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EXPERT ANALYSIS

Coming to an Administrative Law Judge Near You: Insider-Trading Cases

By David A. Wilson, Esq.
Thompson Hine LLP

Insider-trading cases continue to be an important priority for the U.S. Securities and Exchange Commission. At a recent seminar, Andrew Ceresney, the director of the SEC's Enforcement Division, said the agency brought 80 cases based on insider-trading law in fiscal year 2014, which ended on September 30. The pace of enforcement in this area shows no signs of slowing down.

While the law in this area has not evolved significantly in the last decade, the SEC's approach to enforcement has become more aggressive. Furthermore, the Dodd-Frank Act has given the agency a new tool: the use of administrative proceedings, rather than the federal courts, to bring cases.

The SEC enforcement staff has made clear that it will use its discretion to file insider-trading charges in that forum when advantageous. So far, the SEC has articulated no other rationale and no guidelines for how it will choose the forum.

Given some recent high-profile failures in federal court cases, and the SEC's near-perfect record before administrative law judges, it is expected that the agency will bring more of those cases before its own ALJs.

DODD-FRANK EXPANSION

Before Dodd-Frank was enacted in 2010, the SEC could bring enforcement cases administratively only when the respondent was a regulated entity, such as a broker-dealer or an investment adviser, or an individual employed by one. That law now allows the SEC to bring cases before an ALJ that, previously, could only be brought in federal court.

Take, for example, a circumstance in which an employee of company XYZ allegedly tips a friend that XYZ is about to announce that its breakthrough cancer drug is going to receive Food and Drug Administration approval. The friend buys XYZ stock, and two days later, when the company makes its announcement, the stock's value shoots up 50 percent.

Since neither the alleged trader nor the alleged tipper is affiliated with a regulated entity, before Dodd-Frank, they could only be sued in federal court. Now, the SEC apparently has unbridled discretion as to whether it will file in federal court or with an ALJ. Neither the alleged tipper nor the alleged tippee has anything to say in the matter, and the SEC has articulated no criteria for how it will exercise its discretion.

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THE LIMITATIONS OF THE ADMINISTRATIVE FORUM

Why does this matter to those under investigation by the SEC? The agency has a number of important advantages when it litigates before an ALJ. Those advantages are significant, as the commission's track record in ALJ proceedings is far better than in federal court over the last few years.

First, there is no jury in an SEC administrative proceeding. The case is tried to an ALJ who is employed by the SEC. The rationale for ALJs hearing cases involving regulated entities has been that the complexity of the regulatory structure requires specialized expertise beyond what a federal district court judge, who hears all kinds of cases, might have.

While insider-trading law is not simple, the facts of most insider-trading cases should be as understandable to juries as those in any complex commercial case. Of course, where the Department of Justice proceeds criminally in an insider-trading case, the defendant has a right to a jury.

Second, the pace of an administrative proceeding is substantially faster than in a federal court case. In most cases, the ALJ has 300 days from the date of service of the initial pleading to render a decision.

Within those 300 days, there must be time allotted for hearing preparation, the hearing itself, obtaining transcripts, the submission of post-hearing briefs and finally, the ALJ's decision. Thus, a hearing is generally scheduled for only about four months from the date of service of an order instituting proceedings, or OIP, which is the administrative proceeding's equivalent of a federal court complaint. This schedule leaves limited time for defense counsel's preparation, while the SEC will have had a year or more to investigate the case, gather documents and take testimony from witnesses.

Third, discovery is quite limited in an administrative proceeding. The rules require the SEC to turn over much of its investigative file within seven days after serving the OIP.[1] It can, however, withhold items it claims are protected by privilege or work product, as well as the identities of any confidential sources. Thereafter, a respondent can ask the ALJ to issue subpoenas for documents to third parties and to the SEC itself, as well as for testimony of witnesses who are unlikely to be available for the hearing.

Fourth, the hearing itself is not subject to the same strictures as a federal court trial. ALJs generally err on the side of admitting any evidence that could conceivably be relevant, including hearsay. While the rules permit a motion for summary disposition, such motions are rarely granted. Motion practice is also constrained by the limited discovery and loose standards for the admissibility of evidence at the hearing.

Finally, once an ALJ renders a decision, a respondent has a right to appeal, but that appeal is to the SEC itself. The standard for appeal is *de novo*, based on the record in the case, briefing and argument, but that appeal is to the very entity that authorized the Enforcement Division to bring the action in the first place. The SEC's decision on the appeal can be thereafter appealed to the District of Columbia U.S. Circuit Court of Appeals or for the circuit in which the respondent resides.

CONSTITUTIONAL CHALLENGES

The SEC's first foray into the administrative forum for a case that, previously, could have only been brought in federal court was an insider-trading charge against former Goldman Sachs director Rajat Gupta in 2011. Gupta was charged with tipping Goldman information to hedge fund founder Raj Rajaratnam.

Within weeks of the SEC filing that proceeding, Gupta sued the SEC in federal court, seeking a declaratory judgment and an injunction and alleging that the administrative proceeding denied him his constitutional right to a jury trial in federal court. The SEC moved to dismiss the suit on various grounds, but U.S. District Judge Jed Rakoff of the Southern District of New York denied the SEC's motion, allowing Gupta's challenge to the SEC's chosen in-house venue to go forward.[2]

The SEC responded to this result by dismissing its administrative action against Gupta and filing suit against him in federal court. While his decision did not reach the constitutional issues raised by Gupta's claims, Judge Rakoff has since questioned the propriety of the agency's use of the ALJ forum. During a panel discussion this summer, Judge Rakoff said, "one might wonder from where does the constitutional warrant for such unchecked and unbalanced administrative power derive."

Several other lawsuits challenging the administrative venue were filed this year and are currently working their way through the federal courts. While only one of the cases involves insider-trading charges, they all concern claims that could have only been brought in federal court prior to Dodd-Frank.

One case involves George Jarkesy, a hedge fund manager who was charged with fraudulent microcap stock promotion. Jarkesy's suit claims he could not get a fair hearing before an ALJ because the SEC's previous findings against other defendants implicated him.

The District Court denied, on jurisdictional grounds, his request to enjoin the administrative proceeding.[3] While Jarkesy has appealed that determination, the administrative proceeding against him has already been concluded.

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A second case accuses Wing Chau and his investment management firm Harding Advisory of fraud in connection with collateralized debt obligations.[4] Chau and Harding have challenged the SEC's administrative case on equal protection and due process grounds, arguing that other cases concerning collateralized debt obligations were filed in federal court.[5]

Most recently, in October, two respondents in administrative proceedings filed suits in federal court in New York, seeking a declaratory judgment and injunctive relief against the SEC. The respondents alleged violations of due process and equal protection, because, they said, the SEC's action was unconstitutional under Article II of the U.S. Constitution. One of those cases, brought by Jordan Peixoto, arises from an OIP filed against him alleging insider trading in connection with the securities of Herbalife Ltd.[6]

These lawsuits arise from some, but not all, of the administrative proceedings the SEC has brought under its expanded authority for administrative enforcement. Courts have yet to weigh in on the merits of the constitutional challenges that are pending, and these issues are likely to be reviewed by appellate courts.

At least until the court challenges are resolved, SEC enforcement staff is likely to continue to bring cases before ALJs when it believes the agency is best served by doing so. Why would the SEC file in the forum where it has less chance of winning?

ARTICULATED GUIDELINES

Counsel faced with the prospect of litigating an insider-trading case in the administrative forum must prepare the full presentation of the defense of their clients well in advance of charges being filed. Given the accelerated schedule before an ALJ, they cannot wait until the SEC initiates the proceedings, as they might have before Dodd-Frank, to plan their discovery and at least sketch out the evidence they will present.

Before litigation, the so-called Wells process occurs, wherein the SEC staff notifies counsel that they are prepared to recommend charges and gives counsel an opportunity to submit a

statement as to why charges should not be brought. During this process, counsel should not only advocate the merits of why their clients should not be charged, but should try to persuade the Enforcement Division staff to exercise its discretion to bring charges, if any, in federal court.[7]

Leaving the SEC with what appears to be unfettered discretion to determine the forum of its enforcement cases is troubling, not just for the legal reasons raised by the challenges that have already been filed. The agency is charged with enforcing rules that are designed to make the financial markets more fair and transparent. For it to engage in enforcement actions in ways that are viewed as arbitrary and opaque is contrary to those principles.

Indeed, there are no guidelines pronounced by the SEC for the determination of which circumstances warrant bringing an insider-trading case (or any other enforcement action against a non-regulated entity) in the administrative venue. Allowing the agency to make that determination solely based on its odds of success, rather than on at least some consideration of fairness to those charged with securities law violations, may undermine the legitimacy of the agency and enforcement process.

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NOTES

[1] Sec. & Exch. Comm'n, Rules of Practice (March 2006), *available at* http://www.sec.gov/about/rulesprac2006.pdf.

[2] *Gupta v. SEC*, 796 F. Supp. 2d 503 (S.D.N.Y. 2003).

[3] *Jarkesy v. SEC*, No. 14-114 (BAH), 2014 WL 2584403 (D.D.C. June 10, 2014).

[4] *In the Matter of Harding Advisory LLC et al.,* File No. 3-15574, *order instituting administrative and cease-and-desist proceedings issued* (S.E.C. Oct. 18, 2013), *available at* http://www.sec.gov/litigation/admin/2013/33-9467.pdf.

[5] *Chau et al. v. SEC,* No. 14-cv-01903, *complaint filed* (S.D.N.Y. Mar. 18, 2014).

[6] *Peixoto v. SEC,* 14 CV 8364, *complaint filed* (S.D.N.Y. Oct. 20, 2014).

[7] A description of the Wells process is available starting at page 21 of the SEC Enforcement Manual, *available at* http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

David Wilson is partner-in-charge of **Thompson Hine LLP**'s Washington office and a partner in the firm's business litigation practice group. He focuses his practice on internal and government investigations, securities enforcement matters, and complex civil litigation.