UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDINGS RULINGS
Release No. 743 / February 1, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15127

In the Matter of	:	
	:	ORDER STRIKING CERTAIN
J. KENNETH ALDERMAN, CPA,	:	AFFIRMATIVE DEFENSES
ET AL.	:	OF RESPONDENTS
	:	

On December 10, 2012, the Securities and Exchange Commission (Commission) initiated this proceeding with an Order Instituting Public Administrative and Cease-and-Desist Proceedings (OIP), pursuant to Sections 9(b) and 9(f) of the Investment Company Act of 1940 (Investment Company Act). The hearing is scheduled to commence April 2, 2013.

Pending before me is the Motion to Strike Certain Affirmative Defenses of Respondents (Motion), namely, laches and estoppel, filed on January 11, 2013 by the Division of Enforcement (Division). Respondents Jack R. Blair, Albert C. Johnson, CPA, James Stillman R. McFadden, W. Randall Pitman, CPA, Mary S. Stone, CPA, and Archie W. Willis III (collectively, the Independent Directors) filed an Opposition (Independents' Oppo.) on January 15, 2013. Respondents J. Kenneth Alderman, CPA, and Allen B. Morgan, Jr. (collectively, the Inside Directors) filed an Opposition (Insiders' Oppo.) on January 17, 2013. The Division filed a Reply (Reply) on January 23, 2013. The Independent Directors filed a Supplemental Response in Opposition to Division's Motion to Strike Defenses (Supp. Oppo.) on January 30, 2013.[1]

For the reasons discussed below, I GRANT the Motion.

ALLEGATIONS

The OIP alleges, in sum and substance, as follows. The eight Inside Directors and Independent Directors (collectively, the Directors) constituted the boards of directors for five registered investment companies affiliated with Morgan Keegan & Company, Inc. Id., pp. 1-3. As of March 31, 2007, the five registered investment companies (the Funds) held securities with a combined net asset value (NAV) of approximately $3.85 billion. Id., p. 4. Four of the Funds

[1] This filing is not permitted by the Commission's Rules of Practice. However, because I have ruled entirely in the Division's favor, my consideration of it does not prejudice the Division.

were closed-end, and one was open-end. Id., p. 3. A substantial portion of the Funds' investments were in subordinated tranches of various securitizations, including mortgage-backed securities, for which market quotations were not readily available between January 2007 and August 2007 (the Relevant Period). Id., p. 4. Consequently, a large proportion of the Funds' portfolios had to be periodically valued based on fair value, that is, based on good faith valuation procedures established and overseen by the Directors. Id., pp. 2, 4.

According to Accounting Series Release No. 118, Investment Company Act Release No. 6295 (Dec. 23, 1970) (ASR 118), under such circumstances, the Directors must determine the method of arriving at the fair value of each security, may appoint persons to assist them in that determination and to make the actual calculations, and must continuously review the appropriateness of the method used in valuing each security. OIP, p. 2. The Directors did not so determine a fair valuation method, nor did they continuously review any such method's appropriateness. Id. Instead, they delegated those duties to a fair valuation committee, without providing the committee any meaningful guidance, and did not inform themselves how fair values were being determined. Id. As a result, the NAVs of the Funds were materially misstated at least from March 31, 2007 to August 9, 2007. Id., p. 9.

CONTENTIONS OF THE PARTIES

The Independent Directors raise laches and estoppel as affirmative defenses. Former Independent Directors' Answer and Defenses (Independent Directors' Answer), pp. 12-14. The Inside Directors also raise them as affirmative defenses. Respondent Allen B. Morgan, Jr.'s Answer and Defenses to the OIP (Morgan Answer), p. 8; Respondent J. Kenneth Alderman's Answer and Defenses to the OIP (Alderman Answer), p. 8. The Division moves to strike the laches defense, arguing that it is unavailable as a defense to a Commission administrative proceeding. Motion, p. 4. As to estoppel, the Division argues that the defense is based solely on failure to bring the present proceeding earlier, which is legally insufficient, that Respondents do not allege any affirmative misconduct, and that Respondents do not plead any prejudice rising to a constitutional level. Id., pp. 5-6.

The Independent Directors respond that their laches defense at least raises questions of whether the Division is not acting in the public interest and has violated the Independent Directors' due process rights, that laches has warranted dismissal of Commission administrative proceedings in the past, that they have pled equitable estoppel with sufficient particularity, and that estoppel may be based on omissions rather than just on affirmative misconduct. Independents' Oppo., pp. 3-5. In support of their argument, they attach the notes of an August 2, 2007 conference call between Respondents and various Commission employees (Notes), and an email from the Director of the Commission's Division of Investment Management (Email). The Inside Directors respond that laches has warranted dismissal of Commission administrative proceedings in the past, that they need not plead estoppel with particularity, and that they should be given the opportunity to present their affirmative defenses. Insiders' Oppo., pp. 2-4.

In its Reply, the Division argues that affirmative misconduct in fact must be proven and that Respondents have not identified any such misconduct, and that Respondents still have not identified any prejudice rising to a constitutional level. Reply, pp. 2-5.

DISCUSSION

An affirmative defense may be stricken in an administrative proceeding if it "would not constitute a valid defense under any facts proved, so that evidence in support would be irrelevant." Thorn, Welch & Co., Inc., Administrative Proceedings Rulings Release No. 446 (Oct. 13, 1994), 57 SEC Docket 2421, 2422 (quoting Kingsley, Jennison, McNulty & Morse, Inc., Administrative Proceeding No. 3-7446 (Apr. 9, 1991) (unpublished)). Striking an affirmative defense is appropriate to avoid unnecessary argument and wasted time litigating irrelevant facts. Id.; Gregory L. Amico, Administrative Proceedings Rulings Release No. 460 (Dec. 15, 1994), 58 SEC Docket 850, 851.

A. Laches

The doctrine of laches may bar a claim if there was unreasonable and unexcused delay in bringing it, and the adverse party was materially prejudiced as a result. Advanced Cardiovascular Systems, Inc. v. Scimed Life Systems, Inc., 988 F.2d 1157, 1161 (Fed. Cir. 1993). Some courts have suggested that laches is a valid defense against government enforcement actions, as Respondents correctly note. Nonetheless, the great weight of authority, including authority from all the Circuit Courts of Appeal likely to have jurisdiction over any appeal from this proceeding, is that laches is not so available in this case. U.S. v. Summerlin, 310 U.S. 414, 416 (1940) ("the United States is not . . . subject to the defense of laches in enforcing its rights"); Hatchett v. U.S., 330 F.3d 875, 887 (6th Cir. 2003) (noting that laches may be available in certain cases involving the government, but citing only a contract action as an example); U.S. v. Delgado, 321 F.3d 1338, 1349 (11th Cir. 2003) (same, but citing only an Equal Employment Opportunity Commission action and a case involving the Commonwealth of Puerto Rico); Mount Vernon Mortgage Corp. v. U.S. by Attorney General, 236 F.2d 724, 725 (D.C. Cir. 1956) (laches does not apply to a suit "brought to enforce a public right").

Respondents have failed to identify even a single case where the Commission has sustained a laches defense in a Commission administrative proceeding. See Michael J. Marrie, CPA, Initial Decision Release No. 191 (Sep. 21, 2001), 75 SEC Docket 2718, 2746 ("I am aware of no cases in which the Commission has found a laches defense to be meritorious."). With one exception, the administrative law judge (ALJ) Orders cited by Respondents all support the Division's position. Gregory L. Amico, 58 SEC Docket at 851-52 (considering laches but finding as a matter of fact that a delay of "only two to three years" in bringing the action to be legally insufficient); Dean Witter Reynolds Inc., Administrative Proceedings Rulings Release No. 578 (Feb. 12, 1999), 69 SEC Docket 454, 455-56 (noting that laches cannot be invoked against the Commission but declining to strike "a similar defense"); Egan-Jones Ratings Company, Administrative Proceedings Rulings Release No. 712 (Jul. 13, 2012), 104 SEC Docket 56828, 56832 ("I find that the defense of laches is not available in this proceeding and strike it from Respondents' Answer."). The exception is Piper Capital Management, Inc., Administrative Proceedings Rulings Release No. 577 (Jan. 15, 1999), 68 SEC Docket 3361, 3363-65, in which the ALJ declined to strike a laches defense; oddly, laches apparently had not actually been pled, so I am not persuaded by the case's reasoning. Moreover, that laches may be available against a self-regulatory organization does not necessarily mean that it is available

against the Commission. Independents' Oppo., p. 4 (citing several New York Stock Exchange disciplinary proceedings).

Additionally, the doctrine of laches may not be used to "shrink the limitations period." Michael J. Marrie, 75 SEC Docket at 2745; Advanced Cardiovascular Systems, 988 F.2d at 1161 ("When a limitation on the period for bringing suit has been set by statute, laches will generally not be invoked to shorten the statutory period."). I have separately ruled that at least some alleged violations are not barred by the statute of limitations. J. Kenneth Alderman, CPA, Administrative Proceedings Rulings Release No. 744 (Feb. 1, 2013). To the extent any alleged violations are not statutorily time-barred, they are also not equitably time-barred.

B. Estoppel

Estoppel prevents a party from arguing a particular position or making a particular claim when (1) there was a definite representation to the party claiming estoppel, (2) the latter relied on its adversary's conduct to its detriment, and (3) the reliance was reasonable. See Graham v. SEC, 222 F.3d 994, 1007 (D.C. Cir. 2000) (citing Heckler v. Community Health Services of Crawford County, Inc., 467 U.S. 51, 59 (1984)); see also Gordon Brent Pierce, Initial Decision Release No. 425 (Jul. 27, 2011), 101 SEC Docket 44315, 44324-25. A party seeking to estop the government must also show that the government has engaged in affirmative misconduct going beyond mere negligence, that the government's act will cause a serious injustice, and that the imposition of estoppel will not unduly harm the public interest. United States v. Gamboa-Cardenas, 508 F.3d 491, 502 (9th Cir. 2007). The party asserting estoppel bears the burden of proving it. See id.

The Division concedes that estoppel is not categorically unavailable as a defense in this proceeding, but as with their laches argument, Respondents have failed to identify even a single case where the Commission has sustained an estoppel defense in a Commission administrative proceeding. Motion, p. 5. Although estoppel defenses have been entertained in administrative proceedings, such a circumstance counsels caution in applying the doctrine. E.g., Gordon Brent Pierce, 101 SEC Docket at 44324-25 (reaching the merits of equitable estoppel but rejecting it); see Sharon M. Graham, Exchange Act Release No. 40727 (Nov. 30, 1998), 68 SEC Docket 2056, 2074 ("A respondent bears a particularly heavy burden when he or she seeks to estop the government." (citing Office of Personnel Management v. Richmond, 496 U.S. 414, 419-20 (1990)), review denied, Graham, 222 F.3d 994.

Respondents contend they were prejudiced because they were not notified earlier of the Commission's concerns about manipulation of NAVs. Independents' Oppo., p. 2 ("Had the Independent Directors been so alerted, they could have acted swiftly to establish new procedures." (quoting Independent Directors' Answer, p. 13)); Insiders' Oppo., p. 3 ("at the very least, there are questions as to when the Division and other Commission staff members believed there to be issues regarding the Funds' valuation procedures"). Respondents further contend that "there was no reason for the staff not to have alerted the Independent Directors" that NAVs were being manipulated. Independents' Oppo., p. 2 (quoting Independent Directors' Answer, p. 13). Instead, they argue, "the staff waited and is now suing the [Respondents] for the alleged resulting misevaluation." Independents' Oppo., p. 3.

As pled, there is no set of facts provable by Respondents that would support a valid estoppel defense, because even assuming their allegations are proven, they are not legally sufficient. The Commission is under no general legal obligation to inform potential targets of investigation that they are under suspicion, or that a person they supervise is under suspicion, prior to initiation of an investigation. See William H. Gerhauser, Sr., Exchange Act Release No. 40639 (Nov. 4, 1998), 68 SEC Docket 1289, 1296 ("A regulatory authority's failure to take early action neither operates as an estoppel against later action nor cures a violation." (citations omitted)). In Sharon M. Graham, which is closely analogous, the Commission rejected an estoppel defense based on the Commission's failure "both to identify the [charged] trading as manipulative and to alert [respondents] as to potential violations," because estoppel requires a "definite misrepresentation of fact to another person." 68 SEC Docket at 2074. Indeed, Section 26 of the Exchange Act explicitly bars reliance on the Commission's silence. See Capital Funds, Inc. v. SEC, 348 F.2d 582, 588 (8th Cir. 1965) ("it may be taken as settled that the Commission and its agents may not 'waive' violations of federal law" (quoting 15 U.S.C. § 78z)); see also Graham, 222 F.3d at 1007 ("the SEC's failure to prosecute at an earlier stage does not estop the agency from proceeding once it finally accumulated sufficient evidence to do so"). .

The authority on which Respondents rely is unpersuasive. In Fredericks v. Commissioner of Internal Revenue, 126 F.3d 433, 435 (3rd Cir. 1997), the IRS assessed a tax deficiency in 1992, 14 years after the taxpayer filed his 1977 tax return, the taxpayer raised a statute of limitations defense, and the IRS rejected it based on a revocable tolling agreement (Form 872-A) that it initially told the taxpayer it had lost but that it in fact had in its possession as early as 1984. The Third Circuit Court of Appeals found the taxpayer's equitable estoppel defense meritorious: "The IRS prevented Fredericks from terminating the Form 872-A by misrepresenting that it did not possess such a form, by affirmatively maintaining that misrepresentation and by failing for eight years to notify the taxpayer after discovering its error and adopting an alternative course of action." Id. at 441. In the instant case, by contrast, there was no initial misrepresentation, only silence, and so there has been no opportunity for the Commission to "maintain" such a misrepresentation.

In General Accounting Office v. General Accounting Office Personnel Appeals Board, 698 F.2d 516, 526 & n.57 (D.C. Cir. 1983), the court stated in dicta that government agents may be estopped based on "commission or omission," but noted that the Supreme Court "has yet to make clear whether anything less than 'affirmative misconduct' will justify estoppel." In any event, the court found the General Accounting Office's motion to disqualify opposing counsel, after apparently acquiescing to opposing counsel in earlier rounds of litigation, "falls far short of conduct which would raise a serious question" regarding estoppel. Id. at 527 (internal quotations omitted).

In SEC v. Sands, 902 F. Supp. 1149, 1166-67 (C.D. Cal. 1995), the court struck the defense of "Ratification and Estoppel," but declined to strike the defense of "Waiver and Estoppel," citing to multiple omissions by the Commission. The court's discussion was somewhat obscure, because it cited to Mukherjee v. Immigration and Naturalization Service, 793 F.2d 1006, 1008-09 (9th Cir. 1986), an equitable estoppel case which held that only affirmative misconduct can lead to estoppel against the government. I understand Sands to be directed to

waiver, and not to estoppel or equitable estoppel at all; so understood, it is also inconsistent with Capital Funds, 348 F.2d at 588.

The Independent Directors' evidence is also unpersuasive. The Notes do not reveal a "definite misrepresentation"; in fact, the Notes unequivocally reveal silence. Nor are the views of the Director of the Commission's Division of Investment Management in any way relevant. Email. Indeed, even considering such views arguably infringes on my decisional independence.

In sum, Respondents cannot prove a "definite misrepresentation" consistent with their pleadings. The defense of estoppel is properly stricken from Respondents' Answers.

ORDER

It is ORDERED that the Division of Enforcement's Motion to Strike Certain Affirmative Defenses of Respondents is GRANTED. The Independent Directors' Eighth Defense (Limitations and Laches), to the extent it pleads laches, and Sixth Defense (Estoppel) are STRICKEN. Respondent Morgan's Fourth Defense, to the extent it pleads laches, and Fifth Defense are STRICKEN. Respondent Alderman's Fourth Defense, to the extent it pleads laches, and Fifth Defense are STRICKEN.

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Cameron Elliot
Administrative Law Judge