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SEC Plans to Play Insider-Trading Cases on Home Court

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Following the U.S. Securities and Exchange Commission's back-to-back trial losses in two high-profile insider trading actions, *SEC v. Obus* (S.D.N.Y., May 30, 2014) and *SEC v. Moshayedi* (C.D. Cal., Jun. 6, 2014), the SEC quickly has adopted a plan intended to improve its record: the "home court strategy."

The head of the SEC's Division of Enforcement, Andrew Ceresney, recently announced to the District of Columbia Bar that the SEC intends to bring future insider trading cases as SEC administrative proceedings, rather than as lawsuits in federal court. "I do think we will bring insider-trading cases as administrative proceedings in appropriate cases," he said. "We have in the past. It has been pretty rare. I think there will be more going forward."

Following Ceresney's comments, the SEC announced the hiring of two new judges and three new attorneys for its administrative law judge office, nearly doubling the office's staff. *SEC Announces New Hires in the Office of Administrative Law Judges*, June 30, 2014.

But the procedural safeguards and rights guaranteed to defendants in federal court are largely absent in SEC administrative proceedings. Revisions to the rules governing these are particularly necessary now, given the SEC's expressed intention to rely more on administrative proceedings. The revisions to the SEC's rules governing administrative proceedings proposed below would begin to level the playing field and give defendants a fighting chance, even in the SEC's home court.

HOME-COURT ADVANTAGE

It's no surprise that the SEC would prefer to bring administrative proceedings whenever possible—it enjoys a decided advantage in such proceedings, which are governed by the agency's Rules of Practice. In an administrative proceeding, the case is presented to an administrative law judge, not a jury or Article III judge.

JOEL COHEN

These administrative law judges, or "ALJs," are employees of the SEC, the same entity prosecuting the cases presented to the ALJ.

In addition, the discovery available to defendants in administrative proceedings is considerably more limited than that available in federal civil litigation. The SEC's Rules of Practice do not allow for interrogatories, requests for admission or depositions. See, generally, 17 C.F.R. 201.230–201.234.

Administrative proceedings are conducted on an expedited schedule that disadvantages the defendant far more than the SEC. While the SEC can spend years investigating, building and refining a case (during which there are no deadlines, other than applicable statutes of limitations), once an administrative proceeding is initiated, the ALJ must file a decision within either 120, 210 or 300 days, as specified by the SEC commissioners based on their internal assessment of the complexity of the case. 17 C.F.R. 201.360. To allow time (a) to conduct the trial and (b) for the ALJ to come to a decision, the pretrial preparation time specified by the SEC Rules is even more truncated—approximately one to four months, again based on the commissioners' assessment of the complexity of the case. Id. Even for experienced defense counsel, coming to grips with the facts of the case, assessing the SEC's allegations and mounting a defense is a tall order under such a tight schedule.

If this were not enough, the Federal Rules of Evidence do not apply to administrative hearings; instead, Rule 320 provides that the ALJ may "receive relevant evidence and shall exclude all evidence that is irrelevant, immaterial or unduly repetitious." 17 C.F.R. 201.320. Accordingly, evidence deemed too unreliable to be admissible under the Federal Rules of Evidence—most notably hearsay evidence—is admissible in administrative proceedings. This, too, plays unfairly to the SEC's advantage. Its investigative techniques are more focused on gathering evidentiary snippets suitable to eventual presentations unconstrained by the reliability that underscores the Federal Rules of Evidence.

Even after the conclusion of the administrative proceeding, the SEC's home-court advantage continues. Any appeal of an ALJ's decision must be made to the commission. Of course, to initiate the proceeding in the first place, the SEC's Division of Enforcement had to present the proposed action to the commission for approval. See SEC Enforcement Manual 2.5. Thus, the very same body that approved and instituted the proceeding rules on its merits upon appeal.

Only after the commission has made "any findings or conclusions that in its judgment are proper and on the basis of the record," 17 C.F.R. 201.411, can a party seek review by a federal appellate court. Even then, the appellate court accords substantial deference to the commission's findings, 15 U.S.C. 78y(a)(4), 5 U.S.C. 706(2), thus offering little meaningful

review. *See Valicenti Advisory Servs. Inc. v. SEC* (2d Cir. 1999) (Court must "affirm the findings of the commission as to the facts, if supported by substantial evidence," because the "standard used for judicial review of agency actions is … deferential," and the court "may neither engage in [its] own fact-finding nor supplant the [SEC's] reasonable determinations" (citations and internal quotation marks omitted)).

This bevy of procedural advantages enjoyed by the SEC in administrative proceedings is especially notable in the context of insider-trading cases. As Ceresney recently acknowledged, historically the SEC has filed very few insider-trading cases as administrative proceedings. This is likely a consequence of the historical development of the remedies that can be imposed against individuals and entities subject to administrative proceedings.

In 1990, Congress passed the Securities Remedies and Penny Stock Reform Act, which granted the SEC the authority to bring administrative proceedings imposing civil monetary penalties against SEC registrants and persons associated with such registrants. Thus, only individuals regulated by the SEC were subject to administrative proceedings seeking financial penalties. Given that a key component of insider-trading cases is the alleged financial profit from the wrongful trading—and the consequent disgorgement of such ill-gotten gains and other monetary penalties typically sought by the SEC—the agency's inability to seek monetary penalties against unregulated individuals in administrative proceedings meant it had to pursue cases against such people in federal court.

The 2010 the Dodd-Frank Wall Street Reform and Consumer Protection Act significantly expanded the SEC's authority, giving it the power to bring administrative proceedings seeking monetary penalties against *any* person, regardless whether that person is regulated by the SEC. See Section 929P of Dodd-Frank.

When one considers the type of evidence typically marshaled by the SEC in an insider-trading case, the procedural advantages available to the SEC in an administrative proceeding are revealed more starkly. The SEC rarely has the type of "smoking gun" evidence presented in criminal insider-trading prosecutions; there generally are no cooperating witnesses and no wiretaps or other directly incriminating evidence. Instead, the SEC tends to build circumstantial cases based on the timing of phone records, alleged conversations (often evidenced through hearsay) and securities trading activity.

Because an administrative proceeding denies a defendant the opportunity to conduct full discovery, it hampers one's ability to test and challenge the circumstantial nature of the SEC's proffered evidence. Without full discovery, it is difficult to dispute the inferences to be drawn from alleged conversations and phone records or to develop competing inferences. Moreover, the unavailability of depositions and the admissibility of hearsay means not only that a defendant is unable to exclude such evidence from his trial, but also that he is unable to confront such declarants before trial, if they testify at all.

In sum, the constricted discovery available to the defense, the brief time allotted for the defendant's pretrial preparation and the SEC's ability to present otherwise-inadmissible evidence meaningfully lowers the burden for the SEC to prove its allegations.

Combined with the paucity of meaningful appellate review and the fact that the supposedly impartial ALJ deciding the case is an employee of the SEC, one may question whether administrative proceedings even pass constitutional muster. Every stage of the proceeding—from investigation through appeal—and every government official involved, is controlled by the SEC in its executive enforcement role: from prosecutor, to judge, to "jury."

At least one federal judge has expressed extreme skepticism on this point; in a recent opinion affirming a settled SEC action on remand from the U.S. Court of Appeals for the Second Circuit, Judge Jed Rakoff of the Southern District of New York mused about administrative proceedings: "One might wonder: From where does the constitutional warrant from such unchecked and unbalanced administrative power derive?" *SEC v. Citigroup Global Markets Inc.* (S.D.N.Y. Aug. 5, 2014).

Earlier this year, defendants in two different SEC administrative actions filed suits in federal court seeking to have their administrative proceedings enjoined as violating their due-process rights. *See Jarkesy v. SEC* (D.D.C. Jun. 10, 2014); *Chau v. SEC* (S.D.N.Y. Mar. 19, 2014). However, both challenges failed to halt the impending administrative proceedings, and these defendants were forced to proceed in the SEC's administrative proceeding setting. Nonetheless, should a challenge to administrative proceedings prove successful in the future—the federal *Chau* case is still pending—the SEC may have to reconsider how it pursues its cases.

THE NEED FOR CHANGE

Against this backdrop, and in light of Ceresney's statement that the SEC will pursue more insider-trading cases (as well as other forms of cases) as administrative proceedings in the future, SEC general counsel Anne Small recently acknowledged that the rules governing SEC administrative proceedings may be out of date and in need of revision. Speaking during a Q&A session with members of the District of Columbia Bar, Small noted that it was "entirely reasonable to wonder" whether those rules should be updated to correspond with the more complex administrative matters the SEC expects to take on—including insider-trading actions—such as by allowing more flexibility on trial preparation time or allowing for depositions to be taken. "We want to make sure the process is fair and reasonable, so [changing] procedures to reflect the changes makes a lot of sense," she said.

Taking Small at her word, the SEC would be well advised to revise the procedures governing administrative proceedings so that they more closely resemble those applicable in federal civil litigation. At a minimum, the SEC's procedures should include more time for a defendant to prepare his case, including the right to engage in full discovery and depositions, and the application of the Federal Rules of Evidence and related guidance to ensure unreliable evidence is barred from administrative proceedings. The SEC should also consider setting up an independent corps of administrative judges who are not in its employ, as several states—including Georgia, Minnesota, New Jersey and Oregon—have done. See, e.g., New Jersey's Office of Administrative Law, described here.

Finally, appellate review should be conducted solely by Article III courts, or at the very least by a separate body within the SEC that played no role in the investigation and initiation of the administrative proceeding.

The SEC understandably wants to win more of its cases. But if the price is to reduce fairness, both justice and the SEC's credibility will suffer. Only through revisions like those described above can the SEC hope to achieve a modicum of fairness sufficient to give defendants a fighting chance on the SEC's home turf.

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