August 2015 • Vol. XXVIII • Number 8

PLUS Journal *Reprint*
5353 Wayzata Blvd., Suite 600
Minneapolis, MN 55416-4758
phone 800.845.0778 or 952.746.2580

PLUS
PROFESSIONAL LIABILITY UNDERWRITING SOCIETY
Journal
YOUR SOURCE FOR PROFESSIONAL LIABILITY EDUCATION AND NETWORKING

The SEC's Use of In-house Courts: What it Means For Private Equity Firms

By Rachel Simon & Sarah Voutyras

Rachel Simon *is a Vice President and D&O Claim Expert at Swiss Re Corporate Solutions. She was formerly a Principal at Skarzynski Black and Assistant Vice President, Executive Assurance Claims at Arch Insurance Group. She specializes in handling complex D&O and related E&O claims. Rachel can be reached at Rachel_Simon@swissre.com.*

Sarah Voutyras *is an associate with the law firm Skarzynski Black LLC in its New York office. Her practice includes commercial litigation and all aspects of business, professional, property and general liability insurance matters. She can be reached at svoutyras@skarzynski.com.*

The 2010 Dodd-Frank Act brought about huge changes to the American financial regulatory environment, particularly through expansion of the breadth of the SEC's authority over financial institutions such as private equity ("PE") and hedge funds. Under Dodd-Frank, PE advisors and PE firms with over $150 million assets under management are now required to register with the SEC as investment advisors and fully comply with the Investment Advisers Act ("IA Act").

With so many new entities from the PE industry now subject to SEC regulation, the SEC in October 2012 launched an initiative to examine and assess the issues and risks presented in the PE industry,[1] and in January 2013 announced that it expected to bring more enforcement actions involving PE.[2] In May 2014 the SEC announced that its initiative was "nearly complete" and that it had determined that private equity funds and hedge funds present "unique risks" to investors that are not present in the public investment sphere as PE advisers typically use clients' funds to obtain controlling interests in non-public companies not subject to rigorous disclosure requirements, and are therefore faced with "temptations and conflicts with which most other advisers do not contend."[3]

Given the SEC's recent remarks in other contexts that it expects to bring more administrative proceedings ("APs") due to Dodd-Frank,[4] private fund managers should expect the SEC to bring more enforcement actions through APs before administrative law judges ("ALJs") than in federal court before Article III judges. In fact, the number of APs initiated by the SEC in the 12 months prior to March 31, 2015 is nearly 50% higher than the number of administrative proceedings initiated in the 12 months prior to March 31, 2010.[5] A number of these high-profile proceedings involve PE and hedge funds.

The increase in APs has raised a lot of concerns. APs differ from civil actions in that (1) there is no right to a jury, even when significant financial penalties and forfeitures are demanded, (2) even the most complex cases must be decided within 300 days of filing, which arguably only limits a respondent's ability to defend itself given that the SEC may spend years investigating a case before initiating proceedings, (3) there is no meaningful pre-trial discovery because SEC rules do not allow for interrogatories, requests for admission, or depositions, and (4) the evidence rules are more lenient. For example ALJs are allowed to consider any "relevant" evidence they deem appropriate, even evidence that would be considered inadmissible "hearsay" in an Article III court. In addition, an appeal of an ALJ's decision is heard by the SEC itself—the very body which, prior to the AP, determined that an enforcement action was warranted.

Perhaps most concerning is that an AP initiated and prosecuted by the SEC is decided by an ALJ that is hired and paid by the SEC. Indeed, one former SEC ALJ has publicly stated that during her tenure at the SEC, she came "under fire" for finding too often in favor of defendants.[6]

The SEC's use of APs has been highly criticized as the empirical evidence suggests that the SEC has an unfair advantage over respondents in APs that it does not have when bringing enforcement actions in federal court. According to an analysis conducted by the Wall Street Journal, the SEC won against 90% of defendants before ALJs in contested cases from October 2010 through March of 2015, compared to a 69% success rate in federal court during the same time period.[7] The Journal analysis also found that the SEC has a 95% success rate in appeals of ALJ rulings—the appeals its own commissioners hear.[8] Judge Jed Rakoff of the United States District Court for

the Southern District of New York, has described the impressive success rate of the SEC in APs as "hardly surprising" given the "informality and arguable unfairness" of these proceedings.[9]

A number of AP respondents have brought constitutional challenges to the SEC's use of administrative proceedings and, until very recently, these challenges have been largely unsuccessful. Federal courts have rejected arguments that AP procedural rules violate due process and equal protection,[10] that the SEC's unfettered discretion to choose between APs and federal court violates due process and equal protection,[11] and that the dual layer of tenure protection provided to ALJs violates the separation of powers doctrine,[12] holding that they lack subject matter jurisdiction to hear such complaints given that the appeal process provided for by Dodd-Frank (whereby the ALJ's decision is reviewed by the SEC itself) is "entirely adequate".[13] ALJs on the other hand have (of course) found that the statutory scheme governing the ALJ removal structure is constitutionally sound and that they do not have the authority to decide whether the SEC's use of APs is unconstitutional.[14]

A recent decision issued, however, may finally provide AP respondents some avenue to challenge the use of APs in the Appointments Clause of Article II. In *Hill v. SEC*, Case No. 15-01801, a federal judge in the Northern District of Georgia granted a preliminary injunction enjoining an AP, holding that the hiring process for ALJs violates the Appointments Clause, which requires that "inferior officers" of the executive branch be appointed by the President, Article III courts, or Department Heads. Because the ALJ in *Hill* was found to be an "inferior officer" and, like all SEC ALJs, was hired by the SEC's Office of Administrative Law Judges through a bureaucratic hiring process (and not "appointed" by the President, an Article III court, or a Department Head), the AP was found unconstitutional.

Several complaints making the same challenges remain pending around the country, including one by private equity queen Lynn Tilton and her firm Patriarch Partners, who is the subject of an AP alleging violations of the IA Act (Case No. 15-02472, S.D.N.Y.). However, whether they succeed will depend on whether the respective courts find that (1) there is subject matter jurisdiction to hear the constitutional challenges and (2) SEC ALJs are "inferior officers." Court decisions on whether there is subject matter jurisdiction to hear constitutional challenges to APs have varied. In *Bebo v. SEC*, Case No. 15-0003 (Mar. 3, 2015) for example, a federal court in Wisconsin dismissed the plaintiff's claims that Dodd-Frank's grant upon the SEC of unfettered discretion to forum select violates equal protection and due process rights, holding that such claims were "subject to the exclusive remedial scheme set forth in the Securities Exchange Act." However in *Duka v. SEC*, Case No. 15-00357 (Apr. 15, 2015) a federal court in New York held that there was subject matter jurisdiction to hear the plaintiff's claims that the dual for-cause protections afforded to ALJs violates the separation of powers doctrine (and instead denied the plaintiff's motion for an injunction on its merits). Notwithstanding the *Duka* decision, the SEC in *Tilton* continues to argue that the court does not have jurisdiction to hear Tilton's constitutional claims.

Recent cases out of New York suggest that the main obstacle faced by plaintiffs will be whether SEC ALJs are considered "inferior officers" as the *Hill* court in Georgia held. In both *Duka* and *Tilton* the SEC has filed a statement challenging the *Hill* decision that SEC ALJs are inferior officers, arguing that an ALJ is a "mere employee." Notably, the SEC in *Duka* has also stated, in response to the court's questions concerning whether the appointments clause violation could "easily be cured," has stated that it has no intention of changing the ALJ hiring process.

The criticisms, however, may not have fallen on deaf ears. On June 4, 2015, ALJ James Grimes found that investment advisor The Robare Group and two of its principals did not violate the IA Act by failing to disclose a compensation arrangement tied to investments in certain mutual funds, holding that the SEC's disclosure requirements were difficult to interpret and that the respondents' good faith reliance on their compliance experts relieved them of liability.[15] That same day, the SEC, in response to complaints made in a separate proceeding involving private equity firm Timbervest, LLC, that the ALJ was unfairly biased towards the SEC, invited the ALJ to submit an affidavit addressing whether he has experienced any pressure to rule in the commission's favor.[16] Timbervest is currently appealing the ALJ's $1.9 million judgment against it and, in addition to challenging the ALJ's impartiality, has argued that the AP against it is unconstitutional.

Perhaps in response to complaints that the SEC has unfettered discretion to choose between an AP and federal court, the SEC in May 2015 issued its first formal guidance on the factors determining whether contested actions will be brought before administrative law judges or in federal district court. This guidance acknowledges the differences between the procedural and evidence rules applicable to APs and those applicable in the federal courts, and arguably encourages the Enforcement Division to consider whether the facts and circumstances of the particular case suggest that fair resolution of the case requires the use of one set of rules over the other—*e.g.*, whether witness testimony that is critical to fair resolution of the matter may be compelled in one forum but not another.[17]

As recently as May 2015 the SEC issued warnings to the private equity industry to expect more fines and enforcement actions coming from the SEC in the next year, particularly involving undisclosed and misallocated fees and expenses as well as conflicts of interest.[18]

The past year has seen a number of these types of enforcement actions via APs, with varying results.

For example, in early 2014 the SEC commenced an AP involving Clean Energy Capital, LLC for, among other things, allocating certain expenses to the PE funds it sold and managed without adequate disclosure to investors, issuing loans to those funds on terms beneficial to itself without notice to investors, and changing distribution calculations without notice to investors. The respondents ultimately paid $2.1 million in disgorgement and civil penalties to conclude the proceedings. In a separate matter, PE fund adviser Lincolnshire Management, Inc. agreed to pay $2 million in disgorgement and penalties to avoid an AP arising from its alleged misallocation of expenses between two portfolio companies owned by separate funds. And, investment advisory firm WestEnd Capital Management, LLC paid $150,000 to prevent the SEC from bringing an AP involving its collection of excessive fees from a hedge fund it managed.

Investment advisor Paradigm Capital Management, Inc., paid $2 million in disgorgement and penalties to avoid an AP involving allegations that it caused a hedge fund client to engage in principal transactions with an affiliated broker dealer without providing effective written disclosure to the fund. In a separate matter, hedge fund advisor Structured Portfolio Management, L.L.C. paid a $300,000 civil penalty to avoid an AP concerning an "inadequately addressed" conflict of interest presented by its allowing a trader to trade the same securities across three hedge funds it advised. And, on March 30, 2015, after an investigation spanning over five years, the SEC commenced an AP against Lynn Tilton and her private equity investment firm Patriarch Partners, LLC relating to the valuation of fund assets and the fees collected as a result.

According to the SEC's most recent warnings, these cases may only be the beginning of the SEC's campaign to ensure compliance with its regulations throughout the PE industry. Although the SEC has acknowledged that it made "some progress" following its earlier warnings that the industry should expect greater scrutiny from regulators, it warns that there is "still room for improvement."[19]

Endnotes

1 May 6, 2014 speech of Andrew J. Bowden at the Private Fund Compliance Forum 2014, *available at* http://www.sec.gov/news/speech/2014--spch05062014ab.html.

2 Jan. 23, 2013 speech of Bruce Karpati at the Private Equity International Conference, *available at* http://www.sec.gov/News/Speech/Detail/Speech/1365171492120.

3 May 6, 2014 speech of Andrew J. Bowden at the Private Fund Compliance Forum 2014, *available at* http://www.sec.gov/news/speech/2014--spch05062014ab.html.

4 *See* Brian Hahoney, SEC Could Bring More Insider Trading Cases In-House, *available at* http://www.law360.com/articles/547183/sec-could-bring-more-insider-trading-cases-in-house (quoting a June 2014 statement from Andrew Ceresney, head of SEC's Division of Enforcement); Jean Eaglesham, SEC Is Steering More Trials to Judges It Appoints, *available at* http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it-appoints-1413849590 (quoting an October 2014 statement made by Kara Brockmeyer, head of the SEC's anti-foreign-corruption enforcement unit).

5 *Compare* https://www.sec.gov/news/studies/2010/34-61986.pdf *with* http://www.sec.gov/reportspubs/special-studies/34-73458.pdf.

6 Jean Eaglesham, SEC Wins With In-House Judges, *available at* http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

7 *Id*.

8 *Id*.

9 Jed S. Rakoff, Is the S.E.C. Becoming a Law Unto Itself?, *available at* http://assets.law360news.com/0593000/593644/Sec.Reg.Inst.final.pdf.

10 *See, e.g., Chau v. SEC,* Case No. 14-1903 (S.D.N.Y. Dec. 11, 2014).

11 *See, e.g., Bebo v. SEC,* Case No. 15-C-0003 (E.D. Wis. Mar. 3, 2015).

12 *See, e.g., Duka v. SEC,* Case No. 15-00357 (S.D.N.Y. Apr. 15, 2015).

13 *See, e.g., Bebo v. SEC,* Case No. 15-C-0003 (E.D. Wis. Mar. 3, 2015).

14 *See, e.g., In the Matter of Charles L. Hill, Jr.*, Admin. Proc. No. 3-1683 (May 14, 2015).

15 *In the Matter of The Robare Group, Ltd.*, Admin. Proc. No. 3-16047 (June 4, 2015).

16 *In re Timbervest, LLC, Admin. Pro. No. 3-15519 (June 4, 2015).*

17 Division of Enforcement Approach to Forum Selection in Contested Actions, *available at* https://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf

18 May 13, 2015 speech of Marc Wyatt, *available at* http://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html#_ednref10.

19 http://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html#_ednref10