UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

PHYLLIS MOLCHATSKY and STEVEN SCHNEIDER, M.D., Plaintiffs, v. UNITED STATES OF AMERICA, Defendant.	09 CIV 8697 (LTS/AJP)

UNITED STATES OF AMERICA'S
REPLY MEMORANDUM OF LAW IN SUPPORT OF ITS MOTION TO DISMISS

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INTRODUCTION

The United States respectfully submits this reply memorandum of law in further support of its motion to dismiss the Complaint for lack of subject-matter jurisdiction. As set forth in the United States' initial memorandum, Plaintiffs' claims against the United States for losses they suffered as a result of the Madoff Ponzi scheme are barred by the FTCA's discretionary function exception. Plaintiffs' response to the United States' motion struggles to avoid this legal bar, but is premised on several analytical errors.

First, Plaintiffs urge application of an inapt legal standard. They discuss the burden of proof and fault the United States for not producing evidence, but they ignore the Supreme Court's test for deciding a motion to dismiss based on the discretionary function exception. In *Gaubert*, the Court held that to survive such a motion, plaintiffs must plead facts that show that their claim falls outside the exception. The United States' motion assumed the truth of Plaintiffs' well-pled factual allegations, and demonstrated that Plaintiffs fail to meet their pleading burden. Plaintiffs thus err by focusing on evidence and proof rather than the sufficiency of their Complaint.

Second, Plaintiffs wrongly assume that they can avoid the discretionary function exception by characterizing their claim as an attack on the SEC's examinations and investigations rather than on the Commission's discretionary failure to act. Numerous decisions have rejected such attempts to circumvent the discretionary function exception through creative pleading, and Plaintiffs are unable to distinguish these cases.

Third, even if the Court were to look behind the Commission's discretionary failure to act, Plaintiffs have shown no reason why the discretionary function exception would not apply.

Plaintiffs ignore the express language of the applicable statutes, which vest the SEC with robust discretion in deciding when and how to investigate potential violations. Although Plaintiffs make conclusory allegations that SEC staff violated mandatory "internal policies," those allegations are contradicted by materials that Plaintiffs attached to and incorporated in their Complaint. Plaintiffs attached the 457-page report by the SEC's Inspector General, which identified no mandatory directives with which the SEC failed to comply, and the SEC's Enforcement Manual, which was an exhibit to the IG's report and *does* provide procedures for conducing investigations, is by its very terms for "guidance only," and so cannot provide a basis for negating the discretionary function exception.

Unable to identify any violation of a mandatory directive, Plaintiffs repeatedly focus on investigatory missteps that the IG found were the product of carelessness or ineptitude. Plaintiffs insist that such conduct cannot be discretionary because it is outside the regulatory framework and not policy-based. But the discretionary function exception applies "whether or not the discretion involved be abused," and the Supreme Court has held that abuse of discretion connotes both negligence and wrongful acts committed in the exercise of discretion. The Supreme Court has similarly already dispatched Plaintiffs' argument that once the SEC decided to investigate Madoff, it was bound to do so in a non-negligent manner. In *Guabert*, the Court expressly rejected the false dichotomy between policy and operational functions, holding that the exception protects *all* discretionary functions that are susceptible to policy analysis.

Finally, because the statutes governing the SEC expressly grant it discretion, there is a presumption that the challenged conduct is susceptible to policy analysis. Plaintiffs have done nothing to rebut this presumption, or to refute the dozens of cases holding that the discretionary

function exception bars lawsuits challenging the way a federal agency conducts its investigations. Indeed, Plaintiffs cannot point to a *single* case where the United States was held liable in tort for the SEC's failure to protect an investor. The reason for this is simple: in passing the FTCA, Congress did not intend for courts to second-guess the way federal agencies regulate private conduct. This case, which challenges the way the SEC investigated Madoff, must therefore be dismissed.

I. Plaintiffs urge application of an inapt legal standard.

In deciding this motion, the Court must determine whether the Complaint pleads facts sufficient to support a finding that the challenged conduct is not the kind protected by the discretionary function exception. Plaintiffs devote considerable (and repeated) attention to the question of who must *prove* whether the exception applies. They contend that this burden belongs to the United States, going so far as to argue that "the Government is required to eliminate, with a preponderance of the evidence, any disputed facts as to" whether the exception applies.[1] But Plaintiffs' focus on the "burden of proof," the "preponderance of evidence," and "disputed facts" is misplaced in response to a motion to dismiss which assumes the truth of Plaintiffs' well-pled factual allegations.

Regardless of who ultimately bears the burden of *proof*, the Supreme Court has held that to survive a *motion to dismiss* based on the discretionary function exception, *plaintiffs* must *plead* facts that support a claim that falls outside the exception:

> For a complaint to survive a motion to dismiss, it must allege facts which would

[1] Pls.' Resp. at 10.

> support a finding that the challenged actions are not the kind of conduct that can be said to be grounded in the policy of the regulatory regime.[2]

According to this test, the United States is not required to produce evidence, and it is not required to prove or disprove anything. Rather, dismissal turns on the adequacy of the Complaint.[3]

The Court's examination of Plaintiffs' Complaint must be guided by two principles that emanate from the Supreme Court's recent decisions in *Twombly* and *Iqbal*.[4]

First, although a court must accept as true well-pled factual allegations, it must reject "mere conclusory statements" or "threadbare recitals of the elements of a cause of action."[5] Second, accepting the complaint's creditable allegations, the court must determine whether they state a "plausible" claim for relief.[6] "[O]nly a complaint that states a plausible claim for relief survives a motion to dismiss," and the court may "draw on its judicial experience and common

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[2] *United States v. Gaubert*, 499 U.S. 315, 324-25 (1991); *see also Wang v. United States*, 61 Fed. App'x 757, 759 (2d Cir. 2003) ("*Plaintiffs* failed to meet *their* burden of *pleading* facts which would support a finding that the conduct of the investigative agents fell outside the scope of the exception.") (emphasis added).

[3] *Gaubert*, 499 U.S. at 334 ("Because *from the face of the amended complaint*, it is apparent that all of the challenged actions of the federal regulators involved the exercise of discretion in furtherance of public policy goals, the Court of Appeals erred in failing to find the claims barred by the discretionary function exception of the FTCA.") (emphasis added); *see also Wang*, 61 Fed. App'x at 758-59 ("We examine the complaint on its face to determine whether Plaintiffs' factual allegations establish federal jurisdiction over claims grounded in the FTCA.").

[4] *See Harris v. Mills*, 572 F.3d 66, 71-72 (2d Cir. 2009) (discussing *Twombly* and *Iqbal*); *Stephenson v. Citco Group Ltd.*, — F. Supp. 2d —, No. 09 CV 00716 (RJH), 2010 WL 1244007, at *16 (S.D.N.Y. April 1, 2010) (applying *Twombly* and *Iqbal*).

[5] *Ashcroft v. Iqbal*, — U.S. —, 129 S. Ct. 1937, 1949 (2009); *see also Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555 (2007) (holding "labels and conclusions" or "a formulaic recitation of the elements . . . will not do"); *Harris*, 572 F.3d at 72; *Thompson*, 2010 WL 1244007, at *16.

[6] *Iqbal*, 129 S. Ct. at 1950; *see also Harris*, 572 F.3d at 72; *Thompson*, 2010 WL 1244007, at *16.

sense" in determining whether a claim is plausible.[7]

Further, in determining the plausibility of a claim, the court may consider any documents that are attached to the complaint or incorporated into it by reference.[8] Here, this means that the Court may consider the SEC Inspector General's 457-page report concerning the way the SEC investigated Madoff. The IG's report was attached as an exhibit to the Complaint, and Plaintiffs heavily rely on it throughout their response.[9] The Court may also consider the SEC's Enforcement Manual, which guides every aspect of how the SEC investigates suspected violations of the securities laws. The manual was an exhibit to the IG's report, which referred to it several times.[10]

On this record—created entirely by Plaintiffs—the Court must determine whether the SEC has discretion in the way it conducts its examinations and investigations, and, if so, whether those discretionary functions are susceptible to policy analysis. If these questions are answered affirmatively, the Court must dismiss this case for lack of subject-matter jurisdiction.

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[7] *Iqbal*, 129 S. Ct. at 1950; *see also Harris*, 572 F.3d at 72; *Thompson*, 2010 WL 1244007, at *16.

[8] *See* Fed. R. Civ. P. 10(c) ("A copy of a written instrument that is an exhibit to a pleading is a part of the pleading for all purposes."); *Roth v. Jennings*, 489 F.3d 499, 509 (2d Cir. 2007) ("Documents that are attached to the complaint or incorporated in it by reference are deemed part of the pleading and may be considered [on a motion to dismiss]."); *In re Wade*, 969 F.2d 241, 249 (7th Cir. 1992) ("A plaintiff may plead himself out of court by attaching documents to the complaint that indicate that he or she is not entitled to judgment.").

[9] *See* Pls.' Resp. at 2 ("To establish that [their] claims fall outside the discretionary-function exception, Plaintiffs rely on the admissible evidence contained in the Report of the SEC's own Inspector General, dated August 31, 2009 . . . .").

[10] *See, e.g.*, IG's Report at 263 n.183 (citing Enforcement Manual as an exhibit).

II. Despite their attempt at artful pleading, Plaintiffs' case is "based upon" the failure to enjoin Madoff.

Hoping to circumvent the discretionary function exception, Plaintiffs frame their case not as an attack on the protected, discretionary act that caused their harm—the Commission's failure to enjoin Madoff—but rather on the antecedent examinations and investigations by SEC staff, which Plaintiffs contend violated mandatory procedures and are unsusceptible to policy analysis. According to Plaintiffs, what matters is the investigations, not the decision whether to enjoin, because "it seems beyond dispute that the SEC would have prosecuted Madoff if its investigations had not been sabotaged by staffers' negligence."[11]

Other courts have rejected such attempts to recharacterize claims for the purpose of avoiding discretionary function immunity. In its motion, the United States cited to several of these decisions[12] and discussed at length two of them—*Fisher Bros.* and *General Dynamics*. In *Fisher Bros.*, the court held that because the damages flowed from the discretionary decision to ban Chilean grapes, the plaintiffs could not avoid discretionary function immunity by focusing instead on the allegedly negligent way the grapes were tested.[13] In *General Dynamics*, the court held that because the damages flowed from the discretionary decision to indict, the plaintiffs could not avoid discretionary function immunity by focusing instead on the allegedly negligent investigation that led to the indictment.[14] In their response, Plaintiffs barely mention these cases.

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[11] *Id.* at 25-26.

[12] *See* Mot. at 15 n.53.

[13] *Fisher Bros. Sales, Inc. v. United States*, 46 F.3d 279, 288 (3d Cir. 1995).

[14] *Gen. Dynamics Corp. v. United States*, 139 F.3d 1280, 1283 (9th Cir. 1998).

They devote a sentence to *Fisher Bros.* and a footnote to *General Dynamics*.[15] To the extent that they even attempt to distinguish these cases, Plaintiffs fall woefully short.

First, Plaintiffs contend that in *Fisher Bros.* and *General Dynamics*, unlike here, there was no evidence that the "agency's actions were unauthorized" or "that the federal agents' conduct violated any mandatory statutes or policies."[16] But this is not true. In *Fisher Bros.*, the plaintiffs alleged, and the court assumed, that the FDA investigation that preceded the Commissioner's decision "conformed neither to the FDA's Regulatory Procedures Manual nor to good laboratory practices generally."[17] And in *General Dynamics*, the district court, before it was reversed, specifically denied immunity because the government's investigators had violated "*mandatory* auditing standards."[18] Just as these allegations did not defeat discretionary function immunity in *Fisher Bros.* and *General Dynamics*, so do Plaintiffs' allegations fail here.

Second, Plaintiffs contend that in *Fisher Bros.* and *General Dynamics*, "the prosecutorial and investigative choices" were "too intertwined . . . to be sufficiently separated."[19] True, but Plaintiffs do not explain how their case is different, and it is not. In *Fisher Bros.*, the court did not permit the plaintiffs to dissociate the negligence of FDA lab technicians from the discretionary decision to ban Chilean grapes. In *General Dynamics*, the court did not permit the

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[15] *See* Pls.' Resp. at 22-23 & n.8.

[16] *Id.*

[17] *Fisher Bros.*, 46 F.3d at 286.

[18] *Gen. Dynamics Corp. v. United States*, No. CV 89-6762 JGD, 1996 WL 200255, at *35 (C.D. Cal. Mar. 25, 1996) (emphasis added).

[19] Pls.' Resp. at 22.

plaintiffs to dissociate the negligence of government auditors from the discretionary decision to indict. Here, the Court should not permit Plaintiffs to dissociate the SEC's allegedly negligent investigations of Madoff from the Commission's failure to enjoin him. In this case, as in *Fisher Bros.* and *General Dynamics*, the conduct on which Plaintiffs focus—even *if* it violated mandatory procedures—matters only to the extent that it informed a discretionary act that cannot be challenged under the FTCA.

In their response, Plaintiffs concede the interconnectedness of the Commission's failure to enjoin and the staff's flawed investigations. "[I]t is beyond dispute," they admit, "that the SEC would have prosecuted Madoff if its investigations had not been sabotaged by staffers' negligence."[20] Plaintiffs were right to cede this point, as any attempt to excise the SEC's investigations from the Commission's ultimate decision would, as the court in *Fisher Bros.* recognized, violate Supreme Court precedent:

> If plaintiffs injured by regulatory policy decisions were permitted to prosecute damage actions by challenging the manner in which the underlying data was collected, federal courts, of necessity, would be required to examine in detail the decisionmaking process . . . to determine what role the challenged data played . . . and what the policymaker's decision would have been if he or she had received the unchallenged data but not the challenged data (or had received other data in lieu of the challenged data). Without such an examination and all of the discovery that would necessarily precede it, a plaintiff . . . would be unable to prove a causal link between the alleged negligence and the alleged injury. Yet this is precisely the kind of inquiry that the Supreme Court sought to foreclose when it ruled out any inquiry into an official's "subjective intent in exercising the discretion conferred by statute or regulation."[21]

Plaintiffs cannot distinguish this case from *Fisher Bros.* and *General Dynamics*, which

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[20] *Id.* at 25-26.

[21] *Fisher Bros.*, 46 F.3d at 286 (quoting *Gaubert*, 499 U.S. at 325).

demonstrate that dismissal is warranted here.

Plaintiffs similarly struggle to reconcile their argument with the D.C. Circuit's decision in *Sloan v. United States Department of Housing and Urban Development*. There, government contractors sought damages for an allegedly negligent investigation that led to their suspension.[22] The court recognized, however, that the challenged investigation was "inextricably tied to the discretionary, quasi-prosecutorial decision to suspend plaintiffs from governmental contracting."[23] "Because the allegedly improper investigation . . . caused no injury 'distinct from the harm caused by the ultimate prosecution itself,'" the court held that the discretionary function exception barred the plaintiffs' claim.[24]

Plaintiffs say that *Sloan* is distinguishable because "the source of [the plaintiff's] injury was HUD's ultimate decision to suspend him from performing contracting work for the agency—an undeniably discretionary choice—and not the investigation itself."[25] But the same is true here. Plaintiffs were hurt by the Commission's failure to stop Madoff. That "undeniably discretionary choice" cannot be separated from the investigations on which it was based. In both *Sloan* and here, an "undeniably discretionary choice"—in *Sloan*, the decision to suspend the contractors; here, the failure to enjoin Madoff—was premised on a faulty investigation.

Plaintiffs also attempt to distinguish *Sloan* by claiming that there, the court found no

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[22] *Sloan v. HUD*, 236 F.3d 756, 759 (D.C. Cir. 2001).

[23] *Id.* at 762.

[24] *Id.* (quoting *Gray v. Bell*, 712 F.2d 490, 515 (D.C. Cir. 1983)).

[25] Pls.' Resp. at 21.

violation of a specific and mandatory duty.[26] Although this is true, it served only as the basis for the court's alternate holding. The court's primary holding *assumed* that the investigators had violated mandatory duties during their investigation, yet still applied the discretionary function exception because the contractors were challenging the sufficiency of an investigation that was inextricably tied to the discretionary decision to suspend them.[27] That the court later found that the investigators did not violate a mandatory duty was irrelevant to this analysis.

Finally, dismissal is supported by another case the United States cited, but which Plaintiffs ignored, *Jayvee Brand, Inc*. There, manufacturers of children's pajamas challenged the Consumer Product Safety Commission's decision to ban fabrics treated with a certain flame retardant.[28] The manufacturers conceded that the decision to ban the fabrics was discretionary and could not be challenged. But "with considerable ingenuity," they argued that the discretionary function exception did not bar their claim because in adopting the ban, the CPSC failed to follow prerequisite statutory procedures.[29] The court rejected that argument, holding that although the "CPSC abused its undoubted discretion by arriving at its decision in the wrong way," "making a discretionary decision *without following mandated procedures* should be characterized, for the purposes of the FTCA, as an abuse of discretion."[30]

These cases—*Fisher Bros.*, *General Dynamics*, *Sloan*, and *Jayvee Brand*—stand for the

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[26] *See id.*

[27] *See Sloan*, 236 F.3d at 762.

[28] *Jayvee Brand, Inc. v. United States*, 721 F.2d 385, 387 (D.C. Cir. 1983).

[29] *Id.* at 388-89.

[30] *Id.* at 389-90 (emphasis added).

proposition that plaintiffs may not avoid the discretionary function exception by framing their claims as challenges to the investigations that underlie discretionary decisions, or by pointing to acts of negligence or even violations of mandatory procedures that are inextricably intertwined with the discretionary acts that caused their injuries. Because Plaintiffs allege that the Commission's failure to stop Madoff resulted directly from the staff's flawed investigations, the discretionary function exception applies.

III. Plaintiffs do not have a viable claim distinct from the Commission's failure to act.

Even if the Court were to look behind the Commission's failure to act, and focus instead on the SEC's failure to detect Madoff's crimes and warn Plaintiffs, the discretionary function exception would apply.

A. No federal directive requires the SEC to issue warnings.

Plaintiffs argue that the SEC was mandated to warn them of Madoff's crimes. But federal law actually *prohibits* SEC staff from publicly disclosing their investigations and examinations. Section 202.5(a) of the Commission's regulations provides that investigations into alleged violations of the securities laws are considered "non-public," "[u]nless otherwise ordered by the Commission."[31] Not surprisingly, then, Plaintiffs have been unable to find a statute, regulation, or policy that specifically required the SEC to warn them about Madoff.

Undeterred by the absence of a mandate, which should end the matter, Plaintiffs persist in their argument that the SEC had no choice but to warn them. According to Plaintiffs, this

[31] *See* 17 C.F.R. § 202.5(a).

requirement somehow sprung from the SEC's decisions to investigate Madoff. They argue that in deciding "to conduct investigations of Madoff," the SEC "took on" a duty "to warn investors or potential investors in Madoff's Ponzi scheme."[32] At least two courts have rejected this exact argument.[33]

In *Hall v. United States*, the victims of a Ponzi scheme operated by an FBI informant brought suit under the FTCA.[34] They alleged that the FBI had *actual knowledge* that the informant was committing a crime, but "'failed to take any action to report the Ponzi scheme or to stop the Ponzi scheme, or to warn any actual or potential victims of the Ponzi scheme.'"[35] Like Plaintiffs here, the victims in *Hall* could not identify a federal directive that would have required the government to warn them directly. They did, however, allege that the FBI violated the Attorney General's Guidelines on Confidential Informants, which required it to notify the U.S. Attorney upon discovering that its informant was committing a crime.[36] Even assuming a violation of these guidelines, the court held that the discretionary function exception barred the victims' claims:

> Plaintiffs do not identify any requirement in the Guidelines that the FBI notify or warn actual or potential victims of the confidential informant's criminal activity even upon learning about it. . . . Thus, whether to warn actual or potential victims is a matter within the FBI's discretion not governed by a policy

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[32] Pls.' Resp. at 24.

[33] *See Hall v. United States*, 233 F.R.D. 591, 596 (D. Nev. 2005); *see also Redmond v. United States*, 518 F.2d 811, 814 (7th Cir. 1975).

[34] *Hall*, 233 F.R.D. at 592.

[35] *Id.* at 593 (quoting the complaint).

[36] *Id.* at 596.

prescribing a particular course of conduct, and is not actionable under the FTCA.[37] Significantly, even though the FBI had actual knowledge that its informant was defrauding the plaintiffs, the court did *not* hold that the FBI had "assumed" a duty to warn them, such that the discretionary function exception did not apply.

In *Redmond v. United States*, the Seventh Circuit similarly rejected a duty-to-warn argument. There, the plaintiff sought to recover for the failure of government agencies, *including the SEC*, to warn him that he was being defrauded by a securities dealer—"a danger which they *knew* to exist."[38] The court rejected the plaintiff's claim because, "in the absence of [a] statute, there is [no] legally-enforceable duty on the part of the Government to warn . . . victims of criminal activity."[39] Although its dismissal rested on the FTCA's misrepresentation exception, the court specifically cited the discretionary function exception in rejecting the plaintiff's duty-to-warn argument, observing that "how best to fulfill" the government's "duty to maintain law and order . . . is wholly within the discretion of its officers, and § 2680(a) excepts from the Act both discretionary functions and discretionary duties."[40] Again, the court made no finding that the United States had "assumed" a duty to warn. Moreover, the allegation in *Redmond* that the government *actually knew* of the danger disproves Plaintiffs' supposed distinction of this case as

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[37] *Id.*

[38] *See Redmond*, 518 F.2d at 814 (emphasis added).

[39] *Id.* at 816; *id.* ("Courts have consistently rejected the contention that, absent legislation, . . . the national government . . . may be held liable for damages resulting from criminal conduct.").

[40] *See id.* at 816-17.

one where "the agents in question" had not "found . . . an impending danger."[41]

Plaintiffs' reliance on the decision in *Peck v. United States* is misplaced. They cite it to support their contention that the government may assume, through its conduct, a duty to warn.[42] But *Peck* did not involve the discretionary function exception; indeed, it was not even an FTCA case. The "duty to warn" discussed in *Peck* refers not to an established federal mandate, but rather to a duty under state law.[43] Even if such a duty existed, and even if the United States breached it, the discretionary function exception would still apply unless Plaintiffs could point to a federal statute or regulation that mandated a warning, and they cannot.

The other cases relied on by Plaintiffs to establish a duty to warn, all premises-liability actions, do not help them. The decision in *Prescott v. United States* is distinguishable because there the plaintiffs argued that the government "acted in contravention of its own regulations."[44] Here, in contrast, Plaintiffs cannot point to a regulation that would have required a warning; indeed, the only regulation that even touches on the subject actually *prohibits* public disclosure by SEC staff.

In the other cases Plaintiffs cite, the courts agreed with the United States that it had no specific, mandatory duty to warn, but held that the discretionary function exception did not apply because the decisions not to place warning signs on the properties in question did not involve

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[41] *See* Pls.' Resp. at 24.

[42] *Id.*

[43] *See Peck v. United States*, 470 F. Supp. 1003, 1017 (S.D.N.Y. 1979).

[44] *See Prescott v. United States*, 973 F.2d 696, 703 n.6 (9th Cir. 1992).

policy considerations.[45] Whether to warn the public about a possible securities fraud, on the other hand, is susceptible to several important policy considerations. Most significant, perhaps, is that the issuance of warnings could frustrate the government's law-enforcement objectives, as warnings "tip off" not only a fraud's victims, but also its perpetrators. Also, the Commission must account for the market panic that such a warning could cause. As Plaintiffs themselves recognize, one aspect of the Commission's mission is to "maintain fair, orderly, and efficient markets."[46] The issuance of a warning could, in some circumstances, frustrate this mission.

Because the Commission is not required to warn the potential victims of fraud, and because any decision to warn by SEC staff (were it even permitted by law) would implicate policy considerations, the discretionary function exception bars Plaintiffs' claim.

B. The SEC did not forfeit its discretion by deciding to investigate Madoff.

Throughout their response, Plaintiffs argue that once the SEC decided to investigate Madoff, it had a mandatory duty to do so in a non-negligent way.[47] Until twenty years ago,

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[45] *See Duke v. Dep't of Agric.*, 131 F.3d 1407, 1410-12 (10th Cir. 1997) (holding that no statute, regulation, or policy specifically prescribed a course to follow, but that decision to place sign did not implicate policy concerns); *Cope v. Scott*, 45 F.3d 445, 451-52 (D.C. Cir. 1995) (concluding "that the posting of signs in Rock Creek Park involves the exercise of discretion," but holding that the failure to do so does not "implicate[] the type of economic, social, or political concerns that the discretionary function exception protects"); *Boyd v. United States*, 881 F.2d 895, 898 (10th Cir. 1989) ("An alleged failure to warn swimmers of dangerous conditions . . . does not implicate any . . . policy judgments with which the discretionary function exception properly is concerned.").

[46] *See* Pls.' Resp. at 25 (quoting the SEC's website).

[47] *See, e.g.*, *id.* at 19 ("Plaintiffs' claim is based on the rule that once the Government exercises its discretion . . . it must conduct its investigations in compliance with any applicable written requirements and otherwise within a permissible range of action."), 31 ("Once a

arguments such as this were made frequently by plaintiffs in FTCA cases. These arguments were based on a mistaken understanding of the decision in *Indian Towing Co. v. United States*,[48] where the plaintiffs had alleged that a barge ran aground due to the Coast Guard's negligent operation of a lighthouse. The Court stated that "once [the government] exercised its discretion to operate a light . . . and engendered reliance on the guidance afforded by the light, it was obligated to use due care to make certain that the light was kept in good working order."[49]

In *Gaubert*, however, the Supreme Court laid to rest the *Indian Towing* "test." There, the court of appeals had relied on *Indian Towing* to distinguish between "policy decisions," for which the United States could not be held liable, and "operational decisions," for which it could.[50] Accordingly, the court of appeals held that "the [government] officials were only protected by the discretionary function exception until their actions became operational in nature and thus crossed the line established in *Indian Towing*."[51] The Supreme Court flatly rejected this analysis:

> The United States was held liable [in *Indian Towing*], not because the negligence occurred at the operational level[,] but because making sure the light was operational "did not involve any permissible exercise of policy judgment." Indeed, the Government did not even claim the benefit of the [discretionary function] exception . . . . The Court of Appeals misinterpreted *Berkovitz*'s reference to *Indian Towing* as perpetuating a nonexistent dichotomy between discretionary functions and operational activities. Consequently, once the court

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regulatory task is undertaken, it is not within an agency's discretion to negligently perform it.").

[48] *Indian Towing Co. v. United States*, 350 U.S. 61 (1955).

[49] *Id.* at 69.

[50] *Gaubert*, 499 U.S. at 321.

[51] *Id.* (internal quotes omitted).

> determined that some of the actions challenged by Gaubert occurred at the operational level, it concluded, *incorrectly*, that those actions must necessarily have been outside the scope of the discretionary function exception.[52]

To hold that the SEC had discretion in deciding *whether* to investigate Madoff, but not in the *way* it investigated him, would give effect to the "dichotomy between discretionary functions and operational activities" that the Supreme Court so plainly rejected in *Gaubert*. Moreover, Plaintiffs' attempt to distinguish the decision to investigate from the manner of investigation is irrelevant, as the applicable statutes expressly vest the SEC with discretion with respect to both.[53]

C. The 1934 Securities Exchange Act does not mandate specific conduct.

Plaintiffs argue that the SEC violated a specific, mandatory provision of the 1934 Securities Exchange Act by failing to share information with examining authorities.[54] The provision they cite states that the "Commission and the examining authorities shall share such information, including reports of examinations, customer complaint information, and other nonpublic regulatory information, *as appropriate* to foster a coordinated approach to regulatory oversight of brokers and dealers that are subject to examination by more than one examining authority."[55] Pointing to the statute's use of the word "shall," Plaintiffs argue that the first part of the test for discretionary function immunity is not met.

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[52] *Id.* at 326 (citations omitted) (emphasis added).

[53] *See, e.g.*, 15 U.S.C. § 78u(a)(1) (providing that SEC may "in its discretion" make investigations "as it deems necessary" and that SEC may "in its discretion . . . investigate any facts, conditions, practices, or matters which it may deem necessary or proper").

[54] *See* Pls.' Resp. at 26-27.

[55] 15 U.S.C. § 78q(k)(2) (emphasis added).

But "the presence of a few, isolated provisions cast in mandatory language" does not necessarily defeat the discretionary function exception.[56] "Only if a federal statute, regulation, or policy specifically prescribes a course of action embodying a *fixed or readily ascertainable standard*, will a government employee's conduct not fall within the discretionary function exception."[57] Accordingly, courts routinely apply the exception even where a federal statute *requires* government employees to act, and particularly where the statute leaves it to the employees to determine what is "appropriate" in fulfilling the requirement.[58]

The 1934 Act does not prescribe how much information the SEC must share; rather, it expressly leaves that to the SEC. Because the statute fails to prescribe a specific course of action "embodying a fixed or readily ascertainable standard," it cannot defeat the discretionary function exception.

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[56] *Sabow v. United States*, 93 F.3d 1445, 1453 (9th Cir. 1996).

[57] *Hughes v. United States*, 110 F.3d 765, 768 (11th Cir. 1997); *accord Autery v. United States*, 992 F.2d 1523, 1529 (11th Cir. 1993); *see also Downs v. United States Army Corps of Eng'rs*, 333 Fed. App'x 403, 408 (11th Cir. 2009) ("A policy, statute, regulation, or contract that indicates an employee 'shall' do something may leave room for policy-based judgments that fall within the discretionary function exception.").

[58] *See, e.g.*, *Ochran v. United States*, 117 F.3d 495, 500-01 (11th Cir. 1997) (holding that discretionary function exception applied even though regulation stated that prosecutor "shall make the necessary and appropriate arrangements" to protect victims, as prosecutor retained authority to determine what was "necessary and appropriate"); *La Union Del Pueblo Entero v. FEMA*, No. B-08-487, 2009 WL 1346030, at *4 (S.D. Tex. May 13, 2009) ("[W]hen 'shall' is modified by a discretionary phrase such as . . . 'as appropriate' an agency has some discretion when complying with the mandate."); *cf. Consumer Fed'n of Am. v. U.S. Dep't of Health & Human Servs.*, 83 F.3d 1497, 1503 (D.C. Cir. 1996) ("Although the word 'shall' is often used to impose a mandatory duty, the inclusion of the words 'as appropriate' directly following 'shall' suggests that the agency [has discretion].") (citation omitted).

D. Plaintiffs' conclusory allegations concerning internal policies are contradicted by materials incorporated into their Complaint.

To defeat the discretionary function exception, Plaintiffs may not generally allege the violation of a mandatory duty; rather, they must specifically identify one with which the SEC failed to comply.[59] In their response, Plaintiffs claim to have identified "internal policies" that were violated by SEC during their examinations and investigations of Madoff, and cite paragraphs 84, 86, 109, 130, and 131 of the Complaint as instances where they have alleged such violations.[60] Those paragraphs of the Complaint, in turn, cite pages 131-33, 136, 144, 262-65, and 284 of the IG's report where, Plaintiffs contend, the IG "repeatedly admits the agency's violation of applicable statutes and the SEC's own internal policies."[61]

Quoting from the report, Plaintiffs argue that SEC staff violated two specific policies: one that purportedly required SEC staff to "create reports" when they "opened and closed their

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[59] *See, e.g.*, *ALX El Dorado, Inc. v. S.W. Sav. & Loan Ass'n*, 36 F.3d 409, 411-12 (5th Cir. 1994) ("[T]he plaintiffs here have alleged only some generalized failures to follow mandatory rules; they have failed—either in the complaint or here on appeal—to point to even one relevant mandatory limitation on that statutory discretion. Such averments are insufficient, in themselves, to defeat the first part of the *Gaubert* test."); *Hobdy v. United States*, No. 91-3204, 1992 WL 149871, at *2 (10th Cir. June 26, 1992) ("While the discretionary function exception does not apply when a federal statute, regulation, or policy specifically prescribes a course of action for an employee to follow, plaintiff failed to set forth the governing regulations. We will not manufacture her argument for her.") (citation omitted); *Hall*, 233 F.R.D. at 596 ("[I]t is not enough for Plaintiffs to identify some source of agency policy generally. Rather, Plaintiffs must allege the [agency's] Manual of Operations specifically prescribes a course of action for an employee to follow . . . which the [agency] violated."); *Lafayette Fed. Credit Union v. United States*, 76 F. Supp. 2d 645, 653 (D. Md. 1999) ("It is not sufficient that Plaintiffs allege vague, generalized failures to follow mandatory rules. In order to defeat the first prong of the discretionary function test, Plaintiffs must identify a breach of a specific mandatory statute, regulation, or policy which prescribes a specific course of conduct.") (citation omitted).

[60] *See* Pls.' Resp. at 5-6, 27 (citing Compl. ¶¶ 84, 86, 109, 130, 131).

[61] *Id*. at 2.

investigations," and another that supposedly required SEC staff to "consult the SEC's [STARS] computer system."[62] According to Plaintiffs, "[t]he Report states that this was in violation of internal policies that made such tasks mandatory."[63] On close examination, however, Plaintiffs' representations concerning the contents of the IG's report prove false.

On page 132 of his report, the IG quotes one SEC staffer as saying they were "supposed to" log information into the SEC's computer system, and another who said that SEC staff "never" used the system. On page 133, the IG quotes another person as saying that her group "did not log their examinations into the STARS system." Nowhere, however, does the IG identify any specific, mandatory SEC policy concerning this issue or conclude that such a policy was violated.

The same is true for the supposed policy on completing case reports. As recounted on page 136 of the IG's report, one person testified that "drafting a closing report at the conclusion of an examination is 'good practice.'" Another said that "staff is supposed to [complete a report] – when they finish an exam." But on the very next page (137), that same person concludes that perhaps no report was completed because no conclusions were reached. Finally, on page 144, the IG concludes only that the lack of a closing report "was a critical error," not that it violated any mandatory policy. Plaintiffs' conclusory allegations that the SEC violated mandatory policies are therefore contradicted by the very report on which those allegations purport to be based.

Plaintiffs' allegations concerning violations of "internal policies" are further contradicted

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[62] *Id.* at 27.

[63] *Id.* at 27-28.

by the SEC's Enforcement Manual, which was an exhibit to the IG's report.[64] That manual comprehensively addresses almost every aspect of an SEC investigation. But by its very terms, the manual provides *no* mandates for SEC staff:

> The Enforcement Manual is . . . designed to be a reference for the staff in the U.S. Securities and Exchange Commission's ("SEC") Division of Enforcement ("Division" or "Enforcement") in the investigation of potential violations of the federal securities laws. It contains various general policies and procedures *and is intended to provide guidance only* to the staff of the Division. It is not intended to, does not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal.[65]

Plaintiffs do not discuss the Enforcement Manual in any of their papers, presumably because, given its "guidance only" disclaimer, it cannot be the source of a *mandatory* directive.[66] And because the "guidance only" manual applies to every aspect of the challenged investigations, it

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[64] *See* IG's Report at 263 n.183 (citing Enforcement Manual as exhibit to report). A copy of the Enforcement Manual is attached hereto as Exhibit A. It is also available at the SEC's website: http://sec.gov/divisions/enforce/enforcementmanual.pdf.

[65] *See* Enforcement Manual at 1.

[66] *See Aragon v. United States*, 146 F.3d 819, 824 (10th Cir. 1998) ("An agency manual, in contrast to a regulation, is not necessarily entitled to the force and effect of law. This is particularly true if the agency did not intend the manual to be mandatory, but rather intended it as a guidance or advisory document.") (citation omitted); *Hamlet v. United States*, 63 F.3d 1097, 1103-05 (Fed. Cir. 1995) (holding that agency personnel manual is not binding if, among other factors, agency did not intend for it to be binding); *WildEarth Guardians v. United States Fish & Wildlife Serv.*, 622 F. Supp. 2d 1155, 1164 (D. Utah 2009) (holding that agency's handbook could not create mandatory directive because it was "intended as a guide" and "was not meant to have the force of law"); *Compagnie Mar. Marfret v. San Juan Bay Pilots Corp*., 532 F. Supp. 2d 369, 381 & n.14 (D.P.R. 2008) (holding that manual was not mandatory in part because it stated that it was "intended only for the internal guidance of personnel"); *Moore v. Hartman*, Civ. A. No. 92-2288 (NHJ), 1993 WL 405785, at *9 n.5 (D.D.C. Sept. 24, 1993) (holding that DOJ manual did not impose mandatory directive, notwithstanding its statement that prosecutors "must" disclose certain evidence to grand jury, because manual stated that it "provides only internal Department of Justice guidance" and "is not intended to, does not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal").

renders implausible Plaintiffs' conclusory allegations that SEC staff violated *mandatory* policies, and requires dismissal of Plaintiffs' claim.[67]

E. Plaintiffs' permissible-range-of-conduct argument does not comport with the Supreme Court's two-part test.

Purportedly relying on *Fazi v. United States*, Plaintiffs argue that the SEC was *so* negligent that the discretionary function exception cannot apply.[68] In *Fazi*, the court ruled for the United States, correctly noting that *Gaubert* prohibits challenges "as to which of a range of permissible courses is wisest."[69] Seizing on this characterization of *Gaubert*, Plaintiffs argue that the SEC's conduct was so "asinine" and with "no basis" that it simply cannot be considered within the "permissible range of conduct."[70]

Plaintiffs' argument is wrong because the discretionary function exception applies regardless of how improperly the government might have acted.[71] Indeed, the FTCA specifically

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[67] *See Iqbal*, 129 S. Ct. at 1950 ("[O]nly a complaint that states a plausible claim for relief survives a motion to dismiss.").

[68] *See* Pls.' Resp. at 30-31.

[69] *Fazi v. United States*, 935 F.2d 535, 538 (2d Cir. 1991).

[70] Pls.' Resp. at 30.

[71] *See, e.g., In re "Agent Orange" Prod. Liab. Litig.*, 818 F.2d 210, 215 (2d Cir. 1987) ("[W]here . . . the Government is performing a discretionary function, the fact that discretion is exercised in a negligent manner does not make the discretionary function exception inapplicable."); *Sabow*, 93 F.3d at 1454 (applying discretionary function exception even where agency exhibited "poor judgment and a general disregard for sound investigative procedure"); *Gasho v. United States*, 39 F.3d 1420, 1435 (9th Cir. 1994) ("That the conduct of the agents may be tortious or motivated by something other than law enforcement is beside the point, as governmental immunity is preserved 'whether or not the discretion involved be abused.'"); *Golden Pac. Bancorp v. Clarke*, 837 F.2d 509, 512 (D.C. Cir. 1988) (holding that discretionary

provides that the exception applies "whether or not the discretion involved be abused."[72] Thus, the Supreme Court, since as early as its decision in *Dalehite v. United States*, has held that the exception covers both "negligence and wrongful acts in the exercise of . . . discretion,"[73] and federal courts have applied the exception even in cases where government employees exercised their discretion with *gross* negligence or intentional misconduct.[74]

Contrary to the premise of Plaintiffs' argument, all that matters is that the challenged "function or duty" is "discretionary"[75] Conduct is "discretionary" under *Gaubert* unless a statute, regulation, or policy says that it is not.[76] Here, Plaintiffs have been unable to identify a statute,

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function exception may apply even when government's actions were "entirely arbitrary or capricious").

[72] *See* 28 U.S.C. § 2680(a).

[73] *Dalehite v. United States*, 346 U.S. 15, 33 (1953).

[74] *See, e.g.*, *Scanwell Labs, Inc. v. Thomas*, 521 F.2d 941, 948 (D.C. Cir. 1975) (holding that "even a gross abuse of discretion will not predicate an award of tort damages" under the FTCA); *Nogueras-Cartagena v. United* States, 172 F. Supp. 2d 296, 318 (D.P.R. 2001) (holding that discretionary function exception applies despite evidence "indicating that [the employee's] actions constituted 'gross negligence'"); *O'Ferrell v. United States*, 968 F. Supp. 1519, 1540 (M.D. Ala. 1997) ("The fact that [the challenged conduct] may have been negligent, wrongful, intentional, or an abuse of discretion does not make the discretionary function exception inapplicable.").

[75] *See* 28 U.S.C. § 2680(a).

[76] *Gaubert*, 499 U.S. at 328 ("We first inquire whether the challenged actions were discretionary, *or* whether they were *instead* controlled by mandatory statutes or regulations.") (emphasis added); *Baum v. United States*, 986 F.2d 716, 720 (4th Cir. 1993) ("The [first] inquiry boils down to whether the government conduct is the subject of any mandatory federal statute, regulation, or policy prescribing a specific course of action. . . . If no such mandatory statute, regulation, or policy applies to remove the challenged conduct from the choice and judgment of the government, then we move to the second tier of the *Berkovitz-Gaubert* analysis."); *Callahan v. United States*, 329 F. Supp. 2d 404, 407 (S.D.N.Y. 2004) ("First, the Court must determine whether the challenged action involves an element of choice or judgment, as opposed to a

regulation, or policy that restricts the SEC's investigations. The first part of the discretionary function test is therefore satisfied.

F. Plaintiffs are not entitled to discovery.

Plaintiffs cannot avoid dismissal based on a supposed need for discovery to find a federal directive that does not exist in any statute, regulation, or the Enforcement Manual, and that the IG did not identify in his 457-page report, on which the Complaint is predicated.

Plaintiffs rely on the D.C. Circuit's decision in *Ignatiev v. United States*.[77] There, the court permitted limited discovery because, although there was no statute or regulation that imposed a mandatory directive, the plaintiffs had not been able to access the Secret Service's "internal objectives or policies" that may have "created the requisite mandatory obligation."[78] This decision is distinguishable for several reasons.

First, in *Ignatiev*, the plaintiffs had been unable to access internal policies. The Plaintiffs here, in contrast, by their own admission, obtained the SEC's Enforcement Manual in response to their FOIA request as early as February 23, 2009—more than six months before they filed suit. According to his own declaration, Plaintiffs' counsel, Howard R. Elisofon, submitted a FOIA request to the SEC on January 26, 2009.[79] He specifically requested any "documents concerning

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circumstance in which a federal statute, regulation, or policy specifically prescribes a course of action for an employee to follow. If no such mandate exists, the action is considered one of choice or judgment and the first step is satisfied.") (citations omitted).

[77] *Ignatiev v. United States*, 238 F.3d 464 (D.C. Cir. 2001).

[78] *Id.* at 466.

[79] *See* Decl. of Howard R. Elisofon (Doc. 14) at 5.

any manuals, policies, procedures, practices, rules, regulations, directives, orders, instructions or customs concerning the conduct by the SEC of audits, inquiries or other investigations of broker/dealers, investment advisory firms, or hedge funds."[80] In response, the SEC referred Mr. Elisofon to its Enforcement Manual, which was (and still is) available on the SEC's website.[81] If Plaintiffs believed that this response was incomplete, they had a remedy under FOIA. They may not, however, use this belief as a basis for obtaining discovery to which they otherwise would not be entitled under the Federal Rules of Civil Procedure in a discretionary function case.[82] In any event, Mr. Elisofon's own declaration undercuts Plaintiffs' assertion that they "have been thwarted" in their efforts "to obtain additional evidence relating to policies not specifically mentioned in the Report, such as manuals or guidelines,"[83] and constitutes a distinction between this case and *Ignatiev*.

Second, *Ignatiev* is distinguishable because there, the plaintiffs had "reason to believe that some . . . guidelines exist[ed]."[84] Indeed, the pertinent statute specifically contemplated that the Director "may prescribe" duties for the Secret Service to perform.[85] Here, in contrast,

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[80] *Id.* at 6.

[81] *Id.* at 11.

[82] *See John Doe Agency v. John Doe Corp*., 493 U.S. 146, 153 (1989) (observing that "FOIA was not intended to supplement or displace rules of discovery"); *McQueen v. United States*, 179 F.R.D. 522, 530-31 (S.D. Tex. 1998) (recognizing "the Supreme Court's numerous pronouncements that FOIA and discovery under the Federal Rules of Civil Procedure serve separate purposes and accordingly operate under different rules").

[83] Pls.' Resp. at 7 (citation omitted).

[84] *Ignatiev*, 238 F.3d at 467.

[85] *Id.* (quoting 3 U.S.C. § 202).

Plaintiffs do not cite any basis for their speculation about the existence of policies other than those in the statutes, regulations, and Enforcement Manual, which Plaintiffs have had for more than a year.

More analogous than *Ignatiev* is the Fifth Circuit's recent decision in *Freeman v. United States.*[86] There, relatives of Hurricane Katrina victims sued the United States for its "inadequate, unorganized, and flawed" response to the tragedy.[87] The United States invoked the discretionary function exception, and the district court dismissed the case at the pleading stage because the plaintiffs could not point to a specific, mandatory directive with which the government had failed to comply.[88] On appeal, the plaintiffs argued that they should have been permitted to take discovery regarding the existence of such mandatory directives, but the court of appeals rejected that argument. It found "no fault in the district court's conclusion that a mandatory directive, if one existed, could be found in the public realm."[89] "This is particularly true," the court observed, because "plaintiffs ha[d] relied on numerous congressional investigations regarding the government's response to Hurricane Katrina."[90]

Like the plaintiffs in *Freeman*, Plaintiffs here rely on a comprehensive investigation of the government's conduct. During the course of preparing his report, the IG took the sworn

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[86] *Freeman v. United States*, 556 F.3d 326 (5th Cir. 2009).

[87] *Id.* at 332.

[88] *Id.* at 333.

[89] *Id.* at 342.

[90] *Id.* at 342 n.16.

testimony of 72 witnesses, 64 of whom were present or former SEC officials.[91] The IG also conducted an additional 61 informal interviews, including 20 of present or former SEC officials.[92] The IG's report included hundreds of exhibits and thousands of pages of transcripts, all of which is publicly available. If no mandatory directive can be found in the statutes that govern the SEC, or in the promulgated regulations that govern it, or in the SEC's Enforcement Manual, or in the IG's 457-page report (which was, after all, aimed at determining where the SEC went wrong), then there is no reason to assume that any amount of discovery would unearth a mandatory directive. The Court should therefore reject Plaintiffs' request for discovery.[93]

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[91] *See* IG's Report at 7-14 (listing witnesses).

[92] *See id.* at 15-20.

[93] *See Mesa v. United States*, 123 F.3d 1435, 1439 (11th Cir. 1997) (holding that appellants failed to "point[ ] to any requested discovery that could reasonably be expected to reveal" conduct outside discretionary function exception); *see also In re Orthopedic Bone Screw Prod. Liab. Litig.*, 264 F.3d 344, 365 (3d Cir. 2001) (affirming stay of discovery pending dispositive motion where proposed discovery was for claims within the FTCA's discretionary function exception); *Creek Nation Indian Hous. Auth. v. United States*, 905 F.2d 312, 313 (10th Cir. 1990) (affirming denial of discovery before plaintiff could ascertain a violation of a nondiscretionary duty where the plaintiff failed to identify any applicable nondiscretionary regulation); *Miller v. United States*, 710 F.2d 656, 666 (10th Cir. 1983) (affirming denial of discovery where "there are no facts which plaintiffs could arguably develop to escape the effect of the statutes and regulations," which were "within the discretionary function exception"); *id.* ("The statutes, regulations and all the publications referred to in the regulations were . . . available to both sides and the pattern they reveal is one coming within the discretionary function exception."); *Hobdy v. United States*, No. 91-3204, 1992 WL 149871, at *2 (10th Cir. June 26, 1992) ("Plaintiff contends that the discretionary function exception does not apply because actions of agents of the United States with respect to contract compliance are governed by federal regulations. . . . [P]laintiff failed to set forth the governing regulations. We will not manufacture her argument for her."); *Goetz & Sons W. Meat LLC v. United States*, No. C07-00986MJP, 2008 WL 449654, at *3 (W.D. Wash. Feb. 19, 2008) ("Although Plaintiff contends that further discovery will uncover internal policies governing the protocol for an inspector's actions, internal policies do not have the effect of law and could not transform Plaintiff's claims into claims properly asserting subject matter jurisdiction.") (citation omitted).

Finally, the Court should deny discovery because even if Plaintiffs *could* find some "internal policy" that pertained to the Madoff investigation, it would not defeat the discretionary function exception. The Supreme Court has said that in determining whether a government actor has discretion, courts should look to "established governmental policy."[94] The Court was undoubtedly aware "that agencies typically make authoritative informal statements of policy positions through published interpretive rules or enforcement guidelines."[95] Indeed, "[t]o determine what is agency policy, courts customarily defer to the statements of the official policymaker, not others, even though the others may occupy important agency positions."[96] The "internal policies" that Plaintiffs speculate may exist, even assuming they do exist, were not enacted by the SEC's official policymaker—the Commission—and so lack the "decretory significance" that is required to bind an agency actor.[97] Therefore, even if SEC staffers did violate an "internal policy," the discretionary function exception would still apply.

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[94] *See Irving v. United States*, 162 F.3d 154, 165 (1st Cir. 1998) ("The *Gaubert* Court instructed inferior courts to look to the requirements set forth by 'established governmental policy' in mounting a discretionary function inquiry.") (quoting *Gaubert*, 499 U.S. at 324).

[95] *Id.* at 166.

[96] *Id.*

[97] *Id.*

IV. The challenged acts are susceptible to policy considerations.

The second part of the discretionary function test is satisfied if the challenged conduct is susceptible to policy considerations.[98] In certain circumstances, satisfaction of this test must be presumed: "When established governmental policy, as expressed or implied by statute, regulation, or agency guidelines, allows a Government agent to exercise discretion, it must be presumed that the agent's acts are grounded in policy when exercising that discretion."[99]

This presumption applies here, as the laws that govern the SEC expressly grant it discretion in deciding when and how to investigate. The 1934 Act specifically provides that "[t]he Commission *may, in its discretion,* make such investigations *as it deems necessary* to determine whether any person has violated, is violating, or is about to violate [the securities laws]."[100] The Act further provides that the SEC may "*in its discretion* . . . investigate any facts, conditions, practices, or matters *which it may deem necessary or proper*."[101] The Act affords similar discretion for the SEC's examinations.[102]

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[98] *Gaubert*, 499 U.S. at 325; *In re Joint E. & S. Dists. Asbestos Litig.*, 891 F.2d 31, 37 (2d Cir. 1989).

[99] *See Gaubert*, 499 U.S. at 324; *id* (holding that regulation that grants discretion "creates a strong presumption that a discretionary act authorized by the regulation involves consideration of . . . policies"); *Nurse v. United States*, 226 F.3d 996, 1001 (9th Cir. 2000) ("When a statute or regulation allows a federal agent to act with discretion, there is a 'strong presumption' that the authorized act is based on an underlying policy decision.") (quoting *Gaubert*).

[100] 15 U.S.C. § 78u(a)(1) (emphasis added).

[101] *Id.* (emphasis added).

[102] *See, e.g.*, 15 U.S.C. § 78q(a) & (b)(1) ("All records of [brokers and dealers] are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission . . . *as the Commission . . . deems necessary or appropriate* . . . .") (emphasis added); 15 U.S.C. § 80b-4(a) ("All records . . . of . . . investment advisers are

In addition to the Act, the SEC's Enforcement Manual leaves it to SEC staff to decide how best to perform day-to-day investigatory functions, including how to handle tips, open and close investigations, conduct witness interviews, request documents, and cooperate with other agencies and organizations.[103] For example, the manual states that in determining whether to open a "matter under inquiry," staff "*should* consider whether a sufficiently credible source or set of facts suggest that a MUI could lead to an enforcement action that would address a violation of the federal securities laws."[104] The manual then provides a list of eight factors that "*may*" be taken into consideration when making this determination.[105]

Once a determination is made to open a MUI, the manual provides a list of procedures for doing so. But even these procedures are only suggestions and not mandatory directives. Staff "*should* consult" with a supervisor "concerning the analysis"; "*should* fill out the electronic MUI form located in the Division's internal systems"; and "*should* maintain a copy of the correspondence" associated with opening the MUI.[106] Higher-level officials "*should* review the form" and "*may*" approve it "if [they are] satisfied that the MUI has the potential to address violative conduct."[107] Further, these officials "*should* draft and send an email message to a

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subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission *as the Commission deems necessary or appropriate* . . . .") (emphasis added).

[103] *See generally* Enforcement Manual (attached as Exhibit A.)

[104] *Id.* at 14 (emphasis added).

[105] *Id*. (emphasis added).

[106] *Id* at 15 (emphasis added).

[107] *Id*. (emphasis added).

Deputy Director with a brief explanation" of the MUI, and the Deputy Director "*should* review the e-mail promptly," and "*may* approve the opening of the MUI by e-mail to [staff]."[108] Thus, although the manual covers the minutiae of the SEC's investigations, it provides nothing close to a *mandatory* directive as to how staff must proceed.

Because "established government policy," as expressed by the statutes and the manual, "allows [the SEC] to exercise discretion" in the way it investigates, this Court must presume that the second part of the test is met. Indeed, application of the presumption in this case is particularly apt, as dozens of courts have held that the manner in which federal agencies conduct their investigations is susceptible to policy considerations.[109] Plaintiffs have no explanation for

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[108] *Id.* (emphasis added).

[109] *See, e.g.*, *Sabow*, 93 F.3d at 1453 (holding that federal investigations "clearly require investigative officers to consider relevant political and social circumstances in making decisions about the nature and scope of a criminal investigation"); *Vickers v. United States*, 228 F.3d 944, 951 (9th Cir. 2000) (recognizing that "the discretionary function exception protects agency decisions concerning the scope *and manner* in which it conducts an investigation so long as the agency does not violate a mandatory directive") (emphasis added); *Valdez v. United States*, No. 08 Civ. 4424 (RPP), 2009 WL 2365549, at *6 (S.D.N.Y. July 31, 2009) (holding that test's second part was satisfied because "a DEA agent's decision to conduct an investigation *in a particular manner* is subject to several policy considerations") (emphasis added); *id.* at *7 ("[D]ecisions about how to conduct investigations fall squarely within the discretionary function exception."); *Salafia v. United States*, 578 F. Supp. 2d 435, 439 (D. Conn. 2008) ("Beginning with the earliest cases brought pursuant to the FTCA, courts have repeatedly concluded that investigative functions qualify as discretionary functions to which § 2680(a) applies. . . . More recent decisions have reached the same conclusion."); *id.* ("That governmental investigations are the kind of discretionary functions covered by § 2680(a) is confirmed by the scores of other cases in accord."); *Woods v. United States*, Civ. Action No. 07-593 (DMC), 2007 WL 3243852, at **3-4 (D.N.J. Nov. 1, 2007) ("The second prong . . . is also satisfied because public policy considerations are involved. *How* a government agent should conduct an investigation is the paradigm decision that is protected by the discretionary function exception.") (emphasis added); *Rourke v. United States*, 744 F. Supp. 100, 103 (E.D. Pa. 1988) ("[T]o the extent that Rourke seeks compensation [based on] a flawed investigation, the discretionary function exception precludes the claims against the government in that the manner of conducting an investigation . . . [is] the kind of 'quintessentially' discretionary activit[y] for which sovereign immunity has not

these cases, and instead focus on two premises-liability cases, *Coulthurst v. United States* and *Whisnant v. United States*. In *Coulthurst*, a federal prisoner sought to hold the United States liable for a prison guard's failure to inspect the prison's gym equipment.[110] In *Whisnant*, an employee sought to hold the United States liable for failing to detect the presence of mold in a Navy commissary.[111] Neither decision supports Plaintiffs' position.

Relying on *Coulthurst*, Plaintiffs argue that because they allege that SEC staffers were motivated by laziness or inattentiveness, the Court must conclude that their actions were not based on policy considerations.[112] But this argument ignores the Supreme Court's admonition that "[t]he focus of the inquiry is not on the agent's subjective intent . . . , but on the nature of the actions taken and on whether they are *susceptible* to policy analysis."[113] The challenged actions meet this objective test. For instance, Plaintiffs cite as examples of "laziness" and "inattentiveness" staffers' decisions not to ask follow-up questions and to take Madoff's statements at face value.[114] Courts have routinely recognized, however, that deciding what questions to ask and whether to credit a witness's testimony are policy-based judgments that fall well within the protection of the discretionary function exception.[115]

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been waived.").

[110] *See Coulthurst v. United States*, 214 F.3d 106, 107 (2d Cir. 2000).

[111] *See Whisnant v. United States*, 400 F.3d 1177, 1179 (9th Cir. 2005).

[112] *See* Pls.' Resp. at 32-33.

[113] *Gaubert*, 499 U.S. at 325 (emphasis added).

[114] *See* Pls.' Resp. at 32.

[115] *See, e.g.*, *Valdez*, 2009 WL 2365549, at *7 (holding that claim that government failed to interview particular witness fell "squarely within the discretionary function exception");

Relying on *Whisnant*, Plaintiffs argue that the SEC may not cite limited resources as the reason it failed to stop Madoff. But while cost considerations may not suffice under the Ninth Circuit's premises-liability jurisprudence, when it comes to regulating private industry and enforcing the law, limited government resources have important policy implications. Most notably, limited resources force the government to choose among competing priorities. For example, Plaintiffs challenge the SEC's decision to investigate possible "front-running" instead of a possible Ponzi scheme.[116] They similarly question the SEC's decision "that a new investigation probing mutual funds was more important than following up on Madoff."[117] But determinations such as these, the product of an agency having to decide where to put forth the most effort, belong exclusively to the Executive Branch. At the end of the day, limited resources affect agency decisions concerning which laws to emphasize, which investigations to initiate, which leads to pursue, which witnesses to question, which questions to ask, and which documents to request. All of these decisions are susceptible to policy analysis in ways that the actions in *Whisnant* simply were not.

The decisions in *Coulthurst* and *Whisnant* are distinguishable in two other important

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Westphalen v. United States, No. CIV-07-47-M, 2007 WL 3408271, at *2 (W.D. Okla. Nov. 15, 2007) (holding that "[w]hat witnesses to interview, what questions to ask, [and] the evaluation of a witness's credibility" was "the kind [of conduct] that the discretionary function exception was designed to shield"); *O'Ferrell v. United States*, 32 F. Supp. 2d 1293, 1297 (M.D. Ala. 1998) (recognizing that discretionary function exception was intended to shield decisions such as "which leads to follow, who should be interviewed, what questions to ask, what statements to make, how long to continue, and the like"); *Hobdy v. United States*, 762 F. Supp. 1459, 1462 (D. Kan. 1991) ("[T]o the extent that plaintiff seeks to challenge the manner or thoroughness of the defendant's investigation, plaintiff's claim is barred by the discretionary function exception.").

[116] *See, e.g.*, Compl. ¶¶ 72-73.

[117] *See, e.g.*, *id.* ¶ 84.

respects. First, as premises-liability cases, neither *Coulthurst* nor *Whisnant* involved the government's regulation of private conduct. The policy implications associated with checking gym equipment in a federal prison and testing for mold in a Navy commissary hardly compare to those associated with deciding how best to regulate the persons and entities who are subject to the nation's securities laws. The Supreme Court surely appreciated this distinction when it held in *Varig* that "whatever else the discretionary function exception may include, it plainly was intended to encompass the discretionary acts of the Government acting in its role as a regulator of the conduct of private individuals."[118]

Second, the decisions in *Coulthurst* and *Whisnant* are distinguishable because neither involved "established government policy . . . [that] allows a Government agent to exercise discretion," and so there was no "strong presumption" in those cases that the challenged actions were covered by the exception. Here, in contrast, federal statutes expressly vest the SEC with discretion to investigate anything "which it may deem necessary or proper," and so the "strong presumption" applies. Plaintiffs have not rebutted this presumption, and under the case law, the way the SEC investigated Madoff is the type of conduct the discretionary function exception was designed to protect.

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[118] *United States v. Varig Airlines*, 467 U.S. 797, 813-814 (1984).

CONCLUSION

The challenged conduct in this case is committed to the SEC's discretion and grounded in policy. The discretionary function exception therefore bars Plaintiffs' suit, and the Court should dismiss it for lack of subject-matter jurisdiction.

Respectfully submitted,

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