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Expert Analysis

New Counterattack On SEC's Home Court Advantage

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In the wake of the 2010 Dodd-Frank Act's broadening of the reach of SEC administrative enforcement proceedings, the agency undertook a major shift toward pursuing such proceedings instead of federal district court actions, its historically preferred enforcement mechanism.[1] Administrative proceedings, which are heard by judges employed by the Securities and Exchange Commission, are widely perceived to favor the agency. Indeed, recent data on the results of such proceedings reveal that the SEC has enjoyed a lopsided record of success, compared to its far more modest record in federal court trials.[2]

Not surprisingly, defendants have sought to enlist the federal courts to resist SEC administrative proceedings. Such efforts have had difficulty overcoming procedural hurdles requiring that a defendant await the outcome of the administrative proceeding and exhaust avenues of review within the agency before any federal court review.

A new line of counterattack being pursued by former Standard & Poor's Rating Services manager Barbara Duka in a case pending before Southern District of New York Judge Richard M. Berman seeks to avoid those procedural hurdles. Duka asserts a facial challenge to the constitutionality of the SEC's administrative mechanism. Her claim is premised on recent Supreme Court decisions holding that the Appointments Clause of Article II of the Constitution requires that agency officials exercising significant discretion—such as SEC administrative law judges—must be subject to the direct authority of the president. Duka's suit is an ingenious effort to address the vexing problem of perceived unfairness to defendants.

Administrative Proceedings

An SEC administrative proceeding is very different from a federal district court action. No jury is provided. Rather, the administrative law judge (ALJ) serves as finder of both fact and law. The Federal Rules of Civil Procedure do not apply. The applicable rules do not provide for defendants to file motions to dismiss based on legal insufficiency, nor to file counterclaims.[3]

Practically, perhaps the most important differences from a federal court action are the timetable and the opportunity for defendants to take discovery. During the pre-charge, investigative phase of the matter, the SEC has the opportunity to—and often does—take years to pursue documents and take witness testimony, while the subject of the investigation has no right of access or participation. Once the SEC brings charges and initiates an administrative enforcement proceeding, however, the adjudicative hearing on the SEC's charges is required to occur within a matter of months. During that period, a defendant generally has no right to take witness depositions. Obtaining documents from third parties can also be a good deal more difficult than in a federal court action.[4]

Appeal from the ALJ's decision at the conclusion of an administrative proceeding is not heard by an independent third party, but by the SEC commissioners themselves. When a decision is appealed, the commissioners can decline to hear it or impose greater sanctions. Only after the commission has entered a final order can the respondent appeal to a U.S. Court of Appeals.[5]

Challenges to Use

A number of defendants recently have brought constitutional challenges to the SEC's initiation of administrative proceedings. Most of these cases, however, have not been adjudicated on the merits. Instead, the SEC typically raises at the outset a jurisdictional challenge to the court's authority to interrupt an ongoing agency adjudica-

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tion by hearing the case.

Under applicable Supreme Court precedent, whether a court has jurisdiction to hear a constitutional challenge to an administrative proceeding depends on (1) whether a finding of no jurisdiction "could foreclose all meaningful judicial review," (2) whether the suit is "wholly collateral" to the review process built into the statutory scheme, and (3) whether the claims are "outside the agency's expertise."[6] How the answer will come out is highly dependent upon the nature of the specific constitutional claim raised.[7] District judges in the Southern District of New York have reached different results in applying these standards to varying constitutional claims.

In *Gupta v. SEC*, Judge Jed S. Rakoff denied the SEC's motion to dismiss a complaint filed by Rajat Gupta, one of the individuals accused of insider trading in the highly publicized Galleon Hedge Funds investigation. Gupta sought to enjoin the SEC's administrative proceeding against him based on a violation of the Equal Protection Clause, arguing that he was singled out and uniquely deprived of the opportunity to contest the allegations against him in federal court, the forum the SEC chose to litigate its enforcement actions against the 28 other Galleon defendants.

Although Rakoff ultimately did not reach the merits of Gupta's equal protection claim, he rejected the SEC's motion to dismiss, holding that the court had jurisdiction over Gupta's action seeking to enjoin the administrative proceeding. Rakoff found that forcing Gupta to wait would foreclose meaningful review of his constitutional claim because the SEC's administrative process does not provide a reasonable mechanism for raising such a claim, and that the equal protection claim was "wholly collateral" to the question of whether Gupta engaged in insider trading. Rakoff also found that the equal protection claim was outside the SEC's regulatory expertise, observing that in order to address it, the SEC would have to pass judgment on its own motives.[8]

A new line of counterattack asserts a facial challenge to the constitutionality of the SEC's administrative mechanism.

Judge Lewis A. Kaplan reached the opposite conclusion regarding jurisdiction in *Chau v. SEC*. Chau and his employer, Harding Advisory LLC, argued that the SEC's choice to pursue them administratively, as opposed to suing them in federal court, violated their constitutional rights. Kaplan found no jurisdiction for plaintiffs' main claim of violation of due process because it was not a broad facial challenge to administrative proceedings in all cases, but rather an "as applied" claim raising specific problems that had arisen during the course of the administrative proceeding, and thus intertwined with that proceeding. Kaplan also rejected jurisdiction over the equal protection claim, in part based on a finding that plaintiffs had been able to actually litigate, and thus would be able to obtain meaningful review of, such claim through the administrative process. Kaplan wrote: "[t]his Court's jurisdiction is not an escape hatch for litigants to delay or derail an administrative action when statutory channels of review are entirely adequate."[9]

Argument in 'Duka v. SEC'

Barbara Duka, the former co-manager of Standard & Poor's Rating Services commercial mortgage backed securities division, raised the latest constitutional challenge to SEC administrative proceedings in an action brought in mid-January of this year. In anticipation of the SEC's filing of an administrative enforcement proceeding, Duka filed a lawsuit seeking declaratory and injunctive relief against the SEC.[10] When the SEC initiated the administrative proceeding a week later, Duka moved to preliminarily enjoin it.[11] In support of her motion, Duka argued that the administrative proceeding, overseen by an ALJ, is unconstitutional under the Supreme Court's decision in *Free Enterprise Fund v. Public Co. Accounting Oversight Bd*.[12]

In *Free Enterprise*, an accounting firm that was the subject of a formal investigation by the Public Company Accounting Oversight Board (PCAOB) sued the PCAOB, seeking a declaratory judgment that it would be unconstitutional for it to exercise its powers under the Sarbanes-Oxley Act of 2002, which created the board.

In its decision, the Supreme Court addressed the Appointments Clause of Article II of the Constitution which vests the executive power in the president and authorizes him to exercise such power through the appointment of all "officers" of the United States. The court determined that the PCAOB was constituted improperly because its members, who acted with the powers of "executive officers," could not be removed from office by the president.

Instead, the board's authorizing statute provided that board members could be removed only "for cause" by individuals whom the president also could remove only "for cause." The court found that giving the discretion to find whether there was cause to remove a PCAOB member to officials—here, SEC commissioners—who themselves are subject to removal only "for cause," and not just because the president disagrees with them, goes too far. The court held that such insulation from presidential authority "contravenes the President's 'constitutional obligation to ensure the faithful execution of the laws.'"[13]

Duka argued that like the PCAOB board members, ALJs appointed by the SEC are "officers" of the United States who enjoy an unacceptable multi-level of protection from removal. ALJs are career appointments, removable only for good cause. They may only be removed by the commission-

ers of the SEC, who themselves are protected by tenure and cannot be removed except for "good cause," defined as inefficiency, neglect of duty, or malfeasance in office. Duka also relied upon a 1991 Supreme Court decision, *Freytag v. C.I.R.*,[14] which held that, based on the position's duties and authority, a Special Trial Judge appointed by the Tax Court was an "inferior Officer" whose appointment was required to comply with Article II.

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In response, as in *Chau*, the SEC has challenged the district court's jurisdiction to interrupt the administrative proceeding to hear the claim. On the merits, the SEC takes issue with the plaintiff's characterization of ALJs as U.S. "officers" and seeks to distinguish the SEC's ALJs from the PCAOB members addressed in *Free Enterprise*. Specifically, the SEC argues that the president retains adequate control of the executive power because the SEC's ALJs "possess the limited adjudicatory authority that the Commission has delegated to them, play a part in a process over which the Commission retains ultimate control, enjoy ordinary tenure protection, and have a long history of use."

The SEC also stresses that ALJ decisions are not "final" until action by the commission itself. According to the SEC, the power and independence of the ALJs "pales in comparison" to the PCAOB members and no constitutional infirmity exists.[15]

Duka's Article II challenge to the SEC's administrative proceedings is not altogether new; other defendants in SEC administrative proceedings have raised such claims in actions filed in the Southern District of New York in recent months, but none progressed through full briefing on the parties' initial motions, as has Duka's.[16] The argument was also raised in a case before Judge Rudolph Randa of the U.S. District Court for the Eastern District of Wisconsin in Milwaukee. In *Bebo v. SEC*, the plaintiff, Laurie Bebo, asserted that an SEC administrative proceeding initiated against her violated the due process and equal protection clauses because it gave the SEC unfettered discretion to decide whether to comply with an individual's right to a jury trial, and because certain key witnesses, who are Canadian citizens, were outside the ALJ's subpoena power. Like Duka, relying on *Free Enterprise*, Bebo also asserted that the administrative mechanism violated Article II because SEC ALJs are too insulated from the authority of the president.

Judge Randa found Bebo's claims "compelling and meritorious," but declined to resolve the underlying questions on jurisdictional grounds. Writing that Bebo's claims were subject to the exclusive remedial scheme set forth in the Securities Exchange Act, the court found that Bebo was required to "litigate her claims before the SEC and then, if necessary, on appeal to the Court of Appeals for the Seventh Circuit."[17]

Conclusion

Judge Rakoff has opined that the true danger arising from the SEC's shift of its enforcement efforts to administrative proceedings is that "it hinders the balanced development of the securities laws." Federal courts are required to give administrative decisions deference unless the decision is "not within the range of reasonable interpretations." Thus, decisions made by ALJs do not benefit from the "balanced, careful and impartial interpretations as would result from having those cases brought in federal court."[18]

Some might find a degree of irony if the SEC's administrative enforcement apparatus were to be struck down based on a constitutional doctrine that equates ALJs with executive branch officers who are required to be more directly answerable to the president, and thus, arguably, farther removed from the impartiality of the preferred forum, the federal courts. But the reality is that the SEC's current ALJ system is widely perceived to disfavor defendants, and many would welcome any ruling that strikes it down. Duka's intriguing constitutional claim provides a promising avenue for such a ruling. Whether the court will tackle the constitutional issues head-on, however, remains to be seen.

1. Stephen Joyce, "SEC to Use Administrative Cases More, Despite Defense Bar Complaints, Officials Say," Corporate Law & Accountability Report (Nov. 7, 2014).
2. Jean Eaglesham, "SEC is Steering More Trials to Judges It Appoints," The Wall Street Journal (Oct. 21, 2014) (reporting that the SEC had a 100 percent record of success in administrative proceedings during fiscal year ending Sept. 30, 2014, while winning only 61 percent of its federal court trials).
3. See SEC Rules of Practice 200-220, 17 CFR §§ 201.200–201.220.
4. See id. at 230-234, 17 CFR §§201.230-201.234.
5. 15 U.S.C. §78y(a)(1); § 77i.
6. *Chau v. SEC*, ___ F.Supp.3d ___, 2014 WL 6984236, *3 (S.D.N.Y. Dec. 11, 2014)(citing *Thunder Basin Coal v. Reich*, 510 U.S. 200, 212-13 (1994).
7. Id. at *5.
8. 796 F.Supp.2d 503 (S.D.N.Y. 2011).
9. *Chau*, 2014 WL 6984236 at *6.
10. *Duka v. SEC*, 15 cv 357 (S.D.N.Y.).
11. Memorandum of Law in Support of Plaintiff Barbara Duka's Motion for a Temporary Restraining Order and a Preliminary Injunction, *Duka v. SEC*, 15-cv-357 (S.D.N.Y. Jan. 26, 2015).
12. 561 U.S. 477 (2010).
13. Id. at 484.
14. 501 U.S. 868 (1991).
15. Memorandum of Law in Opposition to Plaintiff's Motion for a Temporary Restraining Order and a Preliminary Injunction, *Duka v. SEC*, No. 15-cv-357, at p. 2 (S.D.N.Y. Jan. 28, 2015).
16. See *Peixoto v. SEC*, 14 Civ. 8364 (WHP) (S.D.N.Y. Oct. 20, 2014); *Stillwell v. SEC*, 14 Civ. 7931 (KBF) (S.D.N.Y. Oct. 1, 2014).
17. Decision and Order, *Bebo v. SEC*, 15-C-3 (E.D.Wis. March 3, 2015).
18. Jed S. Rakoff, "Is the SEC Becoming a Law Unto Itself?" Address, PLI Securities Regulation Institute (Nov. 5, 2014).