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Dealing With The SEC's Administrative Proceeding Trend

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On Dec. 11, Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York issued a decision suggesting that district court judges should defer to administrative agencies in their choice of administrative proceedings (APs) over federal district court actions to enforce the law.[1] Less than one week later, on Dec. 15, the U.S. Securities and Exchange Commission released a 3-2 commission opinion illustrating its intent to use the administrative forum as a vehicle to interpret the securities laws and regulations aggressively and to attempt administratively to overrule lower court precedent that the SEC does not like.[2] These opinions have appeared amid an upswing of the SEC's use of APs and public debate over the fairness of the SEC administrative forum.

The SEC's Increasing Use of APs

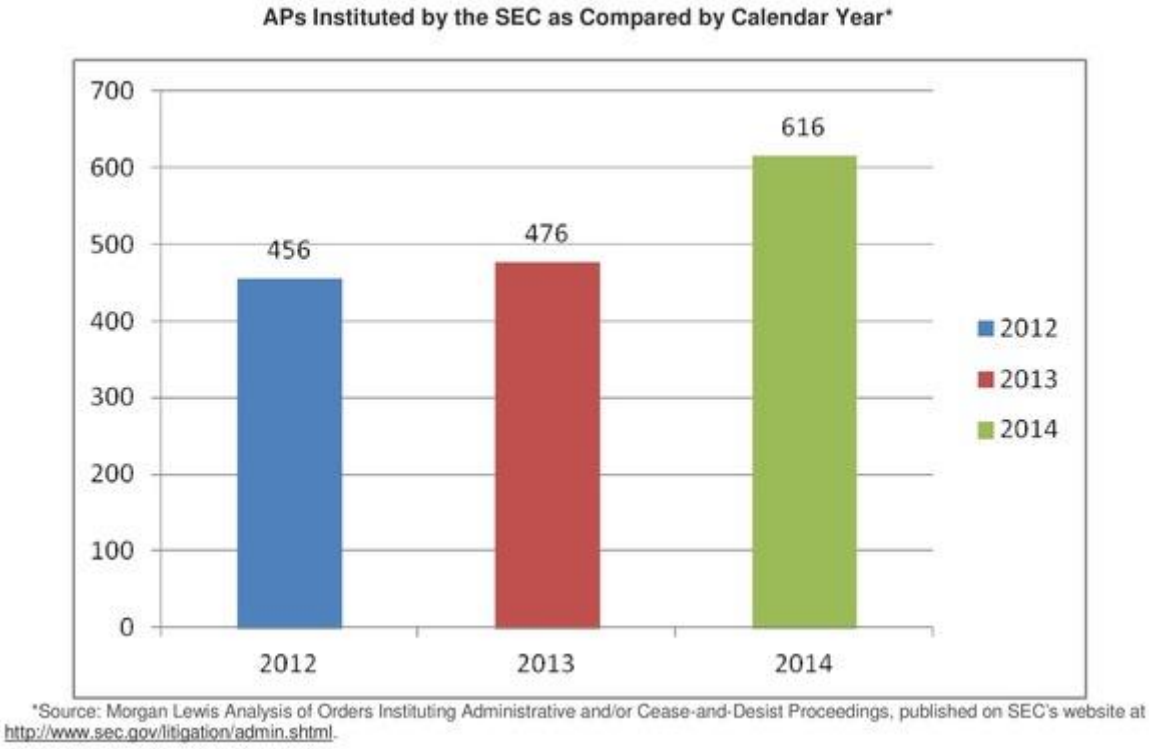
In the full year prior to Sept. 30, 2014, the SEC's Division of Enforcement won all six of its litigated APs but only 11 out of 18 of its federal court trials.[3] This contrast in outcomes provides the division with a powerful incentive to choose APs. Previously, the 2010 Dodd-Frank Act had made that choice easier by expanding the SEC's power to institute internal APs. Dodd-Frank gave the SEC the authority to use the AP mechanism to impose significant financial penalties against nonregistered entities or individuals, whereas previously, the SEC could only seek such penalties against those entities in federal district court actions.

The differences between APs and civil actions are considerable. For example, the timeline for an AP is much shorter — only 300 days from institution to an initial decision by the administrative law judge. Additionally, discovery is limited (essentially precluding depositions, except to preserve evidence), the Federal Rules of Evidence do not apply, and there is no right to a jury. Equally important considerations are that the initial fact finder in an AP is an SEC employee, the first level of review of the administrative law judge's decision is done by the same commissioners who voted to bring the enforcement action in the first place, and an AP respondent's first recourse to an Article III court is to a federal court of appeals that is likely, on a number of issues, to defer to the administrative agency.

In November, Andrew Ceresney, the director of the Division of Enforcement, stated that the SEC's "use of the administrative forum is eminently proper, appropriate, and fair to respondents."[4] Kara Brockmeyer, the chief of the division's Foreign Corrupt Practices Act Unit, recently offered that "it's fair

to say [that bringing cases as APs is] the new normal."[5]

Statistics support what these senior SEC staff are suggesting: An increase in the number of APs instituted by the SEC. As illustrated by the chart below, when compared to calendar year 2012, there have been approximately 35 percent more APs brought in 2014, even though the 2014 calendar year has not yet ended.



Although the foregoing numbers include both settled APs and litigated APs — and thus, do not bear directly on the fairness issues that are unique to litigated APs — Ceresney's November speech discloses that in the SEC's fiscal year ending Sept. 30, 2014, 43 percent of its litigated enforcement cases were brought as APs. The 43 percent figure excludes certain types of actions, such as delinquent filings cases and follow-on APs.

Public Debate Regarding the SEC's Increased Use of APs

The reality and the promise of more APs have spurred controversy and public debate. In 2011, when the SEC instituted an AP against Raj Gupta in connection with alleged insider trading, Gupta sought to enjoin that proceeding. Judge Jed S. Rakoff of the Southern District of New York found that "it would be inherently difficult for the Commission, which will have to approve any final order against Gupta, to be deciding whether it itself engaged in unequal protection in bringing its charges against Gupta."[6]

Judge Rakoff has continued to question the fairness of the SEC's APs. In a Nov. 5, 2014, speech, Judge Rakoff noted that "the law in such cases would effectively be made, not by neutral federal courts, but by SEC administrative judges."[7] A few weeks later, on Nov. 21, Ceresney responded that "using the administrative forum furthers the balanced and informed development of the federal securities laws ...

SEC commissioners have great expertise in the securities laws ... the Commission has input on important questions, but legal rulings either supporting or reversing the Commission frequently are made at the circuit or Supreme Court level."[8]

On Dec. 11, Judge Kaplan ruled that the SEC as plaintiff could decide whether a federal district court or the administrative forum was more appropriate for its enforcement actions.[9] And on Dec. 15, the SEC published its 3-2 commission opinion reviewing In the Matter of John P. Flannery and James D. Hopkins, which demonstrates how the SEC may interpret the federal securities laws in what it — or at least three-fifths of it — sees as the balanced and informed development of that law.[10]

Chau v. SEC Rejects Due Process and Equal Protection Challenges to the AP Process

In October 2013, the SEC brought an administrative action against respondents Wing F. Chau and his firm, Harding Advisory LLC, charging them with making material misrepresentations in connection with the sale of collateralized debt obligations (CDOs), a structured asset-backed security that encompasses the mortgage and mortgage-backed securities market.[11] The respondents in that proceeding then filed a suit in the U.S. District Court for the Southern District of New York seeking an order to enjoin the SEC AP. They argued that the AP deprived them of their rights to due process and equal protection of the law.[12]

Judge Kaplan concluded that the SEC's AP including the right to appeal to a federal court at the end of an AP, would suffice to reveal any injustice or due process violations.[13] Judge Kaplan stressed that "Congress has provided the SEC with two tracks on which it may litigate certain cases. *Which of those paths to choose is a matter of enforcement policy squarely within the SEC's province*."[14] Judge Kaplan went on to say that he:

[R]ecognizes that the growth of administrative adjudication, especially in preference to adjudication by Article III courts and perhaps particularly in the field of securities regulation, troubles some ... These concerns are legitimate, whether born of self-interest or of a personal assessment of whether the public interest would be served best by preserving the important interpretative role of Article III courts in construing the securities laws — a role courts have performed since 1933. But they do not affect the result in this case ... *This Court's role is a modest one*.[15]

In other words, Judge Kaplan decided that the SEC, not the court, was best equipped to determine whether a judge, jury or administrative law judge was the best forum.

The Commission's Expansive Interpretation of the Federal Securities Laws in Flannery

On Dec. 16, 2014, in Flannery, a 3-2 majority of the SEC's commissioners took on the law, which apparently has not been evolving to the majority's satisfaction. Citing the "agency's experience and expertise in administering securities law," the commission opinion set out its own legal interpretation to resolve what it termed "confusion" and "inconsistencies" among various federal district courts in determining the scope of primary liability for fraud under the Securities Act of 1933 (the Securities Act) and the Securities Exchange Act of 1934 (the Exchange Act.).[16]

In particular, the SEC focused on the district courts' interpretation of Janus Capital Group v. First Derivative Traders, in which the U.S. Supreme Court limited primary liability for false and misleading statements under Section 10b-5 of the Exchange Act and Rule 10b-5 thereunder to those who had the "ultimate authority" to make the statement — typically, the speaker of the statement.[17] A number of

federal district courts have since further limited primary liability based on other anti-fraud provisions of the Exchange Act and the Securities Act.[18] The SEC's Flannery opinion concluded that:

- The SEC (although not private plaintiffs) may pursue nonspeakers for false statements under Rule 10b-5 (a) and (c) (prohibiting use of "any device, scheme, or artifice to defraud"), whether or not there has been additional deceptive conduct.[19] Thus, the SEC is essentially unimpeded by Janus.

- Janus is not applicable to Section 17 of the Securities Act, so that Section 17a-3 of the Securities Act also would create primary liability for fraud where, because of a defendant's negligent conduct (even when not deceptive or manipulative), investors receive misleading information in connection with the offer or sale of securities.[20]

Practical Implications of the Trend Toward APs

We appear to be entering a new era of SEC APs, which respondents must view realistically.

Recognize the SEC's Home Court Advantage, as Illustrated by Flannery

In gauging the SEC's risk tolerance for litigating a potential enforcement action, parties and their counsel must consider that the SEC has experienced a greater win rate in its own forum. If the Chau decision does mean that there is no early exit from an AP, the SEC will likely anticipate more wins or, at a minimum, the ability to grind down the respondent, who will have to wait years before seeing a neutral forum.

Additionally, as illustrated by Flannery and discussed above, an AP's structure allows the SEC to interpret, apply and essentially make its own laws, subject only to eventual correction by a court of appeals. Both of these factors are likely to make the agency more litigious and willing to bring such actions.

Prepare Early

Given the speed at which APs move before administrative law judges, parties and lawyers involved in an SEC investigation and expecting a Wells notice should consider taking early steps to prepare for litigation, such as identifying and preparing witnesses and selecting experts. Evidentiary and overall risk assessment should factor in the liberal admission in APs of all forms of evidence, even hearsay.

Be Ready and Willing to Appeal

In light of the SEC's aggressive move to interpret the federal securities laws within the administrative setting, any party litigating against the SEC in an AP should consider laying the groundwork for an appeal to an Article III court from the predictable, adverse SEC opinion. An appellate court, such as the D.C. Circuit, may very well not defer to the SEC's expansive interpretation of the federal securities laws.

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[1] Chau v. U.S. SEC, No. 14-CV-1903 LAK, 2014 WL 6984236 (S.D.N.Y. Dec. 11, 2014).

[2] In the Matter of John P. Flannery and James D. Hopkins, Release No. 33-9689, Securities Act of 1933, Securities and Exchange Commission, (Dec. 15, 2014), available at https://www.sec.gov/litigation/opinions/2014/33-9689.pdf.

[3] Jean Eaglesham, SEC Steering More Trials to Judges It Appoints Unpublished Figures Show 'Win' Rate for Cases Heard by Administrative Law Judges, Wall Street Journal, Oct. 21, 2014, available at http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it- appoints-1413849590 (hereinafter, Eaglesham Article).

[4] Andrew Ceresney, Director, SEC Division of Enforcement, Remarks to the American Bar Association's Business Law Section Fall Meeting (Nov. 21, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#_ftn8 (hereinafter, Ceresney Speech).

[5] Eaglesham Article, supra note 3.

[6] Gupta v. SEC, 796 F. Supp. 2d 503, 512 (S.D.N.Y. 2011).

[7] Jed S. Rakoff, Judge, U.S. District Court for the Southern District of New York, Keynote Address at the PLI Securities Regulation Institute: Is the SEC Becoming a Law Unto Itself? (Nov. 5, 2014), available at http://assets.law360news.com/0593000/593644/Sec.Reg.Inst.final.pdf.

[8] Ceresney Speech, supra note 4.

[9] Chau, 2014 WL 6984236, at *13.

[10] See supra note 2.

[11] Chau, 2014 WL 6984236, at *1.

[12] Id.

[13] Id. at *8.

[14] Id. at *13 (emphasis added).

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

[16] See supra note 2.

[17] Janus Capital Grp. Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011).

[18] See, e.g., SEC v. Kelly, 817 F. Supp. 2d 340, 341 (S.D.N.Y. 2011).

[19] Flannery, supra note 2, at 17–19.

[20] Id. at 22-24, 26. In dictum, the Commission suggested that it may support primary liability for fraud under Section 17(a)(3), without even showing negligence, effectively raising the specter of strict-liability fraud. Id. at n.30.
