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SEC

SEC's Continued Use of Administrative Forum Irks Critics, Raises Sticky Constitutional Questions



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In yet another move consistent with his outspoken style, U.S. District Judge Jed S. Rakoff has launched a new wave of criticism against the U.S. government's securities enforcement regime. Judge Rakoff—whose court sits in the Southern District of New York—has sharply criticized the Securities and Exchange Commission (“SEC”) in the past for its settlements in financial crisis cases, including rejecting two settle-

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ments between the SEC and defendants outright (12 CARE 912, 8/8/14). He also authored an essay attacking the U.S. Department of Justice (“DOJ”) for its supposed failure to prosecute high-level executives in connection with the financial crisis and recession.

Now, Judge Rakoff has turned his attention to the SEC's escalating use of the administrative courts—rather than the federal bench—to decide securities cases (09 CARE 283, 3/11/11). During a keynote address for a PLI event on November 5, Judge Rakoff condemned the SEC for “the dangers that seem . . . to lurk” in its increasing use of its internal administrative proceedings.¹ Judge Rakoff suggested that the SEC's administrative proceedings might be unfair to litigants, damage the SEC's reputation and even stunt the development of the federal securities laws. More recently, Judge Rakoff told an audience at Columbia University Law School on Nov. 21 that securities laws should not be “developed in-house by the SEC,” as administrative law judges (“ALJs”) are susceptible to a “narrow, tunnel-vision view of the law.”

War of Words

Although this is the first time Judge Rakoff has comprehensively laid out these concerns, he previously hinted at them in his final opinion in a recent SEC case

¹ (12 CARE 1504, 11/14/14).

against Citigroup. In August, Judge Rakoff approved the parties' settlement, after the Second Circuit had reversed his initial rejection of the deal (12 CARE 912, 8/8/14). In a footnote at the end of his opinion concerning the SEC's option to pursue an administrative review, Judge Rakoff wrote, "One might wonder: from where does the constitutional warrant for such unchecked and unbalanced administrative power derive?"

The SEC has been quick to push back, even during the same two events at which Judge Rakoff spoke. During the PLI event last month, Andrew Ceresney, the SEC's enforcement division chief, said he disagreed with the proposition that the SEC has an unfair advantage in administrative court, observing that the agency provides defendants access to all of its files.² Ceresney also defended the use of ALJs, noting that they are specialized and fair and that the SEC has lost cases before them. He argued that "[t]he development of the law has been shaped by the district judges, but also by the ALJs."

Likewise, at the Columbia event Nov. 21, Matthew Solomon, the SEC's chief litigation counsel, referred to ALJs as "sophisticated fact finders" who issue "well-reasoned decisions." Mr. Solomon stated, "Our ALJs call balls and strikes just like federal district court judges." Moreover, he pointed out that federal proceedings can often be inefficient and delayed: "What we're finding is that federal judges around the country don't necessarily prioritize our cases the way Judge Rakoff does." The same day, Mr. Ceresney told the American Bar Association's Business Law Section that the SEC's "use of the administrative forum is eminently proper, appropriate, and fair to respondents."³

The SEC's New Tactic

As Mr. Ceresney's comments imply, the fundamental premise of Judge Rakoff's observations—that the SEC is increasingly using its administrative process to prosecute securities cases—is not in serious dispute. The SEC itself makes no secret of its strategy to escalate the number of enforcement actions conducted by administrative proceedings rather than before federal judges. In June, the SEC nearly doubled its ALJ office staff. The same month, Mr. Ceresney stated at a D.C. Bar event that he anticipated the SEC would use the administrative venue "more and more in the future." According to Mr. Ceresney, the SEC's administrative venue is both "a sophisticated trier of fact" and "a more streamlined proceeding." Mr. Ceresney also highlighted that the SEC had threatened administrative proceedings in a number of recent cases, which induced the defendants to settle.

In the same vein, Kara Brockmeyer, the head of the SEC's Foreign Corrupt Practices Act unit, stated at a legal conference in October that administrative proceedings were "the new normal" for the SEC and would be used "more frequently."⁴ Following the SEC's lead, the U.S. Commodity Futures Trading Commission ("CFTC") also intends to rely more heavily on administrative proceedings. The CFTC's new enforcement chief, Aitan Goelman, said the CFTC plans to bring

more cases before in-house judges. According to Goelman, the primary reason for this change in strategy is increased efficiency for a resource-stretched agency.⁵ Unlike the SEC, however, the CFTC has no ALJs of its own, and will instead have to borrow them from the SEC or other federal agencies.⁶

Troubling Implications

Judge Rakoff is not the only critic of the SEC's increased use of administrative proceedings. In particular, numerous former SEC personnel have publicly expressed concern that the SEC's new tactic is a "mistake," that the perception the in-house proceeding is a "home court" could erode the SEC's reputation,⁷ that administrative proceedings let the SEC "dump[] millions of pages of documents on the other side" and give only four or five months to digest the information, that the SEC can receive virtually the same remedies from an ALJ without corresponding due process safeguards, and that "a surge in administrative prosecutions should alarm anyone who values jury trials, due process and the constitutional separation of powers."⁸

The view of administrative proceedings as unfair for litigants is exacerbated by the SEC's track record in both venues. Although the SEC prevailed in 61 percent of its federal cases in the 12 months prior to September 2014, it won every single case heard before an ALJ during that same period.⁹ These sobering statistics, combined with dismissive views of the trier of fact in federal court (Ceresney claimed that juries, unlike ALJs, apply a higher standard than preponderance of the evidence in SEC cases), only add to the perception that the SEC is moving toward litigating cases in-house to make it easier for them to win.

In mid-June, Ceresney stated that insider trading cases in particular would be increasingly brought in administrative proceedings.¹⁰ The timing of Mr. Ceresney's announcement followed a string of losses for the SEC in insider trading cases over the prior six months: Manouchehr Moshayedi (June 6), Nelson Obus (May 30), Rex Steffes and his sons (January 27), Ladislav Schvacho (Jan. 7) and Mark Cuban (Oct. 16). And, on June 4—five years after beginning its investigation and weeks before trial—the SEC dropped its insider trading case against Parker Petif.

Since his remarks, Ceresney has made good on his word: the SEC has already initiated five new administrative actions for insider trading since late September. Although Ceresney has claimed that the SEC's movement toward increasing the proportion of insider trading cases handled administratively is not a reaction to the agency's recent defeats, the timing of the SEC's decision to pursue more insider trader cases administratively is difficult not to view as an attempt to stack the deck in light of its recent prominent losses in these

⁵ Jean Eaglesham, *CFTC Turns Toward Administrative Judges*, WALL ST. J., Nov. 9, 2014.

⁶ *Id.*

⁷ (12 CARE 1493, 11/14/14).

⁸ Russell G. Ryan, *The SEC as Prosecutor and Judge*, WALL ST. J., Aug. 4, 2014.

⁹ Eaglesham, *supra* note 4.

¹⁰ Yin Wilczek, *SEC to Pursue More Insider Trading Cases in Administrative Forum, Director Says*, CORP. L. & ACCOUNTABILITY REP., June 13, 2014.

² *Id.*

³ (12 CARE 1597, 12/5/14).

⁴ Jean Eaglesham, *SEC Is Steering More Trials to Judges It Appoints*, WALL ST. J., Oct. 21, 2014.

high-profile actions. Indeed, Mr. Ceresney acknowledged that one of the factors the SEC considers in choosing whether to pursue an action in court or in-house is whether it would play well before a jury (12 CARE 651, 6/13/14).

Questionable Constitutionality

Unsurprisingly, the SEC has been hit by numerous recent challenges to the legality of its administrative process. In March, Harding Advisory and its principal Wing Chau filed suit against the SEC for “shoehorning” them into an administrative action rather than federal court.¹¹ Another challenge to the fairness of SEC administrative proceedings was brought in August by George Jarkey Jr., a Houston hedge fund manager alleged to have steered bloated fees to a brokerage firm CEO (12 CARE 1243, 10/3/14). Jarkey requested that the D.C. Circuit review the district court’s refusal to prevent the SEC from pursuing an administrative action, contending that such a proceeding is devoid of “minimum standards of fairness.”

Such challenges appear only to be increasing in frequency. In October, two separate lawsuits were filed against the SEC in the Southern District of New York questioning the constitutionality of the agency’s administrative proceedings.¹² The first action arose after the

¹¹ Charles Michael, *CDO Manager Sues to Enjoin SEC Administrative Case Based on Inadequate Procedural Protections*, S.D.N.Y. BLOG, Mar. 21, 2014, <http://sdnyblog.com/cdo-manager-sues-to-enjoin-sec-administrative-case-based-on-inadequate-procedural-protections>.

¹² Charles Michael, *New Suit Challenges Constitutionality of SEC Administrative Proceedings Based on ALJs’ Insulation from Executive Oversight*, S.D.N.Y. BLOG, Oct. 1, 2014, <http://sdnyblog.com/new-suit-challenges-constitutionality-of-sec-administrative-proceedings-based-on-aljs-insulation-from-executive-oversight/>; Jonathan Stempel, *Activist Investor Stilwell Sues SEC to Stop Enforcement Case*, REUTERS, Oct. 1, 2014.

SEC alleged that Joseph Stilwell failed to disclose loans made by funds controlled by Stilwell Value, whereas the other action involved allegations of insider trading.

The arguments raised by these two recent lawsuits against the SEC differ from the criticisms raised Judge Rakoff and the earlier constitutional challenges. Both plaintiffs challenge the administrative proceedings under Article II, contending that ALJs, as executive branch officers, cannot be insulated from presidential oversight. One plaintiff argues that ALJs have “enormous and practically unchecked authority” and exercise “unchecked and unbalanced administrative power.” In support, both plaintiffs point out that ALJs are appointed for life and cannot be removed at will. In effect, they argue that the SEC’s use of ALJs is unconstitutional because they resemble Article III judges more than executive officers, which is in contrast to Judge Rakoff’s contention that federal judges are better-suited to adjudicate federal securities cases and offer better protections for securities defendants than ALJs.

Unanswered Questions

The SEC’s use of administrative procedures raises novel and important questions of constitutional law, ranging from due process to separation of powers. However, despite these questions and the criticisms from both Judge Rakoff and the targets of the agency’s new policy, the SEC has shown no indication that it intends to back off its current strategy of foregoing the courts and forging ahead with administrative hearings before ALJs. As Mr. Ceresney stated Nov. 21, “There is no question that we are using the administrative forum more often now than in past years, given the changes under Dodd-Frank.”

Given that the SEC and Mr. Ceresney seem to have dug in, the only check on the SEC’s aggressive pursuit of securities law violations outside of the federal courts is likely to be a series of adverse rulings on these critical constitutional questions within them.