Congress has specified that only an Officer appointed by the Commission may take the place of the Commissioners in presiding over an SEC administrative hearing.

2. SEC ALJs Are Indistinguishable from Other Judges and Appointees Who Are Deemed "Officers"

SEC ALJs are also indistinguishable from the officers described by the Supreme Court in *Freytag*. 501 U.S. at 881. In *Freytag*, the Supreme Court held that Special Trial Judges

("STJs") were inferior Officers under the Appointments Clause, focusing on: (1) the fact that the "office of special trial judge is 'established by Law,' . . . and the duties, salary, and means of appointment for that office are specified by statute"; and (2) the significance of the STJs' duties and their discretion, including the fact that they "perform more than ministerial tasks." *Id.* at 881-82 (citation omitted).

SEC ALJs share these characteristics and are thus inferior Officers subject to the Appointments Clause. Like the STJs in *Freytag*, the office of administrative law judge is "established by Law."[2] And like the STJs in *Freytag*, SEC ALJs "take testimony, conduct trials, rule on the admissibility of evidence," and can "enforce compliance with discovery orders." 501 U.S. at 881-82; 17 C.F.R. § 200.14; 5 U.S.C. § 556(c). SEC ALJs thus are indistinguishable, for purposes of the Appointments Clause, from the judges found to be inferior Officers in *Freytag*. *See Bandimere*, 844 F.3d at 1181 (recognizing that "SEC ALJs closely resemble the STJs described in *Freytag*" because "[b]oth occupy offices established by law; both have duties, salaries, and means of appointment specified by statute; and both exercise significant discretion while performing 'important functions' that are 'more than ministerial tasks,'" and "both perform similar adjudicative functions") (quoting *Freytag*, 501 U.S. at 881-82).

SEC ALJs, moreover, exercise far more authority than other government personnel who are indisputably subject to the Appointments Clause. *See Free Enterprise*, 561 U.S. at 540 (Breyer, J., dissenting) (listing personnel held to be inferior Officers and citing cases). Indeed, the Supreme Court has found "district-court clerks, thousands of clerks within the Treasury and

[2] An SEC ALJs' duties, salary, and means of appointment are all set forth by statute. *See* 5 U.S.C. §§ 556, 557(b), 5372, 3105. Federal regulations further specify the means of an SEC ALJs' appointment. *See* 5 C.F.R. § 930.204. The Exchange Act and Commission regulations similarly set forth SEC ALJs' broad authority to conduct SEC administrative proceedings. *See* 15 U.S.C. § 78d-1(a); 17 C.F.R. § 200.14; 17 C.F.R. § 200.30-9; 17 C.F.R. § 200.30-10; SEC Rule of Practice 111.

Interior Departments, an assistant surgeon, a cadet-engineer, election monitors, federal marshals, military judges, Article I [Tax Court special] judges, and the general counsel for the Transportation Department [to be] inferior officers." *See* Kent Barnett, *Resolving the ALJs Quandry*, 66 Vand. L. Rev. 797, 812 (2013) (citing *Free Enterprise*, 561 U.S. at 540 (Breyer, J., dissenting)). SEC ALJs function as trial judges, and the SEC itself compares hearings conducted by its ALJs to "non-jury trials in the federal district courts." Office of Administrative Law Judges, *available at* www.sec.gov/ALJ. SEC ALJs thus exercise significant discretion in their adjudicative capacity and, like other adjudicative personnel, that discretion dictates that they are "Officers" subject to the Appointments Clause.[3]

3. The Finality of SEC ALJs Decisions

Notwithstanding *Freytag*'s "substantial authority" test for the determination of whether an ALJ is an inferior Officer, the Commission has followed the outlier view of a panel of the D.C. Circuit that SEC ALJs are employees, and not inferior Officers subject to Article II, because the decisions they issue are only preliminary decisions that are subject to further review by the Commission. *See Lucia*, 832 F.3d at 284-88. But in *Lucia*, the D.C. Circuit relied exclusively on its own precedent, *Landry v. Federal Deposit Insurance Corp.*, 204 F.3d 1125, 1133-34 (D.C. Cir. 2000). *See Lucia*, 832 F.3d at 285 (relying on *Landry* as "the law of the [D.C.] Circuit"). And *Landry*, in turn, misinterpreted the holding in *Freytag* as resting on the fact that an STJ could render a final decision of the Tax Court. *Landry*, 204 F.3d at 1134; *see*

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[3] The Supreme Court has also treated other adjudicative personnel as "Officers" under Article II in a series of cases involving the constitutional status of military tribunals. *See Edmond v. United States*, 520 U.S. 651, 661-63 (1997) (determining whether military judges were principal or inferior Officers under Article II); *Ryder v. United States*, 515 U.S. 177, 180 (1995) (recognizing lower court's decision that "appellate military judges are inferior officers"); *Weiss v. United States*, 510 U.S. 163, 169 (1994) ("The parties do not dispute that military judges, because of the authority and responsibilities they possess, act as 'Officers' of the United States.").

also Lucia, 832 F.3d at 285 ("Our analysis begins, and ends" with the issue of whether the ALJs issue final decisions).

Significantly, the D.C. Circuit has vacated the *Lucia* decision and ordered that the appeal be reheard *en banc*, and the Tenth Circuit recently "disagree[d] with the SEC's reading of *Freytag* and its argument that final decision-making power is dispositive to the question" of whether SEC ALJs are inferior Officers (*Bandimere*, 844 F.3d at 1182). That ruling is correct. In *Freytag*, the Supreme Court rejected the argument that an ALJ's ability to issue a final decision is dispositive on the employee/inferior Officer distinction because the "argument ignores the significance of the duties and discretion that special trial judges possess." *Freytag*, 501 U.S. at 881; *see also Bandimere*, 844 F.3d at 1182-84 ("[B]oth the [SEC] and *Landry* place undue weight on final decision-making authority. . . . [T]he [*Freytag*] Court did not make final decision-making power the essence of inferior officer status."); *Hill*, 114 F. Supp. 3d at 1318-19 (rejecting *Landry*'s interpretation of *Freytag*); *Landry*, 204 F.3d at 1140-42 (Randolph, J., concurring) (explaining majority misapplied *Freytag*); *cf. Samuels, Kramer & Co. v. C.I.R.*, 930 F.2d 975, 985 (2d Cir. 1991) (holding that STJs are inferior Officers even though "the ultimate decisional authority in cases under section 7443A(b)(4) rests with the Tax Court judges") (cited with approval in *Freytag*). *Landry* and *Lucia* thus were wrongly decided, as the Supreme Court in *Freytag* squarely *rejected* the very argument they adopt. *Freytag*, 501 U.S. at 881.

Moreover, even if the finality standard adopted in *Landry* and *Lucia* were appropriate, SEC ALJs *are* able to issue findings and orders that become final, without the requirement of any further review by the Commission itself. Under the relevant provisions of the Administrative Procedures Act of 1946, 5 U.S.C. § 551 *et seq.*, an SEC ALJ is authorized to issue an "initial decision" that "becomes the decision of [the Commission] without further

proceedings" unless the Commission affirmatively decides to review the decision in question and take action. 5 U.S.C. § 557(b). The SEC Rules of Practice also provide that the Commission is not required to review an initial decision issued by an SEC ALJ, and that if the Commission declines to do so, the initial decision will be promulgated by the Commission as a final decision. 17 C.F.R. § 201.360(d)(1); 17 C.F.R. § 201.410; 17 C.F.R. § 201.411. Once this process is complete, the federal securities laws provide that "the action of . . . [the] administrative law judge . . . shall, for all purposes, including appeal or review thereof, be deemed the action of the Commission." 15 U.S.C. § 78d-1(c).

Indeed, while the SEC's website contains links to SEC ALJs' initial decisions and accompanying hyperlinks to supposed "finality orders" issued by the Commission (*see* https://www.sec.gov/ALJ/ALJdec.shtml), *the hyperlinks do not link to orders at all.* Instead, they link to "Notice[s] That Initial Decision Has Become Final," issued by the Secretary of the Commission. *See, e.g.,* https://www.sec.gov/litigation/admin/2016/34-78880.pdf. These ministerial notices state that the time to petition for review has passed, that the Commission has chosen not to review the decision of the ALJs, and that the ALJs' initial decision is final and effective. Given the practical realities of litigation in front of SEC ALJs—in which the majority of initial decisions issued by SEC ALJs become final decisions without additional review by the Commission—this structure grants additional plenary powers to SEC ALJs beyond those described above.

SEC ALJs easily meet the "significant authority" test for inferior Officers, as articulated in *Freytag*. This Court should reject the errors of *Landry* and *Lucia* and follow the sound reasoning of the Tenth Circuit in *Bandimere*.

B. The SEC ALJs' Removal Scheme Violates Article II's Vesting of Executive Power in the President

Article II of the Constitution vests executive power in the President, who must "take Care that the Laws be faithfully executed." U.S. Const. art. II, § 1, cl. 1; *id.* § 3. In discharging this duty, the Constitution authorizes the President to rely on the assistance of executive officers. *Free Enterprise*, 561 U.S. at 483. "In order to maintain control over the exercise of executive power and take care that the laws are faithfully executed," Article II's vesting authority requires that the principal and inferior Officers of the Executive Branch be answerable to the President and not be separated from the President by attenuated chains of democratic accountability. *PHH Corp. v. Consumer Fin. Prot. Bureau*, 839 F.3d 1, 12 (D.C. Cir. 2016) ("[T]he President must be able to remove those officers at will.") (petition for rehearing *en banc* pending).

Specifically, as the Supreme Court held in *Free Enterprise*, Article II requires that executive officers, who exercise significant executive power, not be protected from removal by their superiors at will, when those superiors are themselves protected from removal by the President at will. 561 U.S. at 483-84. Accordingly, as executive officers, SEC ALJs may not be protected by more than one layer of tenure protection.

SEC ALJs, however, are removable from their position by the SEC "only" for "good cause," which must be "established and determined" by the Merits Systems Protection Board ("MSPB"). 5 U.S.C. § 7521(a). In turn, this removal procedure involves two or more levels of tenure protection:

- First, SEC ALJs are protected by statute from removal absent "good cause." 5 U.S.C. § 7521(a).
- Second, the SEC Commissioners, who exercise the power of removal, are themselves protected by tenure. They may not be removed by the President from their position except for "inefficiency, neglect of duty, or malfeasance in office."

See, e.g., *Free Enterprise*, 561 U.S. at 487 (citation omitted); *MFS Sec. Corp. v. SEC*, 380 F.3d 611, 619-20 (2d Cir. 2004) (citation omitted).

- Third, members of the MSPB, who determine whether sufficient "good cause" exists to remove an SEC ALJs, are also protected by tenure. They too are removable by the President "only for inefficiency, neglect of duty, or malfeasance in office." 5 U.S.C. § 1202(d).

This multi-layer good-cause tenure protection is analogous to the tenure structure that was held to violate Article II in *Free Enterprise*. Indeed, like its counterpart in *Free Enterprise*, this removal scheme impairs the President's ability to ensure that the laws are faithfully executed. *Free Enterprise*, 561 U.S. at 498. Because the President cannot oversee SEC ALJs in accordance with Article II, SEC administrative proceedings violate the Constitution.

C. This Administrative Proceeding Violates Due Process

This administrative proceeding also violates the Due Process Clause of the Fifth Amendment to the United States Constitution, which states that "[n]o person shall . . . be deprived of life, liberty, or property, without due process of law." U.S. Const. amend. V. "Due process of law requires that the proceedings shall be fair . . . ." *Snyder v. Commonwealth of Mass.*, 291 U.S. 97, 116 (1934), *overruled on other grounds by Malloy v. Hogan*, 378 U.S. 1 (1964). Contrary to this constitutional mandate, an administrative proceeding that seeks massive penalties in the SEC's own forum against unregistered individuals such as Respondents is fundamentally unfair, and lacks sufficient procedural protections to comport with due process.

1. Administrative Proceedings Lack the Procedural Safeguards That Apply to SEC Enforcement Actions Filed in Federal Court

Before the enactment of Dodd-Frank in 2010, SEC enforcement actions seeking civil penalties against individuals who are not registered with the Commission had to be brought exclusively in federal court. Dodd-Frank, however, lifted that restriction, and the SEC now may bring an action against unregistered individuals in an administrative proceeding that lacks the

same procedural safeguards that are found in federal courts. *See* Pub. L. No. 111-203, §§ 929P(a)(1), (a)(2)(E), (a)(3)(E), and (a)(4)(E) (allowing the Commission to seek civil penalties against "any person" in an administrative cease-and-desist proceeding initiated under the Securities Act, the Exchange Act, the Company Act, and the Investment Advisors Act).

As this Court is well aware, an administrative proceeding is an internal SEC hearing governed by the SEC's Rules of Practice, litigated by SEC trial attorneys, and presided over by SEC ALJs. Administrative proceedings differ from federal actions in several critical ways that make administrative proceedings more advantageous to the SEC. Those differences include:

- In administrative proceedings, a respondent is not entitled to a jury or to a federal judge confirmed by the United States Senate. Instead, SEC ALJs serve as finder of both fact and law.
- The procedural protections afforded by the Federal Rules of Civil Procedure do not apply in administrative proceedings.
- The evidentiary protections afforded by the Federal Rules of Evidence do not apply in administrative proceedings.
- The new SEC Rules of Practice for administrative proceedings expressly allow trial by hearsay, including in some circumstances through the use of *ex parte* investigative testimony and declarations, which deprive respondents of any ability to cross-examine witnesses and meaningfully challenge the SEC's evidentiary support for its claims.
- The new SEC Rules of Practice for administrative proceedings require respondents to disclose theories, other than affirmative defenses, in their answers or risk waiving substantive rights.
- Discovery is significantly limited in administrative proceedings. While the SEC has broad and nearly unfettered discovery rights during the investigative phase of a proceeding—which in this case lasted several years—respondents have limited discovery rights and are subject to an expedited schedule.
- The SEC Rules of Practice do not allow respondents to assert counterclaims against the SEC. Federal court defendants may assert counterclaims against their adversaries.
- Any appeals from the SEC ALJs' decisions go to the Commission itself—the very body which, before initiating an administrative proceeding, determined that an

enforcement action was warranted—and the SEC is empowered to decline to hear the appeal or to impose even greater sanctions.

- A final order of the Commission, after becoming effective, can only be appealed to a United States Court of Appeals under a deferential standard of review.

Each of these differences makes it easier for the SEC to prevail in an administrative proceeding than in federal court.[4] This reality, coupled with the Commission's unfettered discretion over which cases to bring in an administrative proceeding, creates a nearly irresistible temptation to bring marginal or harder-to-prove claims in an administrative proceeding. The current regime accordingly creates a perverse incentive for the SEC to afford *fewer* due process protections to individuals such as Respondents with strong, meritorious defenses than to others who were caught red-handed engaging in truly nefarious conduct.

2. Respondents Have Not Been Afforded Due Process In This Administrative Proceeding

The deprivation of due process attendant to SEC administrative enforcement proceedings is particularly acute for Respondents in this action. First, the case the SEC is pursuing against Respondents is intensely fact driven, making it particularly ill-suited for an administrative forum where Respondents are denied the basic rights of discovery allowed under the Federal Rules of Civil Procedure and must prepare to defend themselves on a hyper-accelerated basis. Indeed, the SEC has produced millions of pages of documents to Respondents, and the parties recently exchanged lists containing nearly two-thousand pre-marked trial exhibits. The SEC, moreover, identified more than fifty individuals on its preliminary witness list—all (or at least the vast

[4] Some observers have found that the SEC has succeeded much more often in administrative proceedings, where it enjoys the procedural advantages described above, than in federal actions. Gretchen Morgenson, *At the S.E.C., a Question of Home-Court Edge*, N.Y. Times, Oct. 5, 2013. In fact, one study conducted in 2015 found that the SEC had won the last 219 decisions before its ALJs—a "winning streak, which began in October 2013"—at a time when it had lost several high-profile decisions in federal courts. Jenna Greene, *The SEC's on a Long Winning Streak*, National L. J., Jan. 19, 2015.

majority) of whom seem to have been interviewed by the SEC. Respondents, however, were only permitted under the applicable Rules of Practice to take the depositions of five percipient witnesses in connection with their trial preparation. This mismatch between the vast scope of the claims at issue and the narrow discovery tools available to Respondents makes it particularly unfair to try those claims in this forum.

Second, the SEC is seeking an eye-popping monetary recovery from Respondents—including through disgorgement and improper Tier III penalties—as well as a cease-and-desist order that would effectively and permanently prevent Respondents from continuing to operate their business and pursue their livelihood. Given the severe consequences to Respondents that could result from an adverse determination, due process demands appropriate protections to ensure the fairness of the proceedings. *See Mathews v Eldridge*, 424 U.S. 319, 334 (1976) ("[R]esolution of the issue whether the administrative procedures provided here are constitutionally sufficient requires analysis of the governmental and *private* interests.") (emphasis added). Indeed, as one federal judge recently remarked when addressing the SEC's pursuit of remedies in administrative proceedings, "[o]ne might wonder: from where does the constitutional warrant for such unchecked and unbalanced administrative power derive?" *S.E.C. v. Citigroup Glob. Mkts. Inc.*, 34 F. Supp. 3d 379, 380 n.8 (S.D.N.Y. 2014) (Rakoff, J.).

Finally, the abbreviated pretrial schedule applicable to this proceeding unfairly interfered with Respondents' procedural due process rights by precluding them from bringing a motion for summary disposition far enough in advance of the hearing to be deemed timely by this Court. As explained above, Respondents sought leave to file a motion seeking the dismissal of claims that Respondents' improperly valued the Funds' portfolios—which is one of the two main theories of liability identified in the OIP—based on a lack of evidence. Despite filing the motion on the

same day that discovery was completed (*i.e.*, the first day that a motion based on a lack of evidence would have been ripe), this Court nevertheless ruled that the request was untimely because the motion could not be heard sufficiently in advance of the hearing. As a result, Respondents have been forced to prepare to defend against the Commission's valuation claims notwithstanding the absence of any evidence to support those claims.

IV. CONCLUSION

Respondents respectfully request that the Court dismiss this unconstitutional proceeding for all of the reasons stated above.

Dated: March 8, 2017

Respectfully submitted,

Terence Healy [WSJ]

Roel C. Campos
Terence M. Healy
Hughes Hubbard & Reed LLP
1775 I Street, N.W.
Washington, D.C. 20006-2401
202-721-4600
www.hugheshubbard.com

Counsel for RD Legal Capital, LLC and Roni Dersovitz

David K. Willingham
Michael D. Roth
Caldwell Leslie & Proctor, PC
725 South Figueroa Street, 31st Floor
Los Angeles, CA 90017-5524
213-629-9040
www.caldwell-leslie.com

Counsel for Roni Dersovitz

CERTIFICATE OF SERVICE

The undersigned certifies that the foregoing Motion To Dismiss Unconstitutional Proceeding was served on this 8th day of March 2017 by U.S. Postal Service on the Office of the Secretary and by electronic mail on the following counsel of record:

Michael D. Birnbaum
Securities and Exchange Commission
New York Regional Office
Brookfield Place, 200 Vesey Street
New York, NY 10281

Jorge Tenreiro
Securities and Exchange Commission
New York Regional Office
Brookfield Place, 200 Vesey Street
New York, NY 10281

Victor Suthammanont
Securities and Exchange Commission
New York Regional Office
Brookfield Place, 200 Vesey Street
New York, NY 10281

Terence Healy WSJ
Terence Healy