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Forum Over Substance? Respondent Rights And The SEC

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The past year has been a tumultuous one for the U.S. Securities and Exchange Commission, as litigants, judges and even respected former members of the SEC's enforcement staff have questioned its decision to rely on in-house administrative law judges to adjudicate matters that previously would have been filed as civil enforcement actions in district court.[1] Initial legal skirmishes on this front did nothing to slow that agency's pivot away from the Article III courts in which settlements and contested claims alike have not always fared so well in recent years.

Recently, however, the legal outlook has become considerably more muddled. Although recent rulings in New York have either upheld the SEC's administrative regime or ruled that such challenges must be made as part of direct appellate review under the Exchange Act, in early June a federal court in Georgia ruled that the SEC's current framework violates the Constitution's appointments clause.[2] That ruling follows closely on the heels of a remarkable request by the commission, in the context of another pending administrative appeal, that one of its own ALJs submit an affidavit addressing bias or "pressure" he received in the course of his decision-making — an invitation that the ALJ conspicuously declined to accept.[3]

These recent skirmishes highlight the tension between respondents' core concerns and the constitutional arguments they have been employing of late to press the attack. At bottom, the central concern with SEC administrative proceedings has always been their lack of procedural protections, including pretrial discovery and the rules of evidence, and their perceived lack of judicial independence. Having failed to gain any real traction on due process grounds, however, recent challenges have focused on the U.S. Supreme Court's 2010 decision in Free Enterprise Fund v. Public Company Accounting Oversight Board[4]and an argument that the tenure protection afforded to ALJs violates the Constitution's vesting of exclusive executive power. Ironically, this argument puts respondents in the position of claiming that ALJs have too much independence, not too little, potentially setting up a regulatory fix in which ALJs would wind up with even less insulation from institutional pressure. For those concerned with the rights of respondents more generally, these challenges do not offer up a long-term solution and could prompt an even less favorable end result.

The Shift Away From Article III Courts

Prior to the Dodd-Frank Act, the SEC could only seek civil penalties in administrative proceedings against regulated persons.[5] For everyone else, the SEC was required to file a civil enforcement action in federal court. That all changed in 2010, and the SEC may now seek civil penalties in either forum without regard to the accused's regulated status.[6] This, together with the SEC's difficulties with several high-profile settlements and contested litigations in district courts, prompted the Enforcement Division to rethink its longtime preference for civil enforcement actions and associated injunctive relief wherever feasible.

The result has been a dramatic shift away from district courts for both negotiated settlements and contested matters alike, with approximately 43 percent of the SEC's litigated cases in 2014 filed as administrative actions.[7] In early May, the SEC released guidelines listing the factors considered when deciding whether to bring a case administratively.[8] These were not intended to be exhaustive, and include broad considerations — such as "the cost-, resource-, and time-effectiveness of litigation" and "fair, consistent, and effective resolution of securities law issues and matters" — that do little to alleviate concerns about the shift away from district courts.

Even in the absence of outright institutional bias, these concerns are warranted. Civil enforcement actions are governed by the Federal Rules of Civil Procedure, the Federal Rules of Evidence and other important procedural protections ensuring that the SEC is held to its burden of proof and that defendants have a full and fair opportunity to gather necessary evidence.[9] By contrast, the SEC's less demanding Rules of Practice permit far less pretrial discovery and generally do not allow pretrial depositions — a key protection where relevant exculpatory information often is in the hands of third parties who may not wish to inject themselves into a pending enforcement matter.[10] The SEC's administrative rules also impose abbreviated time limits, hamstringing the defense's ability to develop exculpatory facts not gathered as part of the SEC's own pre-filing investigation.[11] The SEC correspondingly wins a much higher percentage of its contested administrative proceedings — 100 percent for fiscal 2014 — than with civil enforcement actions.[12]

Recent Challenges and Rulings

Since the beginning of 2014, multiple challenges have been made to the SEC's administrative regime. One of the earliest, Jarkesy v. SEC, asserted equal protection and due process claims, but the district court in the District of Columbia held that it lacked subject matter jurisdiction to adjudicate them.[13] Notwithstanding this result, multiple similar cases followed.[14]

Stilwell v. SEC, filed in the Southern District of New York in October 2014, was the first such case to assert constitutional claims under Article II.[15] Because ALJs are protected from removal absent good cause, and commissioners exercising removal power may only be removed for "inefficiency, neglect of duty, or malfeasance in office," the Stilwell plaintiffs argued that the SEC's current adjudicative scheme violates Article II and Free Enterprise Fund.[16] The Stilwell plaintiffs also claimed that Merit Systems Protection Board members, who determine whether good cause exists, have yet another impermissible layer of tenure protection because they may only be removed for "inefficiency," "neglect of duty," or official "malfeasance."[17] With minor variations, litigants asserting Article II challenges to SEC administrative proceedings have generally mirrored the arguments advanced in Stilwell.[18]

In order to even reach these issues, however, courts must first work through a problematic jurisdictional issue. Under the Exchange Act, respondents must seek direct review of final SEC orders to courts of

appeals.[19] The SEC correspondingly has argued that respondents must await a final SEC order to challenge its administrative procedures.[20] However, because awaiting a final merits determination necessarily requires respondents to spend considerable resources litigating before an ALJ whose very participation is subject to Article II challenge, and such constitutional challenges are not the type of fact-specific matters typically left to agency decision-making, respondents have pushed back hard — highlighting the unfairness of denying them a legitimate forum for their constitutional challenges.

Courts have reached different outcomes on this front.[21] For example, in one ruling, the Eastern District of Wisconsin held that any constitutional claims must first be asserted and exhausted as part of the SEC administrative process and direct appeal — channels of review the court deemed "entirely adequate."[22] However, in Duka v. SEC, a Southern District of New York judge found that he had jurisdiction to decide such claims, and that declining jurisdiction would foreclose all meaningful judicial review of issues wholly collateral to the commission's merits-related determinations.[23] Interestingly, in one of the SEC's own recent administrative rulings, an ALJ openly questioned his ability to decide Article II and other constitutional challenges to the SEC's basic administrative scheme.[24] Two other New York judges recently found that they lacked jurisdiction to hear such challenges, while a federal judge in Georgia reached the exact opposite conclusion.[25]

Rulings on the underlying constitutional question have been similarly mixed. For example, in Duka, the district court ultimately held that statutory limitations on ALJs' removal are "both appropriate and constitutional."[26] But in Hill v. SEC, the Northern District of Georgia reached the opposite conclusion, holding that while plaintiff's Article I and Seventh Amendment claims were unlikely to succeed on the merits, SEC ALJs are inferior officers and therefore must be appointed by the president, department heads or courts of law.[27] In early June, the Hill court granted Mr. Hill's request for a preliminary injunction.

Going forward, we are certain to see more of these claims, and it remains an open question which position will eventually prevail at the appellate level. In Timbervest LLCv. SEC, filed just four days after the Hill court issued its injunction, the plaintiff sought injunctive and declaratory relief on the same basis from the same court.[28] Another case recently filed in the Southern District of New York likewise pursued the same approach used in Hill, but the case was dismissed for lack of jurisdiction.[29] On June 4, the Seventh Circuit heard oral argument on one pending appeal, and the SEC has appealed the Hill decision to the Eleventh Circuit. This holds out the possibility that at least some appellate guidance may be forthcoming in the not-too-distant future.

Due Process and the Downside of a Quick Fix

For individual litigants, the benefits of pursuing these constitutional arguments are straightforward. However, the success of this strategy more generally could leave respondents with even more to dislike about the SEC's adjudicative process. If the tenure protection currently afforded to ALJs were generally declared to be unconstitutional, the most likely consequence would be a revised administrative framework in which ALJs would simply become terminable at will. This was the result in Free Enterprise Fund, where the Supreme Court found the offending tenure protections severable and determined that the board members could simply be removable at will going forward.[30]

This is not likely to be considered an improvement. Nor would it resolve the fundamental procedural and due process issues presented by the SEC's current procedures. For that to happen, the SEC and policymakers will need to revisit more than just the manner in which ALJs are hired and fired. They will instead need to consider making the SEC's administrative forum more like the Article III courts that the

SEC’s staff has sought to avoid.

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[1] See, e.g., Hill v. SEC, No. 1:15-cv-01801 (N.D. Ga. June 8, 2015); Bebo v. SEC, No. 15-C-3 (E.D. Wis. Mar. 3, 2015); William McLucas & Matthew Martens, How to Rein In the SEC, Wall St. J., June 2, 2015.

[2] Hill, No. 1:15-cv-01801, at 42.

[3] In re Timbervest, LLC, Investment Advisers Act Release No. 4103, Investment Company Act Release No. 31660 (June 4, 2015).

[4] 561 U.S. 477 (2010).

[5] See Duka v. SEC, No. 15-cv-357, 2015 U.S. Dist. LEXIS 49474, at *6 (S.D.N.Y. Apr. 15, 2015).

[6] See id.

[7] Andrew Ceresney, Remarks to the American Bar Association’s Business Law Section Fall Meeting, Nov. 21, 2014, available at http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#_ftnref11.

[8] See Division of Enforcement Approach to Forum Selection in Contested Actions, available at https://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf.

[9] See Complaint at 6, Stilwell v. SEC, No. 14-cv-7931 (S.D.N.Y. Oct. 1, 2014).

[10] Id. (citing Rules of Practice 233, 234).

[11] Id. at 7; see also Rules of Practice 360.

[12] Id.; Nate Raymond, U.S. Judge Criticizes SEC Use of In-House Court for Fraud Cases, Wall St. J., Nov. 5, 2014.

[13] 48 F. Supp. 3d 32, 38 (D.D.C. 2014).

[14] See, e.g., Chau v. SEC, 14-cv-01903 (S.D.N.Y. Dec. 11, 2014); Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. dismissed Jan. 30, 2015).

[15] Complaint at 1-2, Stilwell, No. 14-cv-7931.

[16] Id. at 13-14.

[17] Id.

[18] See generally Complaint at 27, Bebo, No. 15-C-3; Complaint at 23, Tilton v. SEC, No. 15-cv-02472, 2015 U.S. Dist. LEXIS 85015 (S.D.N.Y. June 30, 2015); Duka, 2015 U.S. Dist. LEXIS 49474, at *4.

[19] 15 U.S.C. § 78y.

[20] See, e.g., Duka, 2015 U.S. Dist. LEXIS 49474, at *15-16.

[21] See, e.g., id. at *15 (finding that court had subject matter jurisdiction); Tilton, 2015 U.S. Dist. LEXIS 85015 at *37 (finding lack of subject matter jurisdiction).

[22] Bebo, No. 15-C-3, at 9.

[23] Duka, 2015 U.S. Dist. LEXIS 49474, at *12-27.

[24] Hill, No. 1:15-cv-01801, at 10.

[25] Spring Hill Capital Partners LLC v. SEC, No. 1:15-cv-04542, at 1 (S.D.N.Y. Jun. 29, 2015); Tilton, 2015 U.S. Dist. LEXIS 85015, at *37; Hill, No. 1:15-cv-01801, at 22 (N.D. Ga. June 8, 2015).

[26] Duka, 2015 U.S. Dist. LEXIS 49474, at *26.

[27] Hill, No. 1:15-cv-01801, at 23-41.The Hill court did not reach plaintiff's tenure-related argument, but also mentioned in a footnote that it doubted this claim's viability. Id. at 42 n.12.

[28] Complaint, Timbervest LLC v. SEC, 1:15-cv-02106 (N.D. Ga. June 12, 2015).

[29] Spring Hill Capital Partners LLC v. SEC, No. 1:15-cv-04542, at 1 (S.D.N.Y. June 29, 2015).

[30] Free Enterprise Fund, 561 U.S. at 509.

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