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# The SEC is All Dressed Up...Now Where to Go?

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Whether the U.S. Securities and Exchange Commission files a litigated enforcement case in U.S. District Court or as an administrative (or cease-and-desist) proceeding (AP) has enormous consequences for the parties involved. There are significant procedural differences between these two forums, as well as a divergent Commission success rate in each.

The distinctions become particularly acute as the SEC's Division of Enforcement (Division) brings a greater variety and number of litigated enforcement actions as APs rather than in federal court. Indeed, the Dodd-Frank Act expanded the Commission's ability to bring virtually any case as an AP. Yet until recently, the Division's considerations when choosing a forum was largely opaque to the public.

The Division has now issued staff guidance, entitled "Division of Enforcement Approach to Forum Selection in Contested Actions," which identifies several factors that it may consider when making this important decision. Further details certainly would provide even more meaningful guidance to potential defendants. Nevertheless, the guidance, as currently issued, illuminates several considerations for SEC defense counsel in order to best position clients potentially facing a litigated AP.

## Why Does Forum Matter?

For most entities and individuals, just being sued by the SEC is damage enough – the lawsuit's forum may not be top of mind. Procedures and outcomes, however, differ based on the forum.

When the Commission files a civil lawsuit against defendants in U.S. District Court, the parties may engage in extensive discovery under the Federal Rules of Civil Procedure. Parties may obtain documents and depositions from each other and third-parties, and the Court may order recalcitrant recipients of discovery requests to comply. If the allegations or evidence are lacking, defendants have multiple opportunities to seek to summarily eliminate or narrow claims without the need for a costly and uncertain trial. Even at trial, defendants can rest assured that the evidence offered against them complies with the safeguards of the Federal Rules of Evidence. Proceedings are overseen by Article III Judges, and appeals are taken to the U.S. Court of Appeals – sometimes under a de novo standard of review. (Some rulings are reviewed under a more deferential standard.) Decisions may be published and provide precedential value.

In the SEC's administrative forum, the Federal Rules of Evidence and Civil Procedure do not apply. Rather, the proceedings are governed by the more lenient Commission's Rules of Practice. The Rules do not provide for

much discovery. The Division must produce the investigative file to respondents shortly after the proceeding is initiated and the Division has *Brady* and *Jencks* obligations to voluntarily produce exculpatory evidence and witness statements – akin to prosecutors' obligations in criminal trials. Otherwise, respondents primarily must rely on voluntary compliance and informal interviews of potential witnesses. Hearings are held within months of the order instituting proceedings, and an initial decision typically is issued within 300 days. Respondents thus must quickly receive and analyze the investigative record, which the Division staff compiled over the course of months or years during its investigation. Proceedings are overseen by an Administrative Law Judge (ALJ), an SEC employee, and appeals are first heard by the Commission, which also authorized the case in the first place. Commission decisions may be appealed to the U.S. Court of Appeals, but are subject to a deferential standard of review. ALJ and Commission decisions have more limited precedential application than federal court decisions.

Many commentators have noted that the SEC's track record in these forums differs significantly. For example, a May 6, 2015 Wall Street Journal article, entitled "SEC Wins With In-House Judges," reported that between October 2010 and March 2015, the Commission achieved a 69% success rate in federal court, whereas the Division boasted a 90% success rate in administrative proceedings. The article also reported that the Commission decided appeals in the Division's favor 88% of the time, excluding certain categories of cases (including those cases resulted in a 95% affirmance rate). These vastly-divergent outcomes, coupled with the meaningful procedural differences, negatively impact public perceptions about the fairness of the Commission's litigation enforcement program.

The Division's forum selection practices have been subject to criticism and legal challenges. For example, in a November 2014 speech, Judge Rakoff of the Southern District of New York acknowledged the SEC's divergent success rate in APs, and questioned whether the increased use of APs would negatively affect the development of the federal securities laws. And in February 2015, Commissioner Piwowar urged the Commission to issue guidance on forum selection, so as to avoid a perception of unfairness in the Commission's enforcement actions. Moreover, several respondents sued in APs mounted legal challenges in federal court, questioning the constitutionality of the Commission's administrative processes. Indeed, just recently, a Judge in the U.S. District Court for the Northern District of Georgia issued a preliminary injunction halting an ongoing AP because the Judge found a likelihood of success for the respondent's Constitutional challenge to the SEC's appointment of ALJs.

### **The Division's Guidance**

The recently-issued guidance states that the Division "recommends the forum that will best utilize the Commission's limited resources" to further its mission to "protect investors and the integrity of the markets through strong, effective, and fair enforcement of the federal securities laws." It acknowledges that "there is no rigid formula dictating the choice of forum." The guidance identifies four factors that the Division may consider "in assessing whether to recommend that a contested case be brought in the

administrative forum or in federal district court.” The listed factors are not exhaustive, and the Division emphasized that even a single factor could dictate the choice of forum.

*Factor 1: The availability of the desired claims, legal theories, and forms of relief in each forum.*

The Division can only assert certain charges in certain forums, which may lead the Division to favor one forum over another. The guidance specifically explains that failure to supervise or causing charges may only be brought in administrative proceedings, whereas control person or relief defendant charges may only be brought in federal district court. Also, only the federal courts can issue emergency relief, such as TROs or asset freezes. Notably, however, the Division may seek the same range of financial sanctions – particularly disgorgement and a civil penalty – in either forum.

*Factor 2: Whether any charged party is a registered entity or an individual associated with a registered entity.*

The guidance states that regulated entities and their personnel have “long been subject to the Commission's regulatory oversight, which has long included Commission administrative proceedings.” Associational bars and suspensions are only available in APs. The Division thus may choose to seek all remedies against a regulated entity or its personnel in a single AP, rather than first obtaining a district court injunction, and then initiating a follow-on AP for the bar or suspension.

*Factor 3: The cost-, resource-, and time-effectiveness of litigation in each forum.*

The Division indicated, not surprisingly, that it would consider the efficient and effective use of the Commission's limited resources. According to the Division, faster-moving APs may involve fresher witness recollections, and may permit “a more timely public airing” of the facts and circumstances of the conduct and practices at issue in the matter, than slower-moving federal court cases. The Division, however, ignores that its investigations may span months or years, with the timeliness of a message and witness recollections languishing in the interim. Rushing litigation at the end of the Division's overall enforcement process provides little benefit on these points.

The guidance also repeats that certain forums may provide a “one stop shop” for all of the relief sought by the Division – e.g., against defendants and relief defendants in federal court, or a liability determination and associational bar in an administrative proceeding. Defendants found liable in federal court actions, however, may not contest associational bars imposed in follow-on APs; thus those proceedings often consume only marginal additional resources.

Finally, the guidance notes that the differing opportunities for summary disposition and discovery in the two forums may play into the Division's

decision-making process as well.

*Factor 4: Fair, consistent, and effective resolution of securities law issues and matters.*

The guidance further states that ALJs and the Commission have extensive specialized knowledge about the federal securities laws, rules, and practices in the markets. As a result, the Division may seek to bring contested matters that raise unsettled and complex issues in the administrative forum first. In contrast, issues blended with state law or other specialized areas of federal law may warrant consideration by the federal courts in the first instance.

The Division's view on this factor may carry weight for a small number of specialized or complex securities products or practices, but when applied to the majority of cases (even many regulated entity issues) the Division seems to undersell the expertise of the federal judiciary. Moreover, commentators do not uniformly agree that new securities law precedent is best developed when first issued by ALJs and the Commission.

### **Defense Considerations**

Defense counsel has limited ability to influence the Division's choice of forum, and over-reaching on this point could do more harm than good. Nevertheless, experienced defense counsel should seek to position their client(s) in the best place possible on these issues. Several considerations in this regard:

*(1) Identify your client's unique needs and goals.* Engaging with clients involved in SEC investigations about possible outcomes – in the event that the matter cannot be resolved short of litigation – is imperative. Litigating against the SEC entails certain costs and risks, as well as potential rewards, but which differ among the two possible forums. The potential forum might affect the defensive approach, based on assessments of risk tolerance, endurance, and resources, among other things. A frank discussion between client and counsel about potential litigation forums should occur early and be ongoing.

*(2) Gather information early and continuously.* Counsel cannot be over-informed when counseling clients through an SEC investigation. Once a potential issue comes to light, counsel should seek to learn as much as possible about the surrounding circumstances. For entity clients, this may mean conducting a targeted internal investigation into the issues. For individuals, this may mean probing interviews and analysis of available documents. Likewise, counsel should remain as informed as possible during an investigation, both through discussions with other defense counsel and by engaging with the staff when possible. Learning about key documents and witness testimony early will help counsel to efficiently and effectively respond in the event of a Wells notice and an expected AP.

*(3) Ensure a quality investigative record.* Given that more cases may be litigated as APs, where depositions typically are not available, defense counsel should pay close attention to the state of the investigative

testimony. The transcripts as they exist at the end of an investigation may dictate defense counsel's ability to later impeach witnesses and refute the Division's case during an AP hearing. Counsel for testifying witnesses thus should ensure that testimony is clear about time frames and limited to that witness's personal knowledge, among other things. And counsel to entities should consider ensuring that each testifying current and former personnel has separate individual counsel focused on guiding that individual through investigative testimony.

*(4) Highlight case attributes.* As noted in the guidance, certain factors about a litigated case may sway the Division to prefer one forum over another. For example, the guidance recognized that isolated legal issues may be susceptible to early summary resolution, and thus better litigated in a federal district court. Likewise, the need for additional discovery from third-parties may warrant bringing a case in federal court and not as an AP. In appropriate circumstances, defense counsel should consider how to highlight to the staff, including trial counsel, the unique attributes present in a given case. Additionally, certain cases might present opportunities for defense counsel to propose innovative litigation options to narrow the scope of contested issues, which may tilt the balance of forum selection factors in a preferred direction.

*(5) Start trial prep early.* Assuming that all signs indicate that the Division will recommend a litigated AP, defense counsel is well-advised to start preparing for the AP hearing at the earliest stage possible. Engage experts that may be necessary, assemble available evidence, and consider any challenges in obtaining additional documents and testimony from others (e.g., due to privilege issues or evidence located internationally).

*(6) Pick your battleground(s).* If a litigated AP is instituted, the defense team must quickly assess whether and how to challenge the SEC's selected forum. Multiple respondents have sought federal court orders halting their ongoing AP proceedings. To date, many of these challenges have not succeeded. But the SEC's voluntary withdrawal of an AP instituted in an insider trading case after a respondent challenged the forum in federal court in 2011, and the recent preliminary injunction issued by a federal judge in Georgia (in another insider trading case), provide precedent for successful challenges. The numerous factors that influence a decision of whether to mount a similar challenge in a particular case should be considered.

*(7) Make the appellate record.* While litigating an AP, defense counsel should make a complete record of potential issues for appeal. Ensure that defensive arguments and objections are made on the record and supported by admitted evidence, and that all submitted motions are fully ruled upon. Although the process of appealing through the Commission to a U.S. Court of Appeals may be arduous and lengthy, that route can only be fruitful if the appropriate appellate record is made during the AP hearing.

At bottom, the Division will recommend the forum that it prefers for a given case. The recently-issued guidance provides some welcomed illumination into this decision-making process. Yet the guidance does not significantly

constrain the Division's discretion in any particular case. Absent more specific guidance or a change in law, therefore, defense counsel is well-advised to weave applicable portions of the guidance into their overall defensive considerations for clients involved in SEC proceedings.

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