11/5/14

PLI Securities Regulation Institute Keynote Address

IS THE S.E.C. BECOMING A LAW UNTO ITSELF?

by Jed S. Rakoff

I want to express my genuine appreciation for being asked to address this very distinguished and expert audience. Usually I give my speeches ex temp, but this is such a tough crowd that I think I'd better read my remarks.

Specifically, I'm going to discuss some dangers that seem to me to lurk in the S.E.C.'s apparent new policy of bringing a greater percentage of its significant enforcement actions as administrative proceedings. Let me make clear at the outset, however, that I do not intend to discuss in any respect the merits of various legal challenges that have recently been made to this practice. These challenges are currently pending in various courts and forums, and it would be improper for me to state any view of their merits outside of court. I will, instead, limit myself to what I perceive are some dangers this shift poses to the development of the law.

I also want to make clear at the outset that, even though the S.E.C. and I may occasionally hold differing views about one subject or another, I have nothing but respect for the S.E.C.

overall. I think it is obvious that the U.S. Securities and Exchange Commission has been, from its very advent, one of the jewels of the federal regulatory regime, and under its current leadership it is clear it will continue to be so. In fact, one reason I feel comfortable in uttering occasional critiques of those S.E.C. practices that impinge on the courts is because of my confidence that the S.E.C. will at least consider my suggestions and not just reject them out-of-hand in the way a less confident or thoughtful agency might.

Turning to the matter at hand, in recent months the S.E.C. has signaled its intention to bring as administrative actions certain kinds of enforcement actions that historically it has more often brought in the federal courts. As early as October of 2013, Andrew Ceresney, Director of the Division of Enforcement, stated that "Our expectation is that we will be bringing more administrative proceedings given the recent statutory changes." He followed that up last June when, with specific reference to insider trading cases, which previously had only very rarely been brought administratively, rather than in federal court, Mr. Ceresney stated: "I do think we will bring more insider-trading cases as administrative proceedings in appropriate cases." Not to be outdone, Kara Brockmeyer, the head of the SEC's anti-foreign-corruption enforcement unit, stated just two weeks ago that “It’s fair to say it’s the new normal. Just like the rest of the enforcement division, we’re moving towards using administrative proceedings more frequently.”

If you put these statements in historical perspective, you will see that they are just the latest instances of a long-term trend that has accelerated in recent years. When the S.E.C. was first created in the 1930's, its enforcement powers were largely limited to seeking injunctions in federal district courts to enjoin violations of the securities laws, and the only express provision for administrative hearings was to suspend or expel members or officers of national securities exchanges.

Over the next fifty years, the S.E.C. obtained or asserted additional administrative powers, but in each instance, the expansion was tied to the agency’s oversight of regulated entities or those representing those entities before the Commission, and even then was largely ancillary to the broader remedies and sanctions it could obtain only by going to federal court. Thus, soon after its creation, the Commission claimed inherent authority, subsequently approved by the courts, to suspend attorneys, accountants, and other professionals from practicing before it. And when Congress amended the securities laws in 1936 to require registration of brokers and dealers, it granted the S.E.C. the concomitant power to revoke registration as punishment for certain violations. Similarly, with the advent of registered securities associations in 1938, the S.E.C. obtained the power to suspend or expel members of such associations in certain circumstances In 1964, this was extended to allow the S.E.C. to suspend or bar regulated persons who violated the securities laws from associating with members of registered securities associations.

With the Insider Trading Sanctions Act of 1984, the S.E.C., at its request, obtained from Congress the power to order prospective compliance through injunctions, though only as to regulated persons and entities and only for certain violations of the securities laws. Despite that caveat, this marked an important shift. The steady, but constrained, accumulation of narrow administrative powers that accompanied the S.E.C.'s growing role in the first fifty years of its existence provided the Commission with authority that was ancillary to the courts' powers.   Now, however, the S.E.C. had a broad-ranging, quasi-injunctive power that was duplicative of the courts' powers. This was a sign of things to come.

In 1990, Congress, once more at the behest of the Commission, granted the S.E.C. the power to seek through internal administrative proceedings cease-and-desist orders against any entity or person, whether broker/dealer or otherwise, that was accused of violating the securities laws. More importantly, Congress gave the S.E.C. the power to seek through administrative proceedings disgorgement from any such entity or person and fines from regulated entities and persons. It was the addition of these monetary penalties that gave real "bite" to the S.E.C.'s administrative proceedings; but they were still used sparingly.

In 2002, Congress, through the Sarbanes-Oxley Act, went a step further and granted the S.E.C. the power to employ administrative proceedings to bar any person who had violated the securities laws from serving as an officer or director of a public company. The final, and largest expansion of the S.E.C.'s administrative enforcement power came, however, with the passage in 2010 of Section 929P(a) of the Dodd-Frank Act. Section 929P(a) gives the S.E.C. the power through internal administrative proceedings to impose substantial monetary penalties against any person or entity whatsoever if that person or entity has violated the federal securities laws, even if the violation was unintentional.

The net result of all this is that the S.E.C. can today obtain through internal administrative proceedings nearly everything it might obtain by going to court. This sea-change has come about almost entirely at the request of the S.E.C., usually by tacking the provisions authorizing such expansion onto one or another statute enacted in the wake of a financial scandal.

What has been the stated rationale for all these changes? Usually nothing more than a claim of greater efficiency. Thus, for example, when then-Director of Enforcement Robert Khuzami submitted a statement to the Senate Judiciary Committee in support of Dodd-Frank, he devoted all of one sentence to what became Section 929P(a), stating: "Additional legislative proposals that would serve to enhance the Division's effectiveness and efficiency include the ability to seek civil penalties in [administrative] cease-and-desist proceedings." Similarly, the sole legislative history of Section 929P(a) in the House Report on Dodd-Frank states that "This section streamlines the SEC's existing enforcement authorities by permitting the SEC to seek civil money penalties in cease-and-desist proceedings under Federal securities laws."

While a claim to greater efficiency by any federal bureaucracy suggests a certain chutzpah, it is hard to find a better example of what is sometimes disparagingly called "administrative creep" than this expansion of the S.E.C.'s internal enforcement power.

To be sure, an S.E.C. enforcement action brought internally is in some superficial respects more "effective and efficient" and more “streamlined” than a similar action brought in federal court, for the simple reason that S.E.C. administrative proceedings involve much more limited discovery than federal actions, with no provision whatsoever for either depositions or interrogatories. Similarly, at the hearing itself, the Federal Rules of Evidence do not apply and the S.E.C. is free to introduce hearsay. Further still, there is no jury, and the matter is decided by an administrative law judge appointed and paid by the S.E.C. It is hardly surprising in these circumstances that the S.E.C. won 100% of its internal administrative hearings in the fiscal year ending September 30, 2014, whereas it won only 61% of its trials in federal court during the same period.

But, although the informality and arguable unfairness of S.E.C. administrative proceedings might present serious problems for those defending such actions, you might suppose that federal judges would be delighted to have fewer complicated securities cases burdening their overcrowded dockets. The reason, though, that I suggest that the judiciary and the public should be concerned about any trend toward preferring the S.E.C.’s internal administrative forum to the federal courts is that it hinders the balanced development of the securities laws. Let me explain why this is so:

Most of the significant S.E.C. enforcement actions, especially those involving complicated or novel questions of fact or law, are brought under the general anti-fraud provisions of the federal securities laws, that is, section 17(a) of the 1933 Act and section 10(b) of the 1934 Act. The development of the law under these catch-all provisions, which broadly outlaw any fraudulent securities scheme, has mostly been judge-made. Indeed, the S.E.C. has often resisted any attempt to replace these provisions with something more specific, on the theory that such broad statutory provisions provide the flexibility needed to deal with the new schemes that fraudsters are constantly devising.

A good example is the law of insider trading, which is generally charged as a violation of section 10(b) and Rule 10b-5 promulgated thereunder. Although the very first insider trading decision was an internal S.E.C. decision, the famous Cady Roberts decision, since then almost all the major advances in the development of the law of insider trading – as in the Dirks case dealing with tippee liability, the O'Hagen case approving the misappropriation theory, and the like – have occurred in federal courts, usually either the Supreme Court or the Second Circuit. For its part, the S.E.C., though occasionally promulgating rules in response to particular court decisions in this area, has repeatedly resisted any effort by Congress to statutorily define insider trading, preferring to leave the concept sufficiently flexible as to be able to adjust to new developments. But fair notice has nonetheless been provided by the S.E.C.'s almost uniform practice, until very recently, of bringing such cases in federal courts, where the law of insider trading has been developed and elaborated in much-publicized cases.

However, bringing these cases in federal court has not been without its costs to the S.E.C. For while the U.S. Attorney's Office has had a remarkable string of successes in prosecuting criminal insider trading cases, and the S.E.C. has likewise obtained success in civil insider trading cases brought parallel to the criminal cases, nonetheless, when the S.E.C. has filed in federal court those civil insider trading cases that are sufficiently novel that no parallel criminal cases are brought, the S.E.C. has not fared nearly so well. In just this past year, the S.E.C. suffered stinging defeats in two such cases, the Obus case in the Southern District of New York and the Cuban case in the Northern District of Texas. In both these cases, novel and difficult legal issues were presented that led initially to both cases being dismissed by the district courts; but the issues were ultimately resolved by appellate decisions favorable to the S.E.C.'s theories. Nonetheless when, on remand, the cases were ultimately tried to juries, the S.E.C. lost.

Thus, given the expansion of its internal jurisdiction occasioned by Dodd-Frank, the S.E.C. might well be tempted in the future to bring such cases as administrative enforcement actions, and thereby likely avoid the sting of well-publicized defeats. But the result would be that the law in such cases would effectively be made, not by neutral federal courts, but by S.E.C. administrative judges.

This is because, at least in the case of administrative decisions that have been formally approved by the S.E.C., such decisions, though appealable to the federal courts of appeals, are presumed correct unless unreasonable. In other words, while the decisions of federal district courts on matters of law are subject to de novo review by the appellate courts, the law as determined by an administrative law judge in a formal administrative decision must be given deference by federal courts unless the decision is not within the range of reasonable interpretations.

To put it in terms that this audience is familiar with, an S.E.C. administrative judge's formal ruling on an otherwise undecided issue of statutory interpretation of the securities law is, just like rules enacted by the Commission, entitled to "Chevron" deference. And thus, for example, the Second Circuit, in a 2011 decision entitled VanCook v. SEC, overruled its own prior interpretation of a novel 10b-5 issue, stating "The Commission has since issued a formal adjudicatory decision on the subject.... This later interpretation of Rule 10b-5 'trumps' our prior interpretation."

In short, what you have here are broad anti-fraud provisions, critical to the transparency of the securities markets, that have historically been construed and elaborated by the federal courts but that, under Dodd-Frank, could increasingly be construed and interpreted by the S.E.C.'s administrative law judges if the S.E.C. chose to bring its more significant cases in that forum. Whatever one might say about the S.E.C.'s quasi-judicial functions, this is unlikely, I submit, to lead to as balanced, careful, and impartial interpretations as would result from having those cases brought in federal court.

In the short-run, this would be unfair to the litigants. In the longer-run, it might not be good for the S.E.C. itself, which has its own reputation for fairness to consider. But, most of all, in the both the short-run and the long-run, it would not be good for the impartial development of the law in an area of immense practical importance.

Almost from the very outset of the administrative state, the defense of the huge power we accord to administrative agencies –

as classically stated by the second Chairman of the S.E.C., James Landis, in his book The Administrative Process – is that no practical alternative exists in our complex society. But when it comes to interpreting the securities laws, a practical alternative – and the very one provided by the Constitution – has functioned very effectively for decades, namely, adjudication in the federal courts. I see no good reason to displace that constitutional alternative with administrative fiat, and I would urge the S.E.C. to consider that it is neither in its own long-term interest, nor in the interest of the securities markets, nor in the interest of the public as a whole, for the S.E.C. to become, in effect, a law onto itself.