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The Scope Of SEC Defendants' Jury Trial Right: Part 3

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This is the third of four articles examining the scope of the Seventh Amendment jury trial right for civil defendants in U.S. Securities and Exchange Commission enforcement actions. Our first article explained why the Seventh Amendment entitles a civil defendant to a jury finding as to those facts that increase the maximum penalty — the "liability" — to which a defendant is exposed.[1] In the second article, we discussed how the jury trial right extends to an assessment of the number of distinct violations committed and how this issue turns on how one defines the "unit of violation" under the federal securities laws.[2] In this article, we address the issues of reliance and loss (or gain) causation in SEC enforcement actions and the jury's role in assessing such. While the received wisdom among practitioners and some courts is that injury and loss causation have no bearing on an SEC enforcement action and are certainly not issues on which a jury must pass, this is plainly incorrect.

The SEC Penalty Tiers Require Proof of Loss (or Gain) and Causation

As discussed in an earlier article, the federal securities laws authorize a district court to impose civil monetary penalties for securities law violations under a three-tier system. The appropriate penalty tier, and the corresponding maximum penalty that the court may impose, depends on the presence of additional facts beyond the elements of the violation. The base penalty for any violation by a natural person is $5,000 ($50,000 for a corporation or other entity). If the violation involved fraud or recklessness, then the maximum penalty increases to $50,000 ($250,000 for a corporation or other entity). And if the violation involved fraud or recklessness and "resulted in" substantial loss or a significant risk of such loss to others, then the maximum penalty increases to $100,000 ($500,000 for a corporation or other entity). For each penalty tier, the maximum penalty is increased to the gross amount gained by the defendant, if any, "as a result of" the violation.[3]

The use of "resulted in" and "as a result of" language in the text of the SEC penalty provisions clearly suggests a causation requirement. The U.S. Supreme Court has repeatedly explained in other contexts that such language requires proof of causation.[4] This means that, in order to secure a third-tier penalty against a securities law violator, the SEC must prove not only the elements of a securities law violation, but also that the violation caused loss to others or was causally connected to gain by the defendant. In other words, a defendant faces liability for a third-tier penalty (or a penalty measured by the defendant's gain) only if both a violation of the securities laws and a causal connection to either loss (or gain) are shown.[5] And embedded in the concept of causation is the element of reliance.[6]

The Seventh Amendment Entitles Defendants to a Jury Finding on the Issue of Reliance and Loss (or Gain) Causation

If our earlier Seventh Amendment analysis is correct, then a defendant is entitled to a jury finding on the issues of reliance and loss (or gain) causation when the SEC seeks enhanced monetary penalties because the losses or gains caused by the violation are essential components of a defendant's liability for a maximum penalty above the base level. The Supreme Court held in Tull v. United States that, in a government enforcement action seeking monetary penalties, a defendant has a Seventh Amendment "right to a jury trial to determine his liability on the legal claims."[7] Liability for purposes of the Seventh Amendment cannot be assessed apart from the maximum sanction to which one is ultimately exposed. Indeed, the very definition of liability is "the state of being legally responsible for something ... (such as the payment of money)."[8] Thus, if a defendant is to be held liable for an enhanced monetary penalty due to the losses caused by or gain reaped from the violation, then the defendant is entitled to a jury finding on those factual issues. Even if the SEC seeks third-tier penalties relying on a "significant risk of losses," rather than actual losses, the Seventh Amendment requires that the SEC prove to the jury a causal connection between the fraudulent or reckless conduct and the risk that losses could have resulted.[9]

We recognize that courts have long held that, in "civil enforcement action[s] brought by the SEC, reliance, damages, and loss causation are not required elements."[10] An early Second Circuit decision penned by then-Judge Thurgood Marshall held that the SEC need not prove "cause" because "[t]he Commission's duty is to enforce the remedial and preventive terms of the statute in the public interest, and not merely to police those whose plain violations have already caused demonstrable loss or injury."[11] These decisions may be correct to the extent that they address the government's burden to prove and enjoin a securities violation.[12] The SEC must, however, prove causation (including reliance) if it seeks third-tier penalties or penalties based on the gains received by the defendant. Courts have recognized as much.[13] What courts have not considered — because defendants have rarely pressed the issue — is whether the judge or the jury must make that causation determination. The reasoning of Tull answers that question, entrusting to the jury this factual issue critical to liability for a higher maximum penalty.

We recognize that, often, the issue of gain causation for penalty purposes will overlap with the determination of whether the defendant profited from a violation and is thus subject to the equitable remedy of disgorgement. In Tull, the Supreme Court explained that, "if a 'legal claim is joined with an equitable claim, the right to a jury trial on the legal claim, including all issues common to both claims, remains intact.'"[14] This means that, in practice, the defendant will often have a Seventh Amendment right to have the gain amount and causation decided by a jury, even though those issues bear on disgorgement.

Proving Loss, Reliance and Loss Causation for Purposes of Third-Tier Penalties

Placing the loss and causation issues before the jury is likely to have the collateral benefit of imposing more rigor on those determinations. Gone will be simplistic arguments that, because the defendant made a false statement (or otherwise violated the securities laws) concerning an investment, the entire investment loss resulted from the violation. Instead, causation requires a showing of (1) reliance on an investor-by-investor basis (because without reliance a particular investor's loss cannot have been caused by a violation) and (2) that the false statement led to the losses, even after considering other factors such as a downturn in the market, a tough business climate, or a product failure. A loss does not result from the defendant's conduct if external factors such as "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, ... account for some or all of [the loss]."[15] Similarly, placing the loss and causation questions before the jury will require courts to grapple with the question of whether the much-criticized efficient market hypothesis should apply in the enforcement context.[16]

Finally, it is worth highlighting that deciding whether a violation resulted in "substantial losses" (or risk of such) is closely tied to how the unit of violation is defined (which we discussed in the second article in the series). Third-tier penalties are available for "each violation" that results in or creates a risk of substantial losses. Therefore, if the violation is defined narrowly (such as each individual purchase or sale), no single violation may result in substantial losses. Or some investors may have relied on a defendant's misstatements while others did not. Third-tier penalties would be available only for each violation, properly defined, for which the SEC can prove both causation and substantial resulting losses.

Conclusion

The federal securities laws provide for enhanced penalties if the violation resulted in substantial losses (or risk of such losses) or gain to the defendant. The text of those penalty provisions requires a finding that the violation caused those losses (or gains), i.e., that the victim relied on the misrepresentation and the losses (or gains) were not the result of other economic factors. Because those losses (or gains), reliance and loss causation are essential components of a defendant's liability, defendants in SEC enforcement actions have a Seventh Amendment right to a jury trial to determine those facts when the SEC seeks enhanced monetary penalties. These questions are complicated ones, often requiring expert witnesses and always requiring carefully crafted jury instructions. In our final article next week, we will consider the role of scienter in the imposition of a second- or third-tier penalty for otherwise negligence-based securities law violations and the jury's role in determining such.

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[1] 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.

[2] See Matthew T. Martens, Jaclyn N. Moyer, and Derek A. Woodman, The Scope Of SEC Defendants' Jury Trial Right: Part 2, Law360 (July 11, 2016), http://www.law360.com/articles/815542/the-scope-of-sec-defendants-jury-trial-right-part-2. For a more thorough explanation of our argument here, see 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).

[3] 15 U.S.C. §§ 77t(d)(2), 78u(d)(3)(B), 80a-41(e)(2), 80b-9(e)(2). Each of these penalty tier amounts may be adjusted periodically by SEC regulations. See 28 U.S.C. § 2461 note. As of March 5, 2013, the penalties for a natural person under 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).

[4] See Burrage v. United States, 134 S. Ct. 881, 889 (2014) ("In sum, it is one of the traditional background principles 'against which Congress legislate[s]' that a phrase such as 'results from' imposes a requirement of but-for causation" (citation omitted) (quoting Univ. of Texas Sw. Med. Ctr. v. Nassar, 133 S. Ct. 2517, 2525 (2013)); Erica P. John Fund Inc. v. Halliburton Co., 563 U.S. 804, 814-15 (2011) (equating "resulted in" language to loss causation); Dura Pharm. Inc. v. Broudo, 544 U.S. 336, 344 (2005) (agreeing with treatises that have interpreted "as a result" language to require proof of causation).

[5] See Rockies Fund Inc. v. SEC, 428 F.3d 1088, 1099 (D.C. Cir. 2005) (refusing to uphold an SEC decision levying third-tier penalties against the defendant because the SEC did not explain how the defendant's actions resulted in significant losses); In re Reserve Fund Secs. & Derivative Litig., Nos. 09 MD.2011(PGG), 09 Civ. 4346 (PGG), 2013 WL 5432334, at *18 (S.D.N.Y. Sept. 30, 2013) (refusing to impose third-tier penalties given the absence of proof of transaction causation); SEC v. Razmilovic, 822 F. Supp. 2d 234, 260 n.22 (E.D.N.Y. 2011) ("The determination of the extent to which the value of a security was inflated due to fraud is the same regardless of whether the plaintiff must demonstrate loss causation, i.e., that its loss was causally connected to the fraud, or, in essence, gain causation, i.e., that the defendant's ill-gotten gain is causally connected to the fraud."), aff'd in part, rev'd in part on other grounds, 738 F.3d 14 (2d Cir. 2013); SEC v. Huff, No. 08-60315-CIV, 2010 WL 148232, at *3 (S.D. Fla. Jan. 12, 2010) (requiring proof of "gain causation" under penalty provision); Pietro M. deVolpi Jr., Showing Loss in Securities Enforcement Actions, 12 Barry L. Rev. 1, 12–16 (2009) (arguing that loss causation showing should be required for third-tier penalties).

[6] See Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988) ("Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury."); Restatement (Second) of Torts § 548A (Am. Law. Inst. 1977) (explaining that "[a] fraudulent misrepresentation is a legal cause of a pecuniary loss resulting from action or inaction in reliance upon it if, but only if, the loss might reasonably be expected to result from the reliance"). Reliance is often

described as “transaction causation” in the federal securities laws context. See Halliburton, 563 U.S. at 812-13; Dura Pharm., 544 U.S. at 341.

[7] 481 U.S. 412, 425 (1987).

[8] Liability, MERRIAM-WEBSTER, http://www.merriam-webster.com/dictionary/liability (last visited July 13, 2016); see also Black’s Law Dictionary 914 (6th ed. 1990) (defining “liability” as the “condition of being responsible for a possible or actual loss, penalty, evil, expense, or burden”).

[9] Of course, whether losses did or did not result from the violation would be relevant to the question of whether the violation created a significant risk of losses. See In re Reserve Fund, 2013 WL 5432334, at *18 (“Actual investor losses have a bearing on whether Defendants’ conduct presented a risk of substantial investor losses, however.”).

[10] SEC v. Goble, 682 F.3d 934, 943 (11th Cir. 2012); accord SEC v. Teo, 746 F.3d 90, 103 (3d Cir. 2014) (“While there is strong legal support for the application of tort-based proximate causation analysis in the context of private enforcement litigation, we have no such authority on which we can rely to impose any such requirement on SEC-initiated civil actions.”); SEC v. Tambone, 597 F.3d 436, 463 (1st Cir. 2012) (en banc) (noting that the SEC need not “prove reliance on the alleged misrepresentations, economic loss, [or] loss causation”).

[11] Berko v. SEC, 316 F.2d 137, 143 (2d Cir. 1963).

[12] But see In re John P. Flannery, Securities Act Release No. 9689, 2014 WL 7145625, at *25 (SEC Dec. 15, 2014) (recognizing that “Section 17(a)(2) requires that a defendant obtain money or property ‘by use of’ misleading information, suggesting the need for a causal link” and concluding “that a misrepresentation must be at least relevant to, if not the cause of, the transfer of money or property”), vacated on other grounds, Flannery v. SEC, 810 F.3d 1 (1st Cir. 2015).

[13] See supra note 5.

[14] 481 U.S. at 425 (quoting Curtis v. Loether, 415 U.S. 189, 196 n.11 (1974)).

[15] Dura Pharm., 544 U.S. at 342-46. Likewise, in the criminal context, the government must prove that any losses “resulted from the offense” and not “external market forces.” U.S.S.G. § 2B1.1 cmt. n.3.

[16] See Halliburton Co. v. Erica P. John Fund Inc., 134 S. Ct. 2398, 2417 (2014) (reaffirming use of fraud-on-the-market theory to establish reliance element in a securities fraud class action).