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Litigating with the SEC

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The SEC has made clear that it welcomes the possibility of having more cases proceed to litigation and has the resources it needs to take hard cases to trial.[1] The SEC has also added to its recently expanded arsenal of sanctions by requiring admissions of wrongdoing as a condition of settling certain enforcement actions.[2] Given the SEC's higher tolerance for resolution of matters in the courtroom, and likely unwillingness of individuals and entities to settle to harsh terms, there is little doubt that more enforcement actions will proceed to litigation. This chapter provides an overview of the issues that arise in litigating against the SEC in both federal court actions and administrative proceedings.

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Forum Selection by the SEC

Q 20.1 What forums are available to the SEC?

The filing or institution of any enforcement action must be authorized by the Commission.[3] Enforcement seeks authorization by submitting to the Commission an action memorandum that makes a specific recommendation along with its factual and legal foundation.[4] The action memorandum will propose whether the enforcement action should be brought in federal court, in an administrative proceeding before an ALJ, or some combination of both.[5] In the past, federal court was generally the forum of choice to address serious violations because the agency could seek tougher sanctions against a larger universe of individuals and entities.[6] Administrative proceedings, by contrast, were the forum of choice for pursuing less serious violations or actions that might require the technical expertise of an ALJ.[7]

The passage of the Dodd-Frank Act in 2010 gave the SEC more power to bring significant cases administratively. One specific change is that the SEC is no longer limited to seeking civil monetary penalties from regulated entities (such as broker-dealers, investment advisers, and investment companies) and those associated with them.[8] The SEC now has the power to seek penalties from any individual or entity.[9] Further, the Dodd-Frank Act increased the penalties available to the SEC; for the most serious violations, it may now seek up to $160,000 for individuals and $775,000 for entities.[10] As a result, the SEC has the flexibility to use administrative proceedings for cases that previously could have only been brought in federal court.

Q 20.2 What factors into the selection of a forum?

Administrative proceedings have a series of built-in advantages for the SEC. As an initial matter, they are tried before an ALJ who is employed by the SEC.[11] Because discovery is limited and the proceedings move forward quickly, it can much be harder for a respondent to develop the facts or to build an affirmative defense. There is also no procedure available for a respondent to move to dismiss the allegations at the outset of the case; that option is only available to defendants in federal court.[12] For these reasons, it is not surprising that the SEC fares better in administrative proceedings. In cases filed in fiscal year 2011, the agency had an 88% success rate in administrative proceedings versus a 63% success rate for cases filed in federal court.[13]

Another important consideration in selecting a forum is whether the action requires the technical expertise of an ALJ. The SEC has acknowledged that an ALJ who focuses exclusively on enforcement actions might be better equipped to preside over a case with complicated facts and issues particular to the securities industry.[14] For similar reasons, the SEC may prefer to file an administrative proceeding if it wants to seek a more remedial sanction.[15] Indeed, where agency is seeking to impose specific limitations on the activities, functions, or operations of an investment adviser or broker-dealer, the SEC might find it preferable to proceed administratively.[16]

A final reason for the SEC to proceed administratively is simply to avoid public scrutiny into the terms of its settlements. In recent years, district courts have been much more inclined to publicly criticize the proposed settlements in SEC enforcement actions for being too lenient[17] or for failing to include admissions of wrongdoing.[18] Some federal judges have demanded additional detail to enable a more thorough consideration of the fairness, reasonableness, and adequacy of a particular settlement.[19] By filing an administrative proceeding, the SEC can resolve enforcement actions more efficiently and avoid this type of public attention to its negotiated settlements.

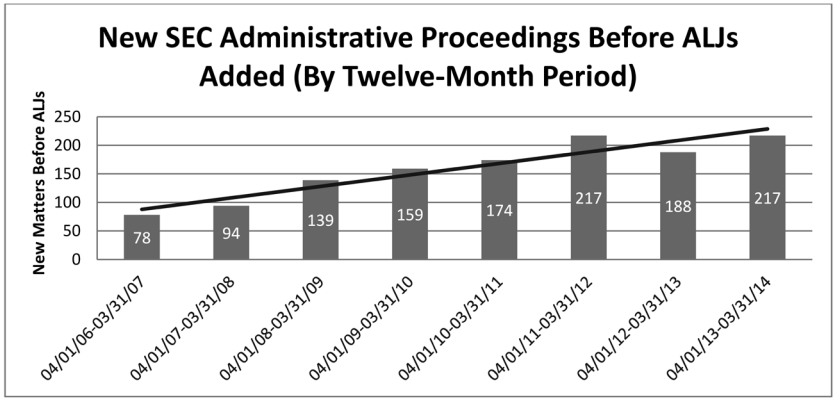
Q 20.3 Will the SEC shift toward more administrative proceedings?

There are signs that the SEC intends to pursue more administrative proceedings than it has in the past. SEC officials have made a series of public statements indicating that the agency plans to use administrative proceedings more frequently. As the SEC's Director of Enforcement Andrew Ceresney stated in late 2013, "[o]ur expectation is that we will be bringing more administrative proceedings given the statutory changes [enacted through the Dodd-Frank Act]. But we evaluate the appropriate forum in each case and make the decision based on the particular facts and circumstances."[20] A few months later, Mr. Ceresney followed up by stating that the agency may file more insider trading cases administratively: "I do think we will bring insider-trading cases as administrative proceedings in appropriate cases . . . We have in the past. It has been pretty rare. I think there will be more going forward."[21]

The statistics indicate there has already been a steady increase over the past several years in the number of newly filed administrative proceedings. In the six months prior to September 30, 2013, the SEC filed 121 new administrative actions.[22] This is the highest number of filings recorded over a six-month period since the passage of the Dodd-Frank Act. This high water mark is a continuation of an upward trend in the number of administrative proceedings filed by the SEC each year:[23]

FIGURE 20-1

New SEC Matters Before ALJs 2006–2014



In response to the growing number of newly filed administrative proceedings, the SEC has added resources to its Office of Administrative Law Judges. On June 30, 2014, the agency announced that it was nearly doubling the staffing resources of the office by adding two new administrative law judges and three new supporting attorneys.[24]

But the shift toward more administrative proceedings should not be overstated. The SEC will continue to pursue enforcement actions in federal court because they are more visible and have an important deterrent function. Furthermore, the Second Circuit's high-profile ruling in *SEC v. Citigroup Global Markets, Inc.* is likely to reign in judicial resistance to proposed settlement agreements.[25] In *Citigroup*, the Second Circuit held that the district court failed to apply the proper standard of review when it refused to approve the parties' proposed consent decree.[26] On remand, the district court reluctantly approved the parties' proposed settlement, acknowledging that "it would be a dereliction of duty for this Court to seek to evade the dictates of the Court of Appeals."[27]

Enforcement Actions in Federal Court

Q 20.4 Is a defendant entitled to a jury trial in federal court actions?

The Seventh Amendment guarantees a right to a jury trial to determine liability when the SEC brings a claim at law for civil penalties.[28] This right extends to both parties in an SEC enforcement action, meaning the agency can choose to have a case proceed before a jury even if the defendant would prefer a bench trial.[29] In actions in which the SEC is seeking purely equitable relief, there is no right to a jury trial.[30] The SEC can therefore pursue actions for injunctive relief—which includes the disgorgement of ill-gotten gains—without needing to present its case to a jury.[31] This is true even though a disgorgement award is monetary in nature.[32] After there has been a finding of liability, the court will be responsible for calculating the appropriate remedies.[33]

Q 20.5 What remedies can the SEC pursue in federal court actions?

The SEC is able to seek injunctions to prohibit future violations of the federal securities laws or SEC rules promulgated thereunder.[34] To obtain such an injunction, the SEC must demonstrate that the defendant violated the securities laws and is likely to do so again.[35] Courts will consider the egregiousness of the violations, the isolated or repeated nature of the violations, the degree of scienter, the defendant's acknowledgment of the wrongfulness of the conduct, and the likelihood that the defendant will again be in a position to engage in future violations.[36] Although injunctions barring future conduct do not have consequences from a practical standpoint, they attract negative publicity and can cause reputational harm. For this reason, judges are sometimes reluctant to impose permanent injunctions in the absence of egregious or repeated conduct.[37]

The SEC also has the power to seek an injunction barring an individual from serving as a director or officer of a reporting company. To impose such a bar, the SEC must prove a violation of section 17(a)(1) of the Securities Act or section 10(b) of the Exchange Act (or the rules promulgated thereunder) and show that "the person's conduct

demonstrates unfitness to serve as an officer or director."[38] In weighing whether to impose this sanction, courts will often consider the egregiousness of the violations, whether the defendant was a repeat offender, the defendant's role or position when he engaged in the violations, the degree of scienter, the defendant's economic stake in the violations, and the likelihood of a recurrence of the misconduct.[39] A defendant is far more likely to avoid the imposition of a director or officer bar if he is a first-time offender, provided that the underlying conduct is not egregious.[40]

Based on the district court's broad power to grant equitable remedies, the SEC can also pursue sanctions that are remedial in nature. First and foremost, the SEC regularly draws on the district court's equitable powers to seek disgorgement of unjust enrichment.[41] When a defendant has reaped such ill-gotten gains, a disgorgement sanction can increase his overall exposure significantly. Additionally, district courts often draw on their equitable powers to impose sanctions designed to address specific misconduct. This includes orders appointing receivers,[42] appointing independent board members,[43] rescinding transactions,[44] freezing assets,[45] imposing a voting trust,[46] and ordering corporate governance changes.[47]

In most federal court actions, the SEC will pursue civil penalties. For most violations, the court will apply a tier-based system adjusted for inflation. For first-tier violations, which do not involve fraud, the penalty may not exceed the greater of $7,500 for an individual (and $80,000 for an entity), or the gross amount of the pecuniary gain.[48] For second-tier penalties, involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement," the penalty may not exceed the greater of $80,000 for an individual (and $400,000 for an entity), or the gross amount of the pecuniary gain.[49] For third-tier penalties, which may be imposed for violations that involve "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulator requirement" and "directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons," the penalty may not exceed the greater of $160,000 for an individual (and $775,000 for an entity), or the gross amount of the pecuniary gain.[50] For cases involving insider trading[51] or violations of the FCPA,[52] other specific penalty provisions apply.

In addition to the civil penalties described above, section 304 of Sarbanes-Oxley allows the SEC to claw back any incentive-based compensation or profits from stock sales received by CEOs or CFOs in the twelve-month period following the public issuing or SEC filing of a financial statement not compliant with the federal securities laws and giving rise to an accounting restatement.[53] The money clawed back by the SEC under section 304 is returned to the company.[54] In cases where there are several years of financials that have been restated, section 304 can dramatically increase a defendant's exposure. Sarbanes-Oxley also allows the SEC to freeze corporate assets before an action is even filed in federal court.[55] Pursuant to section 1103, the SEC can request a temporary (but renewable) order from the district court requiring the issuer under scrutiny to escrow any "extraordinary payments" to be made to its directors, officers, partners, controlling persons, agents, or employees.[56]

Q 20.6 Are there statutes of limitations that apply to federal court actions?

In determining whether a statute of limitations applies to SEC enforcement actions, it will depend on the claims being asserted and the type of relief being sought. For insider trading cases, a five-year statute of limitations applies, beginning from the date of the purchase or sale of the securities.[57] In other cases where monetary penalties are being sought, the five-year limitations period set forth in 28 U.S.C. § 2462 applies and begins running when the fraud is complete, not when it is discovered.[58]

Generally, there is no statute of limitations applicable to actions for equitable relief unless the court determines that the remedy being sought is punitive in nature. For instance, in *SEC v. Bartek*, the Fifth Circuit considered whether a permanent director and officer bar constituted a penalty subject to the statute of limitations in 28 U.S.C. § 2462.[59] The court described a penalty as "a form of punishment imposed by the government for unlawful or proscribed conduct, which goes beyond remedying the damage caused to the harmed parties by the defendant's action."[60] It determined a lifetime ban: (1) would have long-lasting stigmatizing effects; (2) did not address past harms caused by the defendants; and (3) did not address future harms because

there was a minimal likelihood of a repeat offense.[61] For these reasons, it concluded that the district court did not err in characterizing the injunction as a penalty for which the underlying claim is subject to the five-year statute of limitations.[62] Although the case law is not consistent regarding the limitations period applied to many of the various forms of injunctive relief,[63] there is an emerging trend when it comes to disgorgement: most courts do not apply the five-year statute of limitations period, characterizing disgorgement as remedial in nature.[64]

Q 20.7 What are the key litigation considerations in making a Wells submission?

A Wells submission is an opportunity for the subject of an SEC investigation to lay out facts and legal arguments to the staff and the Commission before an action is brought. There can be significant benefits associated with making a Wells submission.[65] Of course, a compelling submission has the potential to make the staff reconsider facts, drop specific claims, or abandon an enforcement action altogether.[66] In the two-year period ending in September 2012, 20% of the individuals who received a Wells notice were able to avoid enforcement action by the SEC.[67] In circumstances where the staff is intent on recommending an enforcement action, it still may be worthwhile to make a Wells submission in an attempt to persuade the Commission to reject the staff's recommendation, or to settle the matter on more favorable terms.[68]

On the other hand, there are situations in which it might be better not to make a Wells submission. If an enforcement action is a foregone conclusion, a Wells submission highlighting the weaknesses in the SEC's theories might even help the SEC in drafting a stronger complaint. Electing not to make a Wells submission might also be sensible in situations where the facts are unclear. Given that the SEC can be expected to take the position that Wells submissions may be introduced as party admissions, and can be used for impeachment purposes, it may be preferable to engage in some discovery before going on record about the facts of the case.[69]

In weighing the decision of whether to make a Wells submission, counsel should be aware that the submission itself can be used by the SEC in litigation and is likely to be considered discoverable by third parties in other proceedings.[70] The SEC's Enforcement Manual

expressly warns "that any Wells submission may be used by the Commission in any action or proceeding that it brings and may be discoverable by third parties in accordance with applicable law."[71] This is true even for Wells submissions that contain offers of settlement. As one district court explained, "Rule 408 does not bar discovery of offers of settlement under Rule 26, so long as the settlement material may reasonably lead to the discovery of admissible evidence."[72] As a result, the court held that a settlement offer made in a Wells submission is discoverable even if it might later be considered inadmissible at trial.[73]

Increasingly, respondents are submitting "white papers" when the staff signals that a Wells notice may be imminent. Such white papers may allow respondents to ward off a Wells notice (which may carry with it disclosure obligations) by convincing the staff that they have misinterpreted the facts or the law, or not taken into account the matter's litigation risk. For the staff's part, telegraphing an intent to move ahead with a Wells notice and inviting the submission of a pre-Wells white paper allows the staff to avoid triggering the Commission's internal speedy prosecution provision that generally requires the institution of an enforcement action within 180 days of the provision of the Wells notice—and thus gives the staff more time to consider the matter.[74] Although respondents should request FOIA confidential treatment for white papers, they should also recognize that white papers may be as discoverable and admissible as Wells submissions.