The Scope Of SEC Defendants' Jury Trial Right: Part 4

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This is the last of four articles examining the scope of the Seventh Amendment jury trial right as applied to the facts that set the maximum monetary penalty a judge may impose against a civil defendant in a U.S. Securities and Exchange Commission enforcement action. The previous articles explained why the Seventh Amendment entitles a civil defendant to a jury finding of those facts that increase the maximum penalty, how defining "each violation" that the jury must pass on could have a significant impact on the potential civil penalty that could be imposed, and why obtaining certain penalties requires the SEC to prove to the jury the causal connection between the violation and any gains or losses.[1] In this article, we address why, even with regard to otherwise negligence-based securities law violations, the SEC must prove scienter to the jury in order to obtain a second- or third-tier penalty.

Is Scienter Required for Certain Civil Penalties?

As we have discussed previously, the federal securities laws create three penalty tiers that are each based on the presence of facts beyond proof of a securities law violation. The base penalty for any individual violation is $5,000 ($50,000 for a corporation or other entity). But if the violation "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement," then the maximum penalty increases to $50,000 ($250,000 for a corporation or other entity). And if the violation also resulted in substantial losses or a significant risk of substantial losses to others, then the maximum penalty increases to $100,000 ($500,000 for a corporation or other entity).[2] A question raised by this penalty scheme is whether second- or third-tier penalties are available for negligence-based or strict liability violations of the federal securities laws.

Courts have held that certain provisions of the securities laws require no proof of scienter — such as an intent to violate the law or even recklessness on the part of the defendant — in order to establish a violation. For example, Section 17(a)(2) and (3) of the Securities Act of 1933 prohibit, respectively, obtaining money by means of a false or misleading statement or engaging in a transaction, practice or course of business that operates as a fraud or deceit on a securities purchaser.[3] In Aaron v. SEC, the U.S. Supreme Court held that the SEC may obtain an injunction against Section 17(a)(2) or (3) violations without proving scienter.[4] A violation of either of those provisions may be established with proof of mere negligence. The question, then, is whether a negligence-based violation of Section 17(a)(2) or (3) is a violation "involv[ing] fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement," thus exposing the defendant to a second- or third-tier penalty.

At first blush, it might appear that negligence-based violations of Section 17(a)(2) or (3) "involv[e] fraud, [or] deceit." Indeed, Section 17(a)(3) even uses the words "fraud" and "deceit," as in "operate as a fraud or deceit." But whether Section 17(a)(2) or (3) violations premised on negligence "involv[e] fraud, [or] deceit" depends on whether the terms

"fraud" and "deceit," as used in Section 17(a), have the same meaning when used in the penalty provisions. The Supreme Court's decision in Aaron makes clear that the use of even the same term in two sections of the federal securities laws does not necessarily lead to the conclusion that the term has the same meaning in both sections. In that vein, Aaron holds that the terms "fraud" and "deceit," when used in Section 17(a)(2) or (3), do not have the same meaning as when used in Rule 10b-5. In Rule 10b-5, those terms suggest an element of scienter. But in Section 17(a), the nearly identical language suggests that negligence would suffice. In other words, context matters.

Second- and Third-Tier Penalties Require Intentional or Reckless Conduct

The text of the penalty provisions suggests that the terms "fraud" and "deceit," as used there, contemplate a scienter element. First, the terms "fraud" and "deceit" generally refer to intentionally misleading conduct. Black's Law Dictionary defines "fraud" as "some deceitful practice or willful device, resorted to with intent to deprive another of his right."[5] It defines "deceit" as "[a] fraudulent and cheating misrepresentation, artifice, or device used by one or more persons to deceive and trick another."[6] And the Supreme Court has interpreted phrases like "implementing [fraudulent] devices" to be "the commonly understood terminology of intentional wrongdoing."[7]

Second, interpreting those terms as carrying with them an intent requirement is supported by the general principle of statutory construction that a word is interpreted according to the company it keeps.[8] The other words in the second-tier penalty provision, i.e., "manipulation" and "deliberate or reckless disregard of a regulatory requirement," are words of intentionality. The Supreme Court has recognized that the term "manipulative" "quite clearly evince[s] a congressional intent to proscribe only 'knowing or intentional misconduct.'"[9] Similarly, "deliberate" means "intentional."[10] And "reckless" acts under the federal securities laws are ones done with what is effectively intent.[11]

A few district courts have validated this interpretation, holding that negligent fraud cannot support third-tier penalties.[12] At least one SEC administrative law judge has likewise recognized that scienter is required to impose third-tier penalties.[13] And as a matter of policy, it makes little sense to read the penalty provisions to allow for potentially crippling monetary penalties for merely negligent violations of the law.[14] For all these reasons, we think the better reading of the penalty provisions is that the terms "fraud" and "deceit," as used there, include an element of scienter.

When Does a Violation "Involve" Fraud or Deceit?

A related and equally important question is what it means for a violation to "involve" fraud or deceit. Is it the elements of the violation that dictate whether the violation involved fraud or deceit? Or does a violation involve fraud or deceit where, under the facts of the particular case, fraud or deceit are present? In other words, can a violation that does not include fraud or deceit as an element nonetheless "involve" fraud or deceit because the factual scenario at issue included fraudulent or deceptive conduct?

A similar issue has arisen in the criminal context. The Armed Career Criminal Act subjects defendants in firearms offenses to enhanced penalties if they were previously convicted of felonies that "involve[] conduct" that presents a serious risk of

physical injury.[15] In applying this provision, courts wrestled for years with whether to look at the offense as defined or the offense as committed. The Supreme Court held that the elements of the offense answer the "involves" question.[16] But, ultimately, after more than two decades of struggling with the question, the Supreme Court concluded that, even under this test, the statute was unconstitutionally vague.[17]

In the SEC penalty context, courts have not squarely addressed whether the elements of the provision violated or the facts of the case should be the focus for determining whether a violation "involves" fraud or deceit. Some courts have looked at the facts of the case to determine whether the violation "involved fraud." In SEC v. CMKM Diamonds Inc., for instance, the defendants admitted to violating Sections 5(a) and 5(c) of the Securities Act. The district court assessed third-tier penalties, notwithstanding the defendants' protestations, after finding that the defendants' "business practices were fraudulent, deceitful, and manipulative."[18]

The Scienter Element of the Penalty Provisions Must Be Found By the Jury

If we are correct that the terms "fraud" and "deceit" as used in the penalty provisions carry with them an element of scienter, then the Seventh Amendment entitles a defendant to a jury trial on that intent element. A defendant is liable for a second- or third-tier penalty only if that scienter is present, and thus Tull v. United States entitles a defendant to a jury determination on that liability question.[19] The SEC would have to prove to the jury that the defendant acted with the necessary intent to defraud.

Consistent with our reading of Tull, at least one district court has suggested that it is inappropriate to impose second- or third-tier penalties if the jury does not expressly find intentional or reckless fraud or deceit. In SEC v. Solow, the SEC urged the district court to submit only a general verdict form to the jury.[20] The defendant opposed the general form and requested that the jury receive a verdict form with special interrogatories. The court ultimately acceded to the SEC's request to submit the general form, and the jury returned a verdict against the defendant, finding that he had violated the federal securities laws without specifying the fraud theory on which it relied. When the SEC sought third-tier penalties totaling $780,000, the defendant argued that the general verdict form did not show whether the jury found him liable for intentional fraud or for mere negligence under Section 17(a)(2) or (3), and therefore that third-tier penalties were improper. In response, the court undertook its own analysis of the evidence presented and concluded that it believed that third-tier penalties were appropriate. But the court recognized the defendant's Seventh Amendment right to have the jury determine his liability and decided not to "theoriz[e] about the jury's views" on the fraud issue. [21] In the absence of a specific finding of scienter by the jury, the court refused to order third-tier penalties.

Conclusion

The federal securities laws provide for second- and third-tier penalties for violations "involv[ing] fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." That language suggests that the SEC must prove that a defendant intentionally or at least recklessly committed the underlying violation in order to obtain second- or third-tier penalties. Not all federal securities laws, however, require proof of scienter to establish a violation. It may be that

second- and third-tier penalties are not permitted for such violations. At a minimum, we read Tull to require the SEC to prove scienter to a jury before a court may impose second- or third-tier penalties for such violations. Defendants in SEC enforcement actions may want to demand that the jury make the requisite scienter findings when threatened with heightened penalties under the federal securities laws.

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[1] For a more thorough explanation, see Matthew T. Martens, Jaclyn N. Moyer and Derek A. Woodman, The Scope of SEC Defendants' Jury Trial Right: Part 1, Law360 (July 1, 2016), https://www.law360.com/articles/809309/the-scope-of-sec-defendants-jury-trial-right-part-1; Matthew T. Martens, Jaclyn N. Moyer and Derek A. Woodman, The Scope of SEC Defendants' Jury Trial Right: Part 2, Law360 (July 11, 2016), https://www.law360.com/articles/815542/the-scope-of-sec-defendants-jury-trial-right-part-2; and Matthew T. Martens, Jaclyn N. Moyer and Derek A. Woodman, The Scope of SEC Defendants' Jury Trial Right: Part 3, Law360 (July 18, 2016), http://www.law360.com/articles/818648/the-scope-of-sec-defendants-jury-trial-right-part-3. A more comprehensive analysis of these issues can be found at Matthew T. Martens & Troy A. Paredes, The Scope of the Jury Trial Right in SEC Enforcement Actions, 71 N.Y.U. Ann. Surv. Am. L. 147 (2016).

[2] 15 U.S.C.§§ 77t(d), 78u(d), 80a-41(e), 80b-9(e). Each of these penalty tiers are periodically adjusted by SEC regulations. As of March 5, 2013, the penalties for the three tiers are $7,500, $80,000, and $160,000, respectively, and the penalties for corporations or other entities are $80,000, $400,000, and $775,000. See 17 C.F.R. § 201.1005. On Aug. 1, 2016, those amounts increase to $8,908, $89,078 and $178,156 for natural persons and $89,078, $445,390 and $890,780 for corporations or other entities. See Adjustments to Civil Monetary Penalty Amounts, 81 Fed. Reg. 43,042 (proposed July 1, 2016) (to be codified at 17 C.F.R. pt. 201).

[3] 15 U.S.C.§ 77q(a)(2), (3).

[4] 446 U.S. 680, 697 (1980).

[5] Black's Law Dictionary 594 (2d ed. 1979).

[6] Id. at 365.

[7] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976).

[8] See, e.g., McDonnell v. United States, No. 15-474, 2016 WL 3461561, at *13 (U.S. June 27, 2016); Yates v. United States, 135 S. Ct. 1074, 1085 (2015) (plurality).

[9] Aaron, 446 U.S. at 690; accord Hochfelder, 425 U.S. at 199 (holding that "[u]se of the word 'manipulative' ... connotes intentional or willful conduct designed to deceive or defraud").

[10] Black's Law Dictionary 492 (9th ed. 2009).

[11] See SEC v. Steadman, 967 F.2d 636, 641 (D.C. Cir. 1992) (observing that recklessness is "'a lesser form of intent'" (quoting Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977)).

[12] See SEC v. Mattera, No. 11 Civ. 8323(PKC), 2013 WL 6485949, at *16-17 (S.D.N.Y. Dec. 9, 2013) (holding that "a finding of recklessness … is necessary to justify second or third-tier penalties" and that negligence was not sufficient); SEC v. Novus Techs. LLC, No. 2:07-CV-235-TC, 2010 WL 4180550, at *13 (D. Utah Oct. 20, 2010) ("Imposition of a third tier penalty requires a finding that [the defendant] acted with a high degree of scienter."), aff'd sub nom., SEC v. Thompson, 732 F.3d 1151 (10th Cir. 2013).

[13] See Harding Advisory LLC, SEC Release No. 734, 2015 WL 137642, at *93 (Jan. 12, 2015).

[14] Cf. Exxon Shipping Co. v. Baker, 554 U.S. 471, 493 (2008) (noting punitive damages limited to circumstances "where a defendant's conduct is 'outrageous,' owing to 'gross negligence,' 'willful, wanton, and reckless indifference for the rights of others,' or behavior even more deplorable" (citation omitted)); Kolstad v. Am. Dental Ass'n, 527 U.S. 526, 536 (1999) (reaffirming "the intent standard [for punitive awards], at a minimum, required recklessness"); Smith v. Wade, 461 U.S. 30, 42 (1983) (recognizing punitive damages are available for conduct that "was done wilfully, or was the result of that reckless indifference to the rights of others which is equivalent to an intentional violation of them" (quoting Milwaukee & St. Paul R. Co. v. Arms, 91 U.S. 489, 493 (1875)).

[15] 18 U.S.C.§ 924(e).

[16] See Taylor v. United States, 495 U. S. 575, 600 (1990).

[17] See Johnson v. United States, 135 S. Ct. 2551, 2563 (2015).

[18] SEC v. CMKM Diamonds Inc., 635 F. Supp. 2d 1185, 1192 (D. Nev. 2009); see also SEC v. Apha Telcom Inc., 187 F. Supp. 2d 1250, 1263 (D. Or. 2002) ("[I]t is my conclusion that [the defendant's] conduct did not amount to fraud, deceit, manipulation, or the like.").

[19] See 481 U.S. 412, 425 (1987).

[20] See 554 F. Supp. 2d 1356, 1366-67 (S.D. Fla. 2008).

[21] Id. at 1367.