

Fate Of The SEC In-House Court: Careful What You Wish For

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On Wednesday, the D.C. Circuit will sit en banc to hear arguments regarding the constitutionality of the U.S. Securities and Exchange Commission's administrative tribunals.[1] This is the latest stop in a string of mounting challenges to this forum that seems destined for U.S. Supreme Court review. Over the past couple of years, these tribunals have come under withering attack in the courts, in the press and, most recently, in Congress. There is near-universal agreement among those covering the issue echoing criticisms that the forum unqualifiedly favors the SEC and disadvantages defendants. Such attacks appear to have had an effect. At least for the foreseeable future, the SEC seems inclined to file virtually all litigation in district court. As the D.C. Circuit considers the question, it is an opportune time to step back and consider whether the current strong movement away from using the administrative forum is universally positive for defendants in SEC cases.

The answer may be more mixed and case-dependent than people realize, as there are some benefits available in administrative proceedings not present in civil litigation. Chiefly, the scrutiny and skepticism arising from these attacks, coupled with recent changes to the rules governing the SEC's in-house courts, may make litigating in administrative tribunals a more viable avenue and opportunity than one might expect, even for entity defendants regulated by the SEC. As such, SEC defendants and the securities defense bar should carefully consider their positions, as the issue is taken up by courts and Congress, before pushing to foreclose the forum entirely for contested hearings on liability and remedies and forcing all SEC litigation into district court.

Background and Recent Constitutional Challenges

The SEC can elect to bring cases in administrative proceedings (APs) before an SEC administrative law judge (ALJ)[2] or in federal district court. APs typically move at a faster pace and contain fewer procedural protections for defendants than district court proceedings. While the SEC has been able to bring cases in APs for decades, until recently the forum was largely relegated to cases involving securities industry participants, such as broker-dealers, investments advisers and their associated persons. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act changed all that and, with just a few exceptions, granted the SEC authority to bring all manner of cases in APs and obtain



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nearly all of the same remedies that it historically could seek only in district court.[3] The SEC's Division of Enforcement embraced this authority, and the number of litigated APs increased. As a result, 2010-2015 saw a 62.5 percent increase in the number of litigated APs filed, while the number of cases brought in district court remained flat.[4]

Not surprisingly, AP defendants (known as “respondents”) — and those representing the interests of securities professionals generally — pushed back hard against this increased usage. Following reports that the AP process was biased because the ALJs, as SEC employees, were more likely to favor the Division of Enforcement,[5] respondents’ challenges to the forum itself on constitutional grounds grew.

As a result of these challenges, a split has emerged among the circuit courts on the somewhat esoteric question of whether the SEC ALJs are “inferior officers.” Under the Constitution’s appointments clause, “inferior officers” must be appointed by the president, courts of law, or the heads of departments.[6] Thus, if a court finds that SEC ALJs — which are hired by the Office of Administrative Law Judges as opposed to being appointed by the chair of the commission — are “inferior officers,” then it follows that their hiring was unconstitutional. In *Bandimere v. SEC*, a divided panel of the Tenth Circuit held that ALJs’ appointments violated the appointments clause. 844 F.3d 1168 (10th Cir. 2016), reh’g en banc denied (10th Cir. May 3, 2017). The D.C. Circuit, on the other hand, upheld the constitutionality of the appointment process, but is now reconsidering the matter en banc.[7] Other circuits have sidestepped challenges to the ALJ’s authority as procedurally premature.[8] Thus, this issue seems likely to ultimately end up before the Supreme Court.[9]

The Reality of Litigating in APs

Regardless of how the court ultimately resolves this constitutional issue,[10] the SEC has been forced to stop bringing APs in the Tenth Circuit in the wake of *Bandimere*, and appears to have determined to reduce dramatically the number of litigated proceedings brought before ALJs elsewhere as well. In fact, since the *Bandimere* decision in December 2016, the SEC appears to have brought only two litigated cases as APs[11] that also could have been filed in district court.[12] This steep decrease in litigated APs raises questions of whether that forum is, in reality, universally worse for respondents than similar civil cases in district court. The focus on all of the perceived procedural failings of APs has left little room to consider their potential upside for certain defendants. A number of factors suggest that APs are neither universally bad for respondents, nor good for the Division of Enforcement, compared to district court.

The Criticisms of ALJ Bias Appear Overblown

The genesis of the controversy over the SEC’s use of APs after Dodd-Frank largely stems from press reports that the SEC was steering more cases toward APs because it had an unfair home-court advantage.[13] However, more recent reports cast doubt on that argument.[14] According to one report, between 2007 and 2015, the Division of Enforcement won liability in 89.8 percent of the 167 APs that it litigated.[15] For the same period in district court, by contrast, the SEC won 92.7 percent of 484 cases at either summary judgment or trial.[16] Even when considering the constitutional question, one judge was careful to note the credentials of the SEC ALJ assigned to the underlying case.[17] To be sure, the SEC likely enjoys some benefit from litigating on its own turf, but it does not seem to be creating the overwhelming home-court advantage that commentators have made it out to be. Thus, although the criticism that SEC ALJs are biased in favor of the agency is difficult conclusively to disprove, it does appear to be somewhat overblown.

Recent SEC Procedural Changes Do More to Level the Playing Field

In addition to the argument that ALJs were inherently biased in the Enforcement Division's favor, some respondents and many in the defense bar have complained that the "rocket docket" time frames in APs created unfair advantages for the division, because, unlike respondents, it has substantial time pre-filing to investigate and prepare its case for trial. However, in response to these criticisms, in August 2016, the SEC adopted new rules of practice^[18] governing the AP process for the first time since 1995. Critics immediately panned the changes as not going far enough to level the playing field.^[19] Nonetheless, these rule changes contain several new and important protections for respondents.

For one thing, the new rules significantly expanded discovery rights for AP respondents by, for example, granting the right to take up to seven depositions under certain circumstances.^[20] The amendments also relaxed, for the more complex cases, the compressed time frames for the pre-hearing period — the period between the SEC filing the case and the administrative trial — from approximately four months to 10.^[21] Further, the new rules explicitly allow for the filing of pre-hearing dispositive motions, akin to motions to dismiss and motions for summary judgment, first after the division files its charging document and, again, following discovery.^[22]

Additionally, as before, APs retain significant pro-defense protections, borrowed from the criminal context, that are unavailable to defendants in district courts. AP critics tend to ignore these protections, but savvy litigators can use them to great effect, just like in a criminal case. For example, the division is required to produce "exculpatory evidence"^[23] akin to Brady^[24] materials, well in advance of any hearing. Likewise, upon demand, the division must produce to the defense any prior statements of its witness.^[25] And, the division is required to turn over its entire investigative file without the need to resort to expensive discovery,^[26] resulting in almost certainly lower defense costs in the AP context. While this may provide cold comfort in "bet the company" litigation, in smaller, more technical cases, this may provide a real benefit.

Outcomes Can Be Worse in District Court: Recent AP Decisions and Court Cases

When considering juries, penalties, disgorgement awards, injunctions and bars, it is also far from clear that litigating AP respondents fare worse than defendants who fight the SEC in district court. In fact, the opposite may well be true. Federal judges in recent years have handed out some of the most onerous remedies against individuals and corporations in the commission's history.

Consider SEC v. Wyly, a case currently on appeal in the Second Circuit after the district court finalized a disgorgement amount of almost \$200 million based partly upon the ruling that nondisclosure of beneficial ownership in certain trusts may have caused the IRS to miscalculate taxes (even the IRS had not decided yet), and thus the avoided taxes were "causally related" to securities violations.^[27] It is hard to see an SEC ALJ attempting to give such direction to another federal agency such as the court did to the IRS in Wyly. Courts have also been willing to impose significant remedies even where defendants were strictly liable or only negligent.^[28] Further, in a trial in district court, defendants must attempt to persuade jurors, who may have biases against securities industry participants — due to wealth or status — that are irrelevant to the SEC's actual charges.

By contrast, there are numerous recent examples where ALJs gave the Division of Enforcement only modest relief, or no relief at all, compared to what the division requested, even when finding that respondents intentionally violated the federal securities laws.^[29] In other cases, ALJs have been unwilling to go along with the SEC's methods.

In one example, after the ALJ called the SEC's original theory of benefit a "wildly exaggerated belief" he permitted the respondent to pursue attorneys' fees against the SEC, even though the respondent was found liable for causing a securities law violation.[30] Moreover, in a recent insider trading case, the ALJ disagreed with the SEC's circumstantial evidence and instead credited the respondents' own testimony when finding no liability.[31] On similar grounds, the same ALJ denied liability in a case regarding an advisers' purported failure to disclose conflicts.[32] The division also recently lost a significant insider trading case against a Wells Fargo trader.[33] Thus, ALJs have shown in several recent decisions a willingness to take the division to task and to credit the testimony of respondents where they believe that the division has failed to meet its burden.[34]

Changes on the Horizon

As noted above, the Supreme Court will likely examine some of the processes around APs. Barring the Supreme Court completely invalidating the AP process, any decision is unlikely to fundamentally change the procedural rules governing APs. It may, however, shape how the commission chooses to use APs, if for no other reason than to counteract negative public perceptions. Congress, moreover, has also set its sights on APs. Pending legislation would provide respondents in SEC administrative proceedings an automatic right of removal to district court and raise the standard of proof in APs to "clear and convincing evidence"[35] from the current "preponderance of the evidence" standard.[36] These would be significant changes and may cause the SEC to permanently shy away from using the administrative forum.

Another reality is that, even if the Supreme Court and Congress do nothing, APs may change significantly simply because of the changing makeup of the commission. One current commissioner has spoken harshly about APs,[37] and there are currently two vacancies. There is no reason to think that, under the current administration, the president will choose future Republican commissioners[38] who are more disposed toward the administrative forum. This is potentially significant, because the commissioners both sign off on initiating proceedings and sit as the first level of appellate review when respondents challenge an ALJ's initial decision.[39] Respondents can further appeal adverse decisions by the commission in their choice of the court of appeals for District of Columbia or to the court of appeals in the circuit where they reside.[40]

What Kind of Cases Should End Up Before an ALJ?

There is no doubt that fundamental differences remain between litigating in APs and in district court. Even with an extended time frame, APs still generally move more rapidly than federal cases, which may disadvantage many respondents.[41] Discovery remains limited, and respondents are still missing the full panoply of protections from the Federal Rules of Civil Procedures and the Federal Rules of Evidence. If the goal is to utilize all of these protections and time available to prepare an appropriate defense to fight "bet the company" litigation, APs are unlikely to be preferable to district court. However, each case is different, and the singular focus on those differences is somewhat overblown. Rather, the issue is whether the total exclusion of APs in favor of the federal forum is the preferred outcome.

It is in fact unclear that the federal forum is always preferable, given recent procedural changes and further potential for change on the horizon. Some respondents may benefit from the speed, efficiency and potential cost savings that the forum brings. This may be particularly true in cases where respondents face nonscienter charges or highly technical cases and, thus, could benefit from the presence of a decision maker familiar with the federal securities laws, who may not be moved by emotional overtures often made to juries. Another context in which respondents may benefit from

having their case heard before an ALJ is in a so-called “bifurcated” settlement, where the parties agree not to dispute liability, but wish to litigate the question of remedies. This is because ALJs are often less willing to impose harsh remedies than district judges. Finally, it should be noted that APs often receive less press attention than large civil trials.[42]

For the moment, the future of APs remains unclear. Given the negative press, the SEC might, on its own initiative, revert back to the pre-Dodd-Frank practice of bringing APs primarily against industry participants and for nonscienter and technical charges. Except now, there would be additional procedural protections and focus on maintaining fairness that could be beneficial for respondents willing to fight it out in these proceedings. In any event, it seems clear that the conventional wisdom that district court is the only viable forum to litigate against the SEC is exaggerated.

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[1] Raymond J. Lucia Cos. v. SEC, 832 F.3d 277 (D.C. Cir. 2016) reh'g en banc granted (D.C. Cir. Feb. 16, 2017).

[2] ALJs operate independently from the SEC. 5 U.S.C. § 554(d)(1)–(2) (2016). Further, they effectively serve with life tenure, as removal is only for good cause as established by a separate administrative board. 5 U.S.C. § 7521(a). Although the commission recently published guidelines explaining the factors it considers in authorizing litigating cases in either the administrative forum or federal court, SEC Enforcement Div., Division of Enforcement Approach to Forum Selection in Contested Actions, available at <http://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf>, ultimately the discretion continues to rest with the commission.

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 929P, 124 Stat. 1376, 1862-65 (2010) (allowing the SEC to seek fines from any firm or individuals beyond just those that are registered with the SEC); see also Breon S. Peace et al., "Changes and Challenges in the SEC's ALJ Proceedings," Cleary M&A and Corporate Governance Watch (Oct. 20, 2016), <http://www.clearymawatch.com/2016/10/2220/>.

[4] Urska Velikonja, "Are the SEC's Administrative Law Judges Biased? An Empirical Observation," 92 Wash. L. Rev. 315 (2017).

[5] The Division of Enforcement is responsible for investigating potential violations of the federal

securities law and litigating the SEC's enforcement actions.

[6] Article II, Section 2, Clause 2.

[7] *Raymond J. Lucia Cos. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016) reh'g en banc granted (D.C. Cir. Feb. 16, 2017).

[8] E.g., *Chau v. SEC*, 72 F. Supp. 3d 417, 436 (S.D.N.Y. 2014), aff'd, 665 F. App'x 67 (2d Cir. 2016) (defendants' challenge "would upend all manner of administrative enforcement schemes"); *Tilton v. SEC*, 824 F.3d 276 (2d Cir. 2016); *Bennett v. SEC*, 844 F.3d 174, 187 (4th Cir. 2016); *Bebo v. SEC*, 799 F.3d 765, 774 (7th Cir. 2015); *Hill v. SEC*, 825 F.3d 1236, 1245 (11th Cir. 2016).

[9] *Tilton* has petitioned the Supreme Court to grant certiorari to consider both the jurisdictional questions and whether ALJs are inferior officers under the Constitution. *Tilton*, 824 F.3d 276, petition for cert. filed, (Jan. 18, 2017) (No. 16-906).

[10] To the extent that the Supreme Court may require the SEC to institute changes to APs, it is unlikely that disposition of settled matters in APs will be impacted.

[11] *In the Matter of David Pruitt*, Exch. Act Release No. 80548 (Apr. 28, 2017); *In the Matter of Windsor Street Capital LP*, Sec. Act Release No. 10293 (Jan. 25 2017).

[12] APs have exclusive jurisdiction in the first instance for certain types of proceedings, including SEC actions to delist public companies and to collaterally bar individuals and entities from participating in the securities industry.

[13] Jean Eaglesham, "SEC Is Steering More Trials to Judges It Appoints," *Wall St. J.* (Oct. 21, 2014), <http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it-appoints-1413849590>.

[14] *Velikonja*, supra note 4 at 6. ("[T]here is no evidence that the SEC is more likely to prevail in enforcement cases decided by ALJs than in those adjudicated by federal judges."); *McLucas and Matthew Martens*, "How to Reign In The SEC," *WALL ST. J.*, June 2, 2015, <http://www.wsj.com/articles/how-to-rein-in-the-sec-1433285747> ("Whatever the complaints about the administrative process, there is no evidence that the ALJs harbor bias.").

[15] *Velikonja*, supra note 4 at 30. Other statistical analyses bear similar results that the SEC succeeds at similar rates in federal court as it does in front of an ALJ. See *David Zaring*, "Enforcement Discretion at the SEC," 94 *Tex. L. Rev.* 1155, 1189 (2016) ("[T]here is no statistically significant distinction between the rates of success."); *Joseph A. Grundfest*, "Fair or Foul?: SEC Administrative Proceedings and Prospects for Reform Through Removal Legislation," 85 *Fordham L. Rev.* 1143, 1178 (2016) ("[T]he data suggest that, in the aggregate, the Commission has no particular advantage or disadvantage in federal court or before an ALJ.").

[16] *Velikonja*, supra note 4 at 30.

[17] See *Duka v. SEC*, 103 F. Supp. 3d 382, 388 n.6 (S.D.N.Y. 2015) abrogated by *Tilton v. SEC*, 824 F.3d 276 (2d Cir. 2016) (noting the "distinguished biography" of the ALJ).

[18] The procedures for the SEC's ALJs are codified at 17 C.F.R. §§ 201.100-900.

[19] E.g., Peter J. Henning, "A Small Step in Changing S.E.C. Administrative Proceedings," N.Y. Times (Sept. 28, 2015), <https://www.nytimes.com/2015/09/29/business/dealbook/a-small-step-in-changing-sec-administrative-proceedings.html>.

[20] 17 C.F.R. § 201.233(a).

[21] 17 C.F.R. § 201.360(a)(2).

[22] 17 C.F.R. § 201.250(a), (b).

[23] 17 C.F.R. § 201.230(b)(3).

[24] *Brady v. Maryland*, 373 U.S. 83 (1963).

[25] Jencks Act, 18 U.S.C. § 3500.

[26] 17 C.F.R. § 201.230(a)(1).

[27] *SEC v. Wyly*, No. 10 Civ. 05760 (S.D.N.Y. Sept. 25, 2014); *SEC v. Wyly*, No. 10 Civ. 05760 (S.D.N.Y. Feb. 26, 2015) (finalizing order).

[28] *SEC v. Heart Tronics Inc.*, No. 11 Civ. 01962 (C.D. Ca. Apr. 15, 2016) (ordering over \$200,000 in fines, disgorgement and interest, and imposing an officer and director bar, even in the absence of a scienter-based finding of liability); *SEC v. Bronson*, No. 12 Civ. 6421, 2017 WL 1169660, at *12 (S.D.N.Y. Mar. 27, 2017) (ordering over \$10 million in disgorgement and penalties and injunctive relief for the unregistered sale of securities under strict liability on summary judgment).

[29] In the Matter of Lawrence M. Labine, Initial Decision Release No. 973 (March 2, 2016) (limiting disgorgement to \$100,000 despite the SEC's \$500,000 request, and imposing only a two-year bar from association with any investment adviser, broker or dealer, where respondents failed to disclose material conflicts and made material misrepresentations and omissions of risk); In the Matter of Judy K. Wolf, Initial Decision Release No. 851, (Aug. 5, 2015) (imposing no sanctions for compliance employee who falsified logs because she was near retirement age and without a job).

[30] In the Matter of Thomas R. Delaney II, at 34, Initial Decision Release No. 755 (Mar. 18, 2015); In the Matter of Thomas R. Delaney II, Admin. Proc. Rul. Release No. 2772 (Jun. 4, 2015).

[31] In the Matter of Charles L. Hill, Initial Decision Release No. 1123 (Apr. 18, 2017).

[32] In the Matter of the Robare Group Ltd., at 39, Initial Decision Release No. 803 (June 4, 2015).

[33] In the Matter of Gregory T. Bolan Jr., Initial Decision Release No. 877 (Sept. 14, 2015).

[34] See also In the Matter of Miguel A. Ferrer, Initial Decision Release No. 513 (Oct. 29, 2013) (finding no fraudulent conduct or activity of fund after thirteen days of hearings for multiple respondents accused of misleading financial advisers).

[35] Financial CHOICE Act of 2017 H.R.10, 115th Cong.

[36] *Steadman v. SEC*, 450 U.S. 91 (1981).

[37] Michael S. Piwowar, Commissioner, SEC, Remarks at the “SEC Speaks” Conference 2015 (Feb. 20, 2015), available at <https://www.sec.gov/news/speech/022015-spchcmosp.html>.

[38] Although only three out of the five commissioners can be from the same party at once, 15 U.S.C. § 78d(a), even chosen Democrats would likely to also be skeptical of aggressive use of APs.

[39] See 17 C.F.R. § 201.410.

[40] 15 U.S.C. §§ 78y(a)(1), 77i(a).

[41] Andrew Ceresney, Dir., Div. of Enf’t, SEC, Remarks to the American Bar Association’s Business Law Section Fall Meeting (Nov. 21, 2014), available at <https://www.sec.gov/news/speech/2014-spch112114ac> (noting that although most APs are resolved within 300 days, in federal court after 300 days the SEC is likely still in discovery or at the motion-to-dismiss stage).

[42] Of course, respondents cannot — at least not presently — choose which forum the commission files in. Thus, the SEC could attempt to file in district court in every situation where it would be preferable for the commission. In reality, however, the SEC is resource-constrained and itself often prefers to litigate in APs given the venue’s “rocket docket” and lesser discovery burdens. Moreover, choice of venue is not always so clearly a zero-sum proposition, and circumstances may exist where both parties may wish to be in an AP.