

What's Missing From The SEC's Forum Selection Guidance

Law360, New York (May 21, 2015, 10:34 AM ET) --

In its May 8, 2015, guidance on forum selection, the U.S. Securities and Exchange Commission missed a golden opportunity — instead of addressing the legitimate and widespread criticism of its recent forum selection practices, the SEC dodged the key issues, and in doing so raised more questions.

Since the Dodd-Frank Act of 2010 expanded the SEC's ability to obtain various forms of relief in an administrative forum, the SEC has increasingly pursued enforcement actions in administrative proceedings before an SEC administrative law judge.[1] Specifically, the Dodd-Frank Act allows the SEC to attain civil monetary penalties and disgorgement in administrative proceedings against all defendants, regardless of their status as registered entities or persons associated with one.

The SEC's administrative forum has been dubbed its "home court" because the prosecutors are SEC staff, SEC administrative law judges preside over the cases, and the commission itself, after having authorized the case initially, decides all appeals in the first instance.

The SEC's success rate in administrative proceedings over the past five years has been 90 percent and in the fiscal year ended Sept. 30, 2014, it was a perfect 100 percent. In federal district court, however, the SEC's five-year record is just south of 70 percent.

One of the most prominent critics of this SEC trend is U.S. District Judge Jed S. Rakoff. In addition to his doubts over the ALJs' ability to develop the law in the same way a district judge can, Judge Rakoff expressed his concern about defendants' limited discovery and the inapplicability of the Federal Rules of Evidence in administrative proceedings.[2]

The SEC's guidance purports to describe how its Division of Enforcement selects whether to commence enforcement actions in federal court or administrative proceedings. This guidance comes on the heels of extensive criticism from the bench, academics and practitioners concerning the SEC's increasing use of its administrative forum. It's unlikely that the guidance will mollify these critics, however, as it does no more than list nonexhaustive, nonmandatory and unweighted factors for the Division of Enforcement's consideration of how to "best utilize the Commission's limited resources to carry out its mission." Despite recent and ongoing legal battles over the constitutionality of the administrative forum, any



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consideration of defendants' rights, beyond their impact on the SEC's costs, is glaringly absent. Moreover, while the guidance touts fairness as a key consideration, it missed a golden opportunity to make the forum selection process fairer to defendants.

The frequency with which SEC enforcement actions parallel criminal charges makes the lack of these safeguards particularly troublesome. Since many statutes enforced by the SEC — including the mainstay anti-fraud provisions of the Securities Act of 1933 and the Exchange Act of 1934[3] — have criminal parallels distinguished only by the requisite intent level, it is disconcerting that administrative law judges and commissioners with no jurisdiction over criminal matters may attempt to interpret these laws and establish new precedents in an effort to shape criminal jurisprudence.

The U.S. Supreme Court's 1984 ruling in *Chevron USA Inc. v. Natural Resource Defense Council* held that an agency's interpretation of ambiguous law controls unless it is unreasonable.[4] However, just last fall, in a rare note accompanying a denial of a petition for certiorari to the Supreme Court, Justice Antonin Scalia, with Justice Clarence Thomas' support, questioned whether Chevron deference was owed to the SEC's interpretations of statutes that contemplate criminal punishment.[5] Defining crimes is the exclusive province of the legislature, and Chevron deference in this context may improperly imbue agencies such as the SEC with power that was never intended, thereby raising separation-of-powers questions.

Although the guidance cites fairness as an important factor, rights available to defendants apparently do not figure much into the SEC's stated calculus for forum selection. After noting that certain claims can only be resolved in one of the forums, such as "failure to supervise" charges and certain actions against registered persons and entities, which must be pursued administratively, versus emergency relief such as asset freezes, which can only be pursued in a federal district court, the guidance stated the key factors for forum selection:

- **Cost-Effectiveness:** The guidance noted that costs and availability of pretrial discovery in each forum differs. In administrative proceedings, depositions are generally unavailable, though the SEC has Brady[6] and Jencks[7] production obligations.
- **Resource Allocation:** The SEC's ability to obtain relief against multiple defendants in a single proceeding impacts resource effectiveness, as does the likelihood of summary dispositions, which are more frequently and broadly granted by district courts.
- **Time to Verdict:** The guidance noted that administrative hearings are resolved faster than claims brought in federal district court. According to the SEC, this impacts the "freshness" of a testifying witness' recollection and allows for "a more timely public airing" of the conduct at issue. This signals that, all other things being equal, older conduct is more likely to be litigated in an administrative hearing.
- **Fairness, Consistency and Securities Law Expertise:** The guidance noted that the SEC's administrative law judges (and the commission itself) have expertise concerning securities

industry practices, thus implying that they are better suited to preside over complex securities law claims than federal district court judges and better equipped to facilitate the consistent development of federal securities jurisprudence. Finally, the guidance implied that fairness to similarly situated and charged parties may weigh in favor of a similar forum.

A Missed Opportunity

The fact that the SEC discusses the unavailability of depositions only in terms of cost and the expedited hearing process only in terms of witnesses' recollection and speedy resolution belies the substantial negative impact these conditions have on the ability of defendants to present a viable defense. Furthermore, completely absent from the guidance is any recognition that the administrative forum deprives defendants of the ability to have a jury trial — something the SEC itself routinely demands in federal district court actions — or that defendants' first appeal is to the commission, which authorized the case in the first instance, rather than a neutral arbiter.

Lastly, because the SEC's timing to commence an action is bound only by the statute of limitations, it is hardly fair for the agency to complete all of its litigation preparation, including expert analysis and testimony, and then — and only then — file charges in an administrative forum with limited discovery and an expedited hearing schedule.

If fairness is really a factor, why doesn't the SEC allow defendants to choose the forum? The Federal Energy Regulatory Commission allows defendants to make an election of whether to proceed administratively or in federal district court. If the FERC can carry out its mandate despite affording putative defendants such a right, then certainly as esteemed an agency as the SEC can manage it as well.[8]

Similarly, why doesn't the SEC adopt the same production obligations under Brady and Jencks in a civil enforcement action brought in district court as it does in administrative proceedings? The SEC's Rules of Practice require the production of Brady material in administrative proceedings, but the enforcement staff maintains it has no such obligation when it pursues cases in federal district court.[9] This difference makes no sense now that the SEC has the power to pursue many of the same enforcement actions in either forum. The SEC could easily rectify this discrepancy by adopting a policy clearly stating that all defendants have access to all exculpatory information regardless of the forum in which they are tried. The SEC would be doing no more than the FERC and the Federal Election Commission.[10]

The SEC is facing much broader attacks than the issues noted above. Defendants are challenging the constitutionality of the SEC's entire approach to administrative proceedings.[11] The guidance was an opportunity to address some of those concerns, and guidance is always welcome. But in this case, the SEC's guidance says little about defendants' rights, which suggests that, to the SEC, "carry[ing] out its mission" means winning the actions it brings as opposed to discovering the truth and achieving the right outcome. As the investor's advocate, the SEC has a well-deserved reputation for fair and effective policing of the nation's financial markets. That reputation is only enhanced, not weakened, when the commission employs fairness for the benefit of all parties in the guidance it provides.

There is no doubt that the vast majority of enforcement actions are based in legitimate efforts to police markets and protect investors, which is why so many settle on terms favorable to the agency or are resolved in court with the SEC as the victor. Either judicial forum will enable the Division of Enforcement to provide strong and effective enforcement of the federal securities laws; the question is whether each

forum provides fair enforcement of those laws. The SEC's failure to articulate whether and how it will address the issues noted herein was an opportunity missed. It was an opportunity for the agency to short-circuit needless criticism and distracting legal challenges by addressing head on many of the legitimate concerns raised about the optics of its perceived "home court" advantage. Hopefully, it was not an opportunity lost.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P, 124 Stat. 1376, 1862-65 (2010).

[2] See Stephanie Russell-Kraft, Rakoff Continues Crusade Against SEC Admin Courts, Law360 (Nov. 21, 2014, 1:46 PM ET), <http://www.law360.com/articles/598561/rakoff-continues-crusade-against-sec-admin-courts>; Stephanie Russell-Kraft, Rakoff Hopes SEC Will 'Think Twice' About Using Admin Court, Law360 (Mar. 3, 2015, 4:42 PM ET), <http://www.law360.com/articles/627028t>.

[3] Securities Act of 1933 §§ 17(a), 24, 15 U.S.C. §§ 77q(a), 77(x); Securities Exchange Act of 1934 §§ 10(b), 32, 15 U.S.C. §§ 78j(b), 78ff.

[4] 467 U.S. 837 (1984).

[5] Cara Salvatore, Scalia, Thomas Seek Case Challenging SEC Power, Law360 (Nov. 10, 2014, 2:30 PM ET), available at <http://www.law360.com/securities/articles/594841>.

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

[7] The Jencks Act, 18 U.S.C. § 3500.

[8] 16 U.S.C. § 823b(d).

[9] SEC Enforcement and Disciplinary Proceedings Rule, 17 C.F.R. § 201.230.

[10] Federal Energy Regulatory Commission Enforcement of Statutes, Regulations, and Orders, 129 FERC ¶ 61,248 (2009) (adopting a policy requiring the disclosure of exculpatory materials at the investigation stage — before the defendant has chosen a forum for the action); Federal Election Committee Agency

Procedure for Disclosure of Documents and Information in the Enforcement Process (adopted May 26, 2011), available at http://www.fec.gov/members/walther/statements/stw_statement_on_disclosure_of_documents_procedure.pdf (adopting a more robust disclosure policy in its enforcement actions to effectuate the principle of Brady).

[11] See, e.g., *Tilton et al v. SEC*, No. 15-02472 (S.D.N.Y. filed Apr. 1, 2015) (alleging ALJs are unconstitutionally appointed public officers); Respondents' Petition for Interlocutory Review and Emergency Motion to Stay the Hearing and Prehearing Deadlines, In the Matter of Harding Advisory LLC and Wing F. Chau, Admin. Proc. File No. 3-15574 (filed Feb. 27, 2014) (alleging the SEC administrative hearing violated defendants' due process rights).

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