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Underwriters of D&O and Professional Liability Insurance

In this issue ... *we look at the controversy over the Securities and Exchange Commission's (SEC) use of its in-house tribunal.*

Background

For many years the SEC has operated its own in-house courtroom —usually referred to by the SEC as "administrative proceedings"— in which it has heard and adjudicated hundreds of civil cases alleging securities-related infractions. The extent of these judicial powers was originally limited to defendants that were registered with, and regulated by, the SEC: essentially securities industry professionals. Entities and individuals falling outside these parameters were pursued by the SEC through the U.S. federal court system.

However, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) expanded the power of the SEC to use its administrative proceedings to pursue unregistered and unregulated parties (Dodd-Frank, Section 929P). With this enhanced authority, the SEC's use of the administrative proceedings increased significantly. As Andrew Ceresney, director of the SEC Enforcement Division said in a November 21, 2014 speech: "There is no question that we are using the administrative forum more often… given the changes under Dodd-Frank."

But along with this increased reliance on its own courtroom has come added scrutiny: is there a "home-court" advantage enjoyed by the SEC in cases passing through the administrative proceedings compared to those cases heard in the U.S District court system?

Some Data

According to a paper in the Review of Banking and Financial Law (Volume 34, 2014-2015), in 2011 the SEC won 88% of the hearings taking place in its own forum, versus a success rate of only 63% for cases heard in the federal court system. For the period of September 2013 to September 2014 the in-house process produced a perfect 100% success rate for the SEC, which managed only 61% through the federal courts.

During the broader post Dodd-Frank period of October 2010 through March 2015, the SEC notched up victories in more than 90% of its internal hearings, but achieved only a 69% success rate in federal courtrooms (Wall St Journal, May 6, 2015). It is data such as these that has drawn criticism of the SEC's administrative proceedings, among the more notable critics has been the outspoken federal Judge Jed S. Rakoff, who cautioned that the SEC risked becoming "a law unto itself."

Other Features of the Administrative Proceedings

Given the above data, defendants informed by the SEC (which chooses the prosecutorial route it will take based on certain criteria) that the case will be heard in the SEC's own forum could justifiably feel the odds are already stacked against them; other significant elements of the administrative proceedings might do little to diminish that belief. Here is a simplified comparison between some key features of the SEC proceedings and the federal justice system:

The SEC administrative proceedings	**The Federal Court system**
No juries. Cases heard and verdicts reached by the SEC Administrative Court Judges.	Cases heard by federal judges; verdicts reached by independent juries.
Not subject to federal Rules of Evidence: "hearsay" evidence can be introduced.	Proceedings governed by federal Rules of Evidence: "hearsay" evidence not permitted.
Any appeal must initially be made internally to the SEC before any federal review can take place.	Normal independent federal appeals process.
No sworn depositions permitted.	Depositions of witnesses generally allowed as needed.
In general, a maximum period of four months between charges filed and case being heard.	No similar deadlines: it can take years to get to trial.
Decision must be handed down with 300 days of case commencing.	Legal process allowed to run its course as necessary. It can take years to reach a verdict.

These procedural disparities, generally inuring to the detriment of defendants consigned to the SEC's internal system of justice, coupled with the comparative success rates, have created a rising clamor for changes to the administrative proceedings process. The SEC's position has been further embattled by a federal judge expressing concern that elements of the SEC's forum might actually be unconstitutional.

The SEC blinks

On September 24, 2015 the SEC announced it would propose amendments to the rules governing its administrative proceedings. These include:

- The permitting of pre-trial depositions, but only three, with up to five for multiple defendants.
- The four-month gap from charges to commencement would double to eight.
- The 300-day cap on the administrative proceedings would be extended by a further thirty days.

These concessions might seem to be offered reluctantly: less than a year ago the SEC Enforcement Director was claiming that: "our use of the administrative forum is eminently proper, appropriate, and fair to respondents."

Outside commentators generally see these moves by the SEC as helpful, but that they do not go far enough. Areas of contention that remain include: the continued use of hearsay evidence (though in a more limited way), an appeal process that still starts with the SEC itself, a 3/5 limit on depositions that is insufficient, and that eight months is still too short a time to adequately prepare for an SEC internal hearing.

Comment

With a federal judicial process that is notorious for being protracted and seemingly interminable, it is certainly

understandable that the SEC has sought to expedite and streamline its enforcement process by utilizing the administrative proceedings option wherever possible. D&O liability insurance professionals know that even ostensibly straightforward securities cases in the federal system can drag on indefinitely, draining the resources, time, and energies of all parties involved.

However, the data on success ratios, and the disparities in the protections available to defendants between the administrative proceedings and federal system make it difficult for the SEC to maintain there is equal treatment under both forums.

The challenge for the SEC is to retain the very real benefits of efficiency and expediency achieved through its in-house forum without appearing to compromise the right of defendants to a fair hearing, and the proposed rule changes at least recognize there is an existing measure of inequity. The period for public comment on the proposals expires on December 4; it will be interesting to see what comments emerge, and how the SEC responds.❖

Our Denver office has Moved

The Denver office of Chicago Underwriting Group has moved to a new location in the same neighborhood:

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