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EXPERT ANALYSIS

Fast-Track Justice: Is the SEC Exercising 'Unchecked and Unbalanced Power'?

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U.S. District Judge Jed Rakoff filed a terse opinion Aug. 5 on remand in the Citigroup saga. In it, Judge Rakoff noted the 2nd U.S. Circuit Court of Appeals' invitation to the Securities and Exchange Commission to avoid the courts altogether "and employ its own arsenal of remedies instead."¹ Judge Rakoff wondered, "From where does the constitutional warrant for such unchecked and unbalanced administrative power derive?"²

The short answer to Judge Rakoff's question is that Congress bestowed these expansive administrative powers on the SEC. In 1990, Congress passed legislation designed to enable the commission to maintain "an aggressive and comprehensive program to enforce the federal securities laws" as they applied to regulated entities and associated persons.³

This legislation, the Securities Enforcement Remedies and Penny Stock Reform Act of 1990⁴, was a progenitor of the comprehensive Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.⁵ Dodd-Frank extended the commission's enhanced enforcement powers to non-regulated entities and individuals.⁶

Of course, pointing to legislation does not answer the due process issue raised by Judge Rakoff.

In his recent remarks at a District of Columbia Bar Association function, SEC Enforcement Director Andrew Ceresney responded to concerns that filing insider-trading cases as administrative proceedings was inherently unfair to respondents.

After pronouncing administrative proceedings "fair," Ceresney said "a number of cases in recent months ... settled" when the Enforcement Division "threatened" to bring them as administrative proceedings. Not surprisingly, this remark did little to assuage his audience.

Implicit in Ceresney's comment is a recognition that the ability of defense counsel to fully develop and present a robust defense in an administrative proceeding is significantly curtailed.

Ceresney's remark is revealing of the impetus driving the division's increased preference for its in-house forum. The division does not like to lose cases; no trial lawyer does. Marginal cases — on the law, the evidence or both — are contested, and federal court is the forum of choice to defend against a serious enforcement action. Federal court also poses the greater risk to the division because of procedures and rules that — imperfectly, perhaps — maintain a balance between the parties. Then, too, there is the right to a jury trial in federal court.



With the increased use of administrative proceedings, revisions to the rules of practice may be necessary to level the playing field and better protect the rights of respondents in these actions.

The recent trial of Mark Cuban on insider-trading charges is a case in point.⁷ By any measure, the evidence against Cuban was thin, and the theory of liability (misappropriation) was not without its problems. The case was not complex and took less than two weeks to try, including jury selection and the five hours of deliberation the jury required to reach its verdict.

The outcome turned on a swearing contest between the defendant and the division's star witness, the former CEO of the company whose stock was at issue. The jury believed Cuban and returned a verdict in his favor.

Many practitioners have commented that the division lost the Cuban case when it elected to file its complaint in Dallas, the defendant's "home court," rather than in the Southern District of New York. The real problem for the division's case was that the critical testimony of the CEO, who was not charged by the SEC, was presented by videotape, because he refused to appear in court. As a Canadian citizen, he could not be compelled to do so.

A jury of New Yorkers, in weighing the credibility of Cuban against that of the absent CEO, could very well have reached the same decision as the Dallas jury, and for the same reasons. It is less certain that the outcome would have been the same had the action been filed as an administrative proceeding. If it had been, Cuban could have used his considerable resources to challenge the constitutional issues arising from that forum selection.

Recent filings have shown that the division's increased use of the administrative process is not limited to insider-trading cases. With the increased use administrative proceedings, revisions to the rules of practice may be necessary to level the playing field and better protect the rights of respondents in these actions.

RENEWED FOCUS ON FINANCIAL REPORTING FRAUD

On July 2, 2013, the Enforcement Division announced the formation of the Financial Reporting and Audit Task Force⁸ to "enhance its ongoing enforcement efforts related to accounting and disclosure fraud."⁹ Orphaned in the post-Madoff restructuring of the division, financial reporting fraud now assumes its place among the division's other specialty units, staffed with a cadre of skilled and experienced enforcement lawyers and accountants dedicated to a singular mission.

The typical investigation of financial reporting fraud requires many months to complete. Tens of thousands, if not hundreds of thousands, of documents are subpoenaed from a variety of sources. Dozens of witnesses are called to testify.¹⁰ An issuer will have undertaken an internal investigation once it became aware of the division's interest.

An internal investigation is not the equivalent of, nor a substitute for, trial preparation, though. This is especially true for a person who might be left to fend for himself after the issuer settles.

Ceresney has said admissions will be required in settlements of "egregious"¹¹ cases. Assume an issuer whose core business is government contracting is required to admit to conduct that constitutes a Section 10(b) violation as part of the settlement of a financial reporting fraud case. The fraud admissions will have collateral consequences to the issuer's ability to defend against private lawsuits and debarment proceedings, among other disabilities.

This scenario may meet the dictionary definition of a "bet-the-company" case. Now toss into the mix the division's "threat" to bring the action as an administrative proceeding.

TIMELINE AND PROCEDURES OF AN ADMINISTRATIVE PROCEEDING¹²

Three principles govern the construction of the rules of practice. First among them is that the "rules ... shall be construed and administered to secure [a] just ... determination of every proceeding."¹³

This objective of securing a "just determination" can be frustrated in several ways.

Unrealistic time constraints

The SEC controls the clock in an administrative proceeding. The proceeding is initiated by an order instituting proceeding. The OIP issued by the commission reads like a complaint.¹⁴

Unlike a federal court action, an administrative proceeding is governed by the time period within which the administrative law judge “shall” issue the initial decision, or verdict.¹⁵ The deadlines for initial decisions are not aspirational; they are mandatory.

The judge is required to file the initial decision by one of three deadlines: 120 days from the date of service of the OIP, 210 days from service or 300 days from service.¹⁶ Discovery, trial preparation, pre-hearing conferences, the hearing itself, post-hearing briefing, and submission of proposed findings of fact and conclusions of law must be completed between the filing of the OIP and the initial decision.

Limited discovery

Depositions are perhaps the most striking example of the disparity between federal court actions and administrative proceedings. The rules of practice do not permit a respondent to take discovery depositions.

A respondent wishing to take a witness’s deposition is required to make a “written motion setting forth the reasons why such deposition should be taken, *including the specific reasons why the party believes the witness will be unable to attend or testify at the hearing.*”¹⁷ The administrative law judge, at his or her discretion, may order a deposition only based on delineated findings, including the unavailability of the witness to appear and testify at the hearing.¹⁸

The inability to take discovery depositions of expert witnesses is an acute disadvantage in a financial reporting fraud case. A typical financial reporting fraud case in federal court involves one or more forensic accountants as expert witnesses. Federal Rule of Civil Procedure 26 has dedicated provisions governing expert reports and discovery.¹⁹

In complex federal court actions, expert discovery typically begins after fact discovery has ended. In contrast, the administrative proceeding rule governing experts provides minimal pretrial disclosure, does not require an expert report and has no provision for expert depositions.²⁰

Procedures that reward trial by ambush and result in a distorted record

In an administrative trial, third-party investigative testimony is typically admitted as evidence in chief.²¹ This testimony would not be so admitted in a federal trial, and for good reason. The investigative examination is entirely one-sided. It is unchallenged by respondent’s counsel.

While the rule governing admissibility of prior sworn statements is party-neutral, in practice, it is a favorite tool of Enforcement Division trial counsel who are not required to call the witness live. A party wishing to introduce prior testimony is required to make a motion. The administrative law judge has broad discretion to grant such a motion.

The rule lists four circumstances in which the hearing officer may admit a prior sworn statement. The fifth basis renders the first four moot: “In the discretion of the commission or the hearing officer, it would be ... in the interests of justice, to allow the prior sworn statement to be used.”²²

Unilateral abrogation of the right to trial by jury

Rule 38(a) of the Federal Rules of Civil Procedure provides, “The right of trial by jury as declared by the Seventh Amendment to the Constitution ... is preserved to the parties inviolate.” Of course, a jury trial can be waived, and parties can agree to a bench trial or arbitration, but these options require the consent of the parties.

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this option has always been available to the division, usually it has been exercised in cases more appropriate for “speedy” disposition, rather than complex financial reporting fraud actions.²³

RECENT COMPLEX ENFORCEMENT ACTIONS FILED AS ADMINISTRATIVE PROCEEDINGS

Four recent administrative actions involving allegations of complex disclosure and financial reporting fraud signal the division’s preference for its in-house forum has gotten traction beyond insider-trading cases.²⁴

The actions — *Airtouch*, *Cummings*, *Sherman* and *Neely* — allege serious violations of the anti-fraud provisions and involve complex accounting evidence requiring expert testimony. The stakes for the individual respondents — senior officers, two of whom are CPAs — are high: monetary penalties, officer/director bars, collateral bars and practice bars.

Nearly one year after Ceresney’s announcement of the Financial Reporting and Audit Task Force, and mere weeks after his statement at the District of Columbia Bar Association function, *Airtouch*, *Neely*, *Cummings* and *Sherman* were filed as C&Ds, or cease-and-desist actions. This is a species of administrative proceeding given added muscle by Dodd-Frank. The OIPs provided “that a public hearing for the purpose of taking evidence ... shall be convened not earlier than 30 days and not later than 60 days from service of this order.”²⁵

In practice, administrative law judges typically fashion a “workaround” of the 30/60 service-to-hearing mandate, affording respondents in C&D proceedings more realistic deadlines. Fundamental fairness and due process should not be left to ad hoc cures and workarounds fashioned at the discretion of the administrative law judge and subject to SEC approval.

THE CALL TO REVISE THE SEC RULES OF PRACTICE

On June 17, six days after Ceresney pronounced administrative proceedings fair, the SEC’s general counsel suggested to the District of Columbia Bar that it is “reasonable” to consider revising the rules of practice “to make sure the process is fair.”

It is unlikely that the SEC, on its own initiative, will undertake revisions to its practice rules. Considering the general counsel’s comment an invitation to do so, it would be interesting to see what changes to the rules are feasible and whether those changes serve their intended purpose in practice.

Trial lawyers defending against SEC enforcement actions in federal court are accustomed to tight scheduling orders, discovery limits and judges who are able to exercise broad discretion. The federal rules limit the number and length of depositions, and the number of interrogatories.

Bench trials are traditionally conducted with less than robust attention to the rules of evidence. A district judge can admit or exclude evidence, or disallow witnesses deemed cumulative, with little concern for reversible error.

Comparing apples to apples, the principal differences between a federal court bench trial and an administrative proceeding before an administrative law judge are:

- A federal judge does not have to decide a case within a mandatory deadline.
- A federal judge is not accountable to the plaintiff such that, for example, good cause must be shown to the plaintiff (read “SEC”) to obtain deadline extensions.
- The federal rules provide well established procedures for fact discovery, expert discovery and motion practice in a time frame appropriate to the complexity of a case, as opposed to the arbitrary deadlines imposed in administrative proceedings.

- A neutral federal magistrate who will not serve as the trial judge is available to referee settlement negotiations and modulate excessive demands.

The changes that would reconcile these differences between a federal bench trial and an administrative proceeding are obvious:

- Eliminate the mandatory time limit for filing an initial decision (or empower administrative law judges to extend the end date on the respondent's motion).
- Extend the deadlines for the commencement of hearings to provide a reasonable period for preparation.
- Bring pre-hearing discovery practice and the conduct of the administrative trial more in line with the federal rules of procedure and evidence.²⁶

The more challenging task, however, is in developing criteria to identify which cases are sufficiently complex to merit special rules. Broad reforms to ensure fairness in a complex financial reporting fraud case are unwarranted in a failure-to-supervise case.

The federal and state courts recognize that certain cases require more time than others and apply objective criteria to make these determinations. Even more fundamentally, the amount of damages, or the statutes at issue, are determinative of scheduling, scope of discovery and, in some instances, whether the parties have a right to trial by jury.

The undertaking to revise the SEC's practice rules must begin by defining what type of case requires special handling. Granting additional time cannot be an ad hoc process left to the discretion of individual judges, staff or the commission.

Objective criteria need to be developed and applied uniformly to all actions filed as administrative proceedings. Factors relevant to identifying an appropriate case should include:

- The alleged violations (*scienter*-based fraud or negligence).
- Whether expert evidence is required to prove or defend elements of the violations.
- The potential remedies (disgorgement, bars and penalties).
- The length of the formal investigation.
- The number of witnesses called by staff during the investigation.
- The volume of documents obtained by staff during its investigation.

Applying these factors would have identified *Airtouch*, *Cummings*, *Sherman* and *Neely* as complex cases that should be relieved of the draconian time deadlines and other disadvantages of administrative proceedings. Thus, the first goal of those rules — "to secure [a] just ... determination" — would be better served.²⁷

NOTES

¹ *SEC v. Citigroup Global Mkts.*, No. 11-CV-7387 (JSR), 2014 WL 3827497 (S.D.N.Y. Aug. 5, 2014) (quoting *SEC v. Citigroup Global Mkts.*, 752 F.3d 285, 297 (2d Cir. June 4, 2014)).

² *Id.*

³ H.R. Rep. No. 101-616, at 1380 (1990).

⁴ Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 933.

⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1802. Sen. Christopher Dodd, D-Conn., was a co-sponsor of the 1990 bill, as well as the act that bears his name.

⁶ Section 8A of the Securities Act, 15 U.S.C. § 77h-1; Sections 21B and 21C of the Exchange Act, 15 U.S.C. §§ 78u-2 -3.

⁷ *SEC v. Cuban*, No. 08-CV-2050-D, *complaint filed* (N.D. Tex. Nov. 17, 2008).

⁸ Sometimes referred to as FRAud Task Force.

⁹ Press Release, SEC, SEC Announces Enforcement Initiatives to Combat Financial Reporting and Microcap Fraud and Enhance Risk Analysis (July 2, 2013).

¹⁰ “[A]ccounting fraud cases take lots of resources and effort. They often require a lot of financial analysis, mounds of documents and lots of testimony.” Andrew Ceresney, Co-Dir. of Div. of Enforcement, SEC, Remarks at the American Law Institute Continuing Legal Education Seminar (Sept. 19, 2013).

¹¹ Andrew Ceresney, Dir. of Div. of Enforcement, SEC, Keynote Address at Compliance Week 2014 (May 20, 2014). Exactly what constitutes “egregious” conduct has not been defined. We can all describe accounting fraud that is remarkably horrendous. But what of conduct that is not so obvious? Is it even possible to establish standards so that an issuer has some guidance in assessing where its conduct falls on the spectrum? I am reminded of the card game Robert DeNiro’s character in “Bang the Drum Slowly” fell victim to in the clubhouse: TEGWAR — The Exciting Game Without Any Rules.

¹² Before delving into the time pressures and procedural limitations inherent in an administrative proceeding, the concern about filing complex financial reporting cases as administrative proceedings is not based on any belief or experience that administrative law judges are not fair-minded. The judges are bound by the rules of practice promulgated by the commission. The issues of concern derive from the rules of practice, and not from the judges who must function within them.

¹³ RP 103(a), 17 C.F.R. § 201.103(a). The other two goals are that proceedings should be “speedy” and “inexpensive.” The division’s intention to file complex fraud actions as administrative proceedings raises the question of whether a “just” determination trumps speed and expense, or vice-versa.

¹⁴ RP 200, 17 C.F.R. § 201.200.

¹⁵ RP 360, 17 C.F.R. § 201.360. The commission imposes no such deadlines on its *de novo* review of initial decisions. Anecdotally, two years between the initial decision and the commission’s opinion is not unusual: *In the Matter of Montford & Co. et al.*, AP File No. 3-14536 (May 2, 2014); *In the Matter of Koch et al.*, AP File No. 3-4355 (May 16, 2014).¹⁶ RP 360(a)(2), 17 C.F.R. § 201.360(a)(2). The rule mandates “approximately” one month, two-and-a-half months and four months, respectively, from service of the OIP to the trial. RP 161 governs extensions and postponements. The rule has two important provisions for our purposes: the commission or administrative law judge, “for good cause shown ... may postpone ... any hearing,” and “[p]ostponements ... shall not exceed 21 days unless the commission or the hearing officer states on the record or sets forth in a written order the reasons why a longer period of time is necessary.” 17 C.F.R. § 201.161.

¹⁷ RP 233(a), 17 C.F.R. § 201.233(a).

¹⁸ RP 233(b), 17 C.F.R. § 201.233(b).

¹⁹ Fed. R. Civ. P. 26 (a)(2)(B) and 26 (b)(4).

²⁰ RP 222, 17 C.F.R. § 201.222.

²¹ RP 235, 17 C.F.R. § 201.235.

²² 17 C.F.R. § 201.235(a)(5).

²³ *E.g.*, failure to supervise, *In the Matter of Bloomfield et al.*, AP File No. 3-13871 (Feb. 27, 2014); Section 12(j) revocations, *In the Matter of NEC Corp.*, AP File No. 3-13071 (June 17, 2008); Section 5 violations, *In the Matter of Migliozi et al.*, AP File No. 3-14415 (June 8, 2011); Reg SHO violations, *In the Matter of Hazan Capital Mgmt. et al.*, AP File No. 3-13570 (Aug. 5, 2009); and books-and-records violations, *In the Matter of Stryker Corp.*, AP File No. 3-15587 (Oct. 24, 2013). This is not to say serious fraud cases have not been filed as administrative proceedings in the past, or should not continue to be filed as such in the future. A “pump-and-dump” scheme is hardcore fraud, but relatively simple in concept and proof.

²⁴ *In the Matter of Airtouch Commc'ns et al.*, AP File No. 3-15945 (Aug. 22, 2014); *In the Matter of Cummings*, AP File No. 3-15991 (July 30, 2014); *In the Matter of Sherman*, AP File No. 3-15992 (July 30, 2014); *In the Matter of Neely*, AP File No. 3-15945 (June 25, 2014).

²⁵ Securities Act § 8A(b), 15 U.S.C.A. § 77h-1(b); Exchange Act § 21C(b), 15 U.S.C.A. § 78u-3(b).

²⁶ To avoid trial by ambush, a testifying expert should be required to prepare a report, which should be produced to the opposing party, followed by the expert's deposition. In this same spirit of fairness, if the division's RP 235 motion to admit a prior sworn statement is granted, the respondent should be permitted by rule to take the deposition of the witness. RP 360, 17 C.F.R. § 201.235.

²⁷ 17 C.F.R. § 201.103(a).



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