LOS ANGELES
Daily Journal
www.dailyjournal.com
FRIDAY, MAY 22, 2015
PERSPECTIVE

Fairness of SEC forum is dubious

By Thomas A. Zaccaro, Nicolas Morgan and Peter T. Brejcha

During the tenure of current Chair Mary Jo White, the U.S. Securities and Exchange Commission has increasingly filed enforcement actions before its own administrative law judges, before whom the SEC historically has had a Harlem Globetrotters-like win-loss record, rather than in federal court. The SEC's choice of forum clearly impacts its success rate, in part because the SEC's internal administrative proceedings lack many of the procedural safeguards available in federal court.

Members of the securities defense bar, federal judges and even some SEC commissioners have questioned the fairness of the SEC's administrative process. To stem this criticism, on May 8, the SEC released guidelines that the staff considers in evaluating whether to bring an enforcement action administratively or in federal court. Unfortunately, the guidelines provide little transparency regarding the SEC's decision-making process and fall short of addressing the serious fairness concerns about its administrative proceedings.

SEC Enforcement Director Andrew Ceresney presaged this increase in internal administrative enforcement proceedings last June, when he announced that the SEC would file more insider trading cases as administrative proceedings. This announcement followed back-to-back jury trial defeats for the SEC in high-profile insider trading cases (both juries returned verdicts rejecting the SEC's cases in just hours after multi-week trials). Ceresney's announcement appeared to suggest the SEC's enforcement division, rather than re-evaluating the quality of the cases it filed and brought to trial, would place its thumb on the scales of justice to tilt the playing field in its favor.

SEC Commissioner Michael Piwowar raised a similar concern during a speech in February, in which he stated: "Announcement of this plan to increase the use of administrative proceedings in insider trading cases followed the Commission's loss in two insider trading cases in federal district courts. Regardless of whether these circumstances are linked, this change has the appearance of the Commission looking to improve its chances of success by moving cases to its in-house administrative system."

Except for the most ardent SEC apologists, most commentators readily acknowledge that SEC administrative proceedings favor the home team. Before filing an administrative proceeding, the SEC's enforcement division conducts its own investigation during which it has the power to subpoena documents and take sworn testimony from anyone it pleases. The investigations typically are conducted methodically over the course of months, if not years. The enforcement staff, if it chooses, could create a lopsided record by pursuing evidence that supports its claims and ignoring evidence that does not. Defense counsel, on the other hand, does not participate in the investigation — it cannot subpoena documents or even see the documents the SEC collected, nor can it attend testimony (let alone cross-examine witnesses, one of the greatest engines for the discovery of truth in our modern judicial system).

The advantages to the SEC do not end there. After the enforcement division conducts its lengthy investigation, it then chooses when to file an administrative proceeding. Only then does the defense get access to the investigative record, but the defense, nevertheless, is required to go to trial in just a few months on the lopsided record the SEC has prepared. Unlike federal court, neither the Federal Rules of Evidence nor the Federal Rules of Civil Procedure apply in administrative proceedings, so respondents lack the protections of a formal discovery process. As a result, after being left out of the investigative process, the defense still is unable to subpoena documents or take depositions of third parties to balance the record.

The advantages to the SEC do not stop there. Respondents in administrative proceedings are not entitled to a jury trial. Instead, administrative proceedings are decided by administrative judges employed by the SEC and housed in its offices. The close tie between the judges who preside over these cases and the agency that brings them has caused many to question whether administrative proceedings can be truly objective. According to a published report in the Wall Street Journal, former SEC administrative law judge Lillian McEwen recently revealed that her loyalty to the SEC was once questioned by the chief administrative law judge for having ruled too often in respondents' favor. And, any appeal from an administrative decision is heard in the first instance by the SEC itself — the very commissioners who authorized filing the administrative proceeding in the first place.

The results of internal administrative proceedings reflect the SEC's advantages. While the SEC loses few administrative proceedings (it is reported to win nearly 100 percent of its administratively filed cases), it loses more than a third of the cases it files in federal court. Nonetheless, Ceresney has insisted that the SEC's "use of the administrative forum is eminently proper, appropriate and fair to respondents," and that the admittedly "excellent record in administrative proceedings reflects the strength of the evidence presented in each case," rather than the SEC's "choice of venue." Ceresney's argument suggests that the SEC's weaker record in federal court is due not to the procedural safeguards available in federal court jury trials, but to the fact that the enforcement division actually chooses to file its weaker cases in federal court.

Not surprisingly, the SEC's stance on administrative proceedings has come under fire. Last November, for example, Judge Jed Rakoff of the U.S. District Court for the Southern District of New York gave a speech criticizing the SEC's increasing reliance on administrative proceedings and questioning the fairness of those proceedings. Commissioner Piwowar echoed these concerns in his February speech. The Wall Street Journal recently reported that even Ceresney's immediate predecessor, George Canellos, observed that "there is a lot to be desired about the process" and appealed to the SEC to "end the very grave appearance of injustice."

In response to questions concerning the fairness of its administrative proceedings, SEC Chair White announced in congressional testimony on May 5 that the SEC was evaluating issuing guidelines to provide transparency into its decision-making as to when to file an enforcement case before its internal administrative law judges. Three days later, the enforcement division issued a list of non-exhaustive "potentially relevant considerations" it may take into account when choosing the appropriate forum in which to bring an enforcement action. They include:

* The availability of the desired claims, legal theories, and forms of relief in each forum;

* Whether any charged party is a registered entity of an individual associated with a registered entity;

* The cost-, resource- and time-effectiveness of litigation in each forum; and

* Fair, consistent and effective resolution of securities law issues and matters.

Of course, these factors do little to provide transparency into the SEC's decision-making process or to ameliorate the rising concerns about SEC administrative proceedings. As an initial matter, the guidelines come with the caveat that there is no "rigid formula dictating the choice of forum," and that "[n]ot all factors will apply in every case." In other words, the enforcement division can do whatever it pleases. Perhaps more importantly, the factors do nothing to address the lack of fairness inherent in legal proceedings that are both prosecuted and adjudicated by employees of the same agency.

Thomas Zaccaro *and* **Nicolas Morgan**, *the cofounders of Zaccaro Morgan LLP, are former SEC trial counsel. Zaccaro Morgan LLP is a boutique trial firm specializing in complex civil litigation, government and corporate investigations, and white collar defense.* **Peter T. Brejcha** *is an associate in the firm.*