Client Alert

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Administrative Proceedings vs. Federal Court: The SEC Provides Limited Transparency Into Its Choice of Forum

By Randall J. Fons

For the past two years, the SEC has come under heavy fire, both inside and outside the Commission, for its increasing use of its own administrative proceedings, rather than federal courts, as the preferred forum for bringing its enforcement actions. On May 6, the *Wall Street Journal* published an article entitled "SEC Wins With In-House Judges," reporting that, since 2010, the SEC has won 90% of its cases brought before its own administrative law judges but has won only 69% of its cases brought in federal court. http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803?tesla=y. Two days later, the SEC's Division of Enforcement made public its "approach" to selecting a forum, which was intended to outline the facts and circumstances it considers in determining whether to bring a litigated enforcement action in federal district court or in its own administrative proceedings.[1] http://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf. The guidance, however, ultimately provides the Division with virtually complete discretion in choosing the playing field that will be most advantageous to its case and to its view of the "proper development of the law."

Historically, the SEC has been relatively consistent in the litigated cases it brought in its administrative proceedings and in federal court. While there have always been exceptions, litigated cases involving registered entities such as broker-dealers and investment advisers were generally brought in administrative proceedings, while cases involving non-industry individuals and entities were brought in federal district court. The latter cases often involved insider trading, the FCPA, offering fraud, and public company financial reporting. However, with the passage of the Dodd-Frank Act in 2010, Congress gave the SEC increased remedies in administrative proceedings, the most important being civil money penalties against unregistered individuals and entities. Armed with its new authority, the SEC has ramped up its use of administrative proceedings to pursue litigated cases against individuals and entities that had not previously been at risk of being brought into the SEC's home court.

The SEC's use of administrative proceedings has not gone unchallenged. Respondents in several administrative actions have brought suit against the agency, arguing that the administrative process is unconstitutional and deprives the SEC's targets of substantial due process rights. Judge Rakoff of the Southern District of New York has expressed his doubts about the appropriateness of the expanded use of administrative proceedings, stating that he worried about the balanced growth of the securities laws if those laws are interpreted in a "non-judicial" forum. Andrew Ceresney, the Director of the Division of Enforcement, has mounted a spirited defense of the use of administrative proceedings, arguing that they are fair and unbiased, and that the federal securities laws should, indeed, be interpreted by the experts at the SEC.

[1] The guidance does not apply to settled enforcement actions.

As part of that defense, the Division has now publicized its approach when considering forum. The guidance itemizes four factors the Division considers in deciding whether the SEC will litigate in federal court or administratively. The first two factors do not appear to raise any real controversy, while the second two factors are likely to continue the debate on whether the SEC is acting fairly in pursuing its enforcement agenda.

The first factor the Division considers is which forum has the authority to litigate the specific charges alleged in the case. For example, failure to supervise and "causing" cases can only be brought in administrative proceedings, whereas "control person" and relief defendant cases can only be brought in federal court. In addition, cases where emergency relief such as TROs and asset freezes are sought can also only be brought in federal court. Thus, the Division contends that the claims it brings often dictate the playing field.

The second factor is whether any party is a registered entity or individual associated with a registered entity. If so, the Division states that it is often more efficient and effective, and, therefore, more appropriate, to bring an enforcement action in the administrative forum. By doing so, the SEC can use its specialized experience concerning common industry issues and obtain full relief, including industry bars and monetary penalties.

The third factor, and one that is often cited by the Division in defense of increased use of administrative proceedings, is whether one forum or the other allows the Commission to save its limited resources and obtain a quick resolution of the matter. Here, the Division cites the fact that hearings are held more quickly in an administrative proceeding than in federal court, allowing for a "fresher recollection of relevant events" by witnesses and a "more timely public airing" of the facts. The Division also notes that summary judgment motions are available in federal court, while they are not generally available in administrative proceedings. Finally, the Division notes that pre-trial discovery in federal court is somewhat broader than in administrative proceedings, including the ability to take depositions; though no *Brady* or *Jencks* rights are available to defendants in federal court.

Many believe that this third factor is one that the SEC fails to view fairly. Specifically, although hearings in administrative proceedings are often conducted more quickly than in federal court, a respondent in such a proceeding will often wait years until a court can review the facts and legal theories advanced by the SEC's enforcement program. Moreover, that quick hearing requires the defense to put together its case in a matter of a few short months, while the Division has in most cases had years to investigate the matter and compile its evidence. In addition, while the SEC is required to provide its non-privileged files to respondents in administrative proceedings, that "pre-trial discovery" provides nowhere near the information or protections provided by the Federal Rules of Civil Procedure. As a result, the defense often believes it is at a severe disadvantage in litigating in an administrative proceeding, where the matter is decided by an SEC-employed administrative law judge, and is appealed to the very Commission that authorized the enforcement action in the first place.

The fourth factor considered by the Division is whether a "fair, consistent, and effective resolution of securities law issues and matters" is more likely to be found in the administrative forum or in federal court. Under this consideration, the Division believes that the "extensive knowledge and experience concerning the federal securities laws" held by administrative law judges and the Commission weighs in favor of an administrative proceeding when complex issues arise. Federal courts, according to the Division, are more appropriate for the application of state law or "specialized areas of federal law" other than, presumably, securities law. By bringing

complex securities matters in the administrative forum, according to the Division, the Commission "may facilitate development of the law."

Many have argued, and likely will continue to argue, that the Division has this issue backwards. Although the Commission undoubtedly does have expertise in the securities markets and in the application of some of the more arcane and technical regulations of those markets, the interpretation and development of the law has been, and should continue to be, within the purview of federal courts. Indeed, Judge Rakoff has expressed his concern that the "broad anti-fraud provisions, critical to the transparency of the securities markets, that have historically been construed and elaborated by the federal courts," would be interpreted by SEC-employed administrative law judges rather than federal judges. It is difficult to argue, for example, that an administrative law judge or the Commission itself, rather than the federal courts, is better able to understand matters involving insider trading, financial reporting, or the FCPA.

Despite its best arguments, and now its attempt to provide some transparency into its decisions, the Division is likely to continue to be scrutinized for its ever-increasing use of administrative proceedings against non-regulated entities. And with the open-ended nature of the guidance, there is little to prevent the Division from choosing whatever forum it finds most advantageous.

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