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Implications Of The SEC's Recent Trial Losses

Law360, New York (February 05, 2014, 12:32 PM ET) -- Upon assuming office in 2013, U.S. Securities and Exchange Commission Chairwoman Mary Jo White and Enforcement Director Andrew Ceresney immediately set about emphasizing that the agency would be taking a much more aggressive stance on settlements. The shift was most evident in the agency's new policy of requiring settling parties to admit wrongdoing under certain limited circumstances.[1]

More generally, White has talked about the need "to be certain our settlements have teeth, and send a strong message of deterrence," including through the imposition of increased monetary penalties.[2]

Ratcheting up settlement terms will likely lead more parties to take their chances against the Enforcement Division at trial, a possibility the SEC seemed to embrace. White commented: "If, in fact, a result of our change in settlement policy results in more trials, one clear winner will be the administration of justice, which will always fare best in the open for the public to see and to take stock of what a defendant did and what its government is doing."[3]

She called the SEC's 80 percent success rate in trials over the past three years "impressive," especially given the limited trial tools available to the SEC relative to criminal authorities.

Notwithstanding this show of confidence, recent months have seen a number of significant trial setbacks for the SEC. Since October, the agency has lost four consecutive federal court trials, followed by what was, at best, a mixed verdict. These results raise significant questions both for the SEC and for those on the receiving end of SEC enforcement actions.

Recent SEC Trials

The SEC began fall 2013 on something of a high. In August 2013, following one of the agency's most closely watched trials of recent years, a federal jury found formerGoldman Sachs trader Fabrice Tourre liable on six of seven counts stemming from his role in the creation and marketing of mortgage-backed securities. Ceresney, then co-director of the Enforcement Division, proclaimed that the commission would "continue to vigorously seek to hold accountable, and bring to trial when necessary, those who commit fraud on Wall Street."[4]

Alas, the next five SEC trials ended with significantly different results.

1. SEC v. Cuban

On the heels of its victory in Tourre came a significant setback on Oct. 16 when, after five years of

litigation, the SEC lost its insider trading case against Mark Cuban. The SEC's lawsuit alleged that Cuban sold his stake in an Internet search firm after learning from the company's CEO of a planned private investment in public equity (PIPE) offering.

The company's stock price fell after the PIPE was announced, and Cuban avoided losses in excess of $750,000 by selling his shares prior to the announcement. Following a three-week trial, the jury found Cuban not liable for insider trading, concluding that the information Cuban learned from the CEO was not nonpublic and that Cuban had not promised to refrain from trading on it.[5]

Standing on its own, the Cuban case would not have been indicative of a broader trend in SEC litigation, as the agency had several strikes against it going into the trial. The facts of the case were arguably somewhat tenuous to begin with, leading the judge to grant Cuban's motion to dismiss (though that decision was vacated on appeal).[6]

The SEC's key witness did not testify. And the trial took place before a hometown jury, against a local celebrity. Nonetheless, the trials that followed seemed far more routine, yet found the SEC no more successful.

2. SEC v. Kovzan and SEC v. Jensen

Not long after the Cuban verdict, the SEC was handed back-to-back losses in two financial fraud cases. On Dec. 2, a Kansas jury found in favor of Stephen Kovzan, the former chief financial officer of website design company NIC Inc.

The SEC had sued NIC, Kovzan and the company's CEO (as well as other executives) in 2011, alleging that they made false and misleading filings by concealing nearly $1.2 million in perks paid to the CEO.[7] NIC and the other executives settled the SEC's claims for a combined $2.8 million, while Kovzan proceeded to trial. The jury unanimously found him not liable on all 12 claims against him.[8]

Two weeks later, after a nine-day bench trial, a Los Angeles district court found in favor of the former CEO and CFO of water purification company Basin Water Inc.

The SEC had alleged that the company engaged in sham transactions to boost its reported revenue.[9] The court ruled that no documentary evidence or witness testimony tended to show that the transactions were shams, and further found that the SEC failed to present any direct evidence that the defendants knowingly or intentionally misled anyone and that the SEC's position that scienter could be inferred from circumstantial evidence was "not persuasive."[10]

3. SEC v. Schvacho and SEC v. Yang

Hopes for a better trial record in 2014 were dashed in the first fortnight of the New Year, when the SEC failed to prove its insider trading claims in two more back-to-back cases. On Jan. 7, following a two-day bench trial in November, a George court rejected the case against Ladislav Schvacho, whom the SEC had alleged traded ahead of the acquisition of Comsys IT Partners Inc. based on information provided to him by Comsys' then-CEO, a longtime friend and business associate.[11]

The SEC contended that during the four-month period leading up to the acquisition, the two men socialized together and communicated regularly through phone calls and text messages, all of which were opportunities for Schvacho to learn information regarding the upcoming deal.

The court found that mere “access” to material, nonpublic information was insufficient evidence that Schvacho breached a duty of confidentiality owed to his friend.[12] The court scolded the SEC for “select[ing] an interpretation of the evidence that ignores other interpretations that discredit the SEC’s misappropriation theory in this matter.” The court further called the SEC’s interpretation of the evidence “overreaching” and “self-serving.”

One week later, a federal jury in Chicago found Siming Yang not liable for insider trading. In 2012, the SEC had filed an emergency action freezing the assets of Yang and several other Chinese citizens, alleging they had made substantial stock and option purchases in the days before the public announcement of a management-led buyout of a China-based company.[13]

While conceding that it had no direct evidence of a tip (and could not identify the source of the information), the SEC contended that the highly suspicious timing of the trades, coupled with steps Yang later took to conceal his trading, were sufficient to find him liable for insider trading.[14]

After just a few hours of deliberations, the jury rejected the insider trading claims. However, the jury found in favor of the SEC on separate charges (added in an amended complaint) that Yang had engaged in improper “front-running” by making personal purchases of the stock before trading on behalf of the investment fund he controlled.[15]

Possible Implications of the SEC’s Recent Trial Experience

Before considering the conclusions one can draw from this string of recent losses, it is important not to read too much into what may be a short-term setback for the agency. Cases investigated and litigated by the SEC are often notoriously complex. In contrast to the criminal authorities, the SEC does not have access to wiretaps and search warrants, and has less ability to secure the assistance of cooperating witnesses, and thus SEC actions are much more reliant on circumstantial evidence and inferences drawn from an at times-contradictory record.

Nonetheless, coming as they do just as the SEC is promising to impose tougher settlements, these recent losses do pose a challenge for the agency. One can anticipate several reactions from both the SEC and from individuals and companies who find themselves in the Enforcement Division’s crosshairs.

1. More Administrative Proceedings

One likely consequence may be an increase in the number of enforcement matters filed as administrative cease-and-desist proceedings rather than as federal district court actions. The SEC had already faced pressure to dodge the federal courts after a number of district court judges, most notably Judge Jed Rakoff of the Southern District of New York, began pushing back on SEC settlements and demanding party admissions or additional factual showings before approving settlement agreements. The difficulty of prevailing in litigated court actions will only increase this trend.

While it is unclear whether the SEC is generally more successful in administrative proceedings, there is at least a perception that the Enforcement Division finds a more receptive audience in front of administrative law judges employed by the agency. Indeed, of the four ALJ initial decisions issued between Oct. 29 and Dec. 21, 2013, following full hearings, the SEC prevailed in three.

Historically, the SEC faced statutory limitations in its use of administrative proceedings. While it could

secure significant relief against regulated professionals and entities such as brokers and investment advisers, some remedies were unavailable against individuals and companies not registered with the commission (including public companies and their executives).

However, legislative reforms have largely eliminated these impediments. Sarbanes-Oxley empowered the SEC to obtain officer and director bars in administrative proceedings, and Dodd-Frank similarly made monetary penalties available.

Increased use of administrative proceedings will have significant implications for parties to SEC actions. Beyond the potential "home court advantage" enjoyed by the SEC, respondents in administrative proceedings have greatly reduced discovery rights.

Even where discovery is available, administrative hearings are generally set on an expedited time frame, limiting the amount of discovery and preparation available to the respondents (whereas the SEC staff may have had several years to conduct its investigation before instituting the proceedings).

Moreover, respondents have no right to a jury trial in administrative proceedings. And the appeals process is much more challenging, as the appeal of an ALJ's decision is heard by the commission itself (which, of course, has already determined that there was a sufficient basis to authorize the Enforcement Division to commence the suit), and further appeal of an adverse commission decision to a federal court of appeals is subject to a highly deferential standard of review.

2. More Rigorous Case Assessment by the SEC

One immediate reaction to these litigation defeats on the part of some commentators has been to question the adequacy of the SEC's case-vetting process. Enforcement recommendations by the investigative staff are subjected to multiple layers of review before being authorized by the five commissioners (typically taking many months), and the various participants in this process consider litigation risk as a factor in their charging decisions.

However, the SEC's recent track record suggests that the agency's assessment of litigation risk is perhaps unduly optimistic, particularly when it comes to assessing the value of circumstantial evidence. Fairly or unfairly, the number of high profile criminal securities cases in recent years, aided by tools (such as wiretaps) not available to the SEC, may be leading judges and juries to heightened evidentiary expectations that the SEC is unable to meet.

One would hope that, at minimum, these trial setbacks would lead agency officials to a more realistic recognition of the hurdles that civil enforcement actions face when put in front of a judge or jury, and to modulate both their charging decisions and settlement demands accordingly.

On the latter point, an increase in both the number of cases being litigated, and the number of trial losses, may derive in part from the SEC's settlement inflexibility. The SEC has been known to demand as much in settlement as it could possibly recover if it were to prevail at trial. This posture is partly driven by a concern for consistency and avoiding precedents that could be cited against the agency in future cases.

And, of course, the agency is under constant political pressure to ratchet up its perceived toughness, often by those who do not recognize the challenges it faces as a civil agency enforcing a complex regulatory scheme. But given recent trial results, the agency could be better-served by taking a more

flexible charging and settlement approach, explicitly crediting litigation risks in appropriate cases.

3. Greater Inclination for Parties to Litigate

Finally, indications of a vulnerable SEC, particularly coupled with increasingly onerous settlement terms, may lead more parties to roll the dice and litigate. This is not necessarily a positive development for either the agency or individuals and companies subject to enforcement actions.

Notwithstanding White's extolling of the virtues of public trials, litigation comes at a tremendous resource cost to the SEC (which just recently saw its funding request slashed, leaving its 2014 budget essentially flat with 2013).

Litigating cases diverts manpower and other resources from new and ongoing investigations, exposing investors to risk. Likewise, while taking the SEC to trial may appear more appealing for defendants in light of recent cases, it is extremely costly; frequently, where indemnification agreements exist, it is the company (and its shareholders) who bear the cost for an individual choosing to litigate.

Even for those who ultimately prevail at trial, exoneration is hardly compensation for the financial and reputational costs they suffered over the intervening years. And thanks to the Internet, Google searches will continue to highlight the SEC's allegations long after they have been rejected by the court.

Conclusion

Few would deny that the interests of investors, and the safety of our capital markets, demand an aggressive SEC willing to take risks in pursuing alleged wrongdoers. Were the SEC to secure a 100 percent winning record, it would undoubtedly be criticized for not taking on more challenging cases.

But litigating cases comes at tremendous expense to both the agency and the parties it pursues. Moreover, for some parties — particularly regulated entities and public companies — the stakes of a trial loss are simply too high to risk litigating.

The repercussions of an adverse verdict, as opposed to a settlement agreement without an admission of wrongdoing, make litigation untenable. This creates a fundamental unfairness, with some parties essentially compelled to settle even where the odds of the SEC prevailing in litigation appear diminished based on recent experience.

For an agency that files more than 600 enforcement actions a year, a handful of trial losses may not lead to a massive rethinking of its enforcement approach. But recent setbacks provide an opportunity for the SEC to consider whether it has the leverage to back up its increasingly harsh settlement demands, and whether a more cautious assessment of litigation risk might better serve the interests of justice.

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[1] To date, two SEC settlements have included party admissions. For a more expansive analysis of the policy change and its implications, see Marc Fagel, The SEC's Troubling New Policy Requiring Admissions, Bloomberg BNA Securities Regulation & Law Report (June 24, 2013), available at www.gibsondunn.com/publications/Documents/Fagel-SECs-Troubling-New-Policy-Requiring-Admissions.pdf.

[2] SEC Speech, Chair Mary Jo White, Deploying the Full Enforcement Arsenal (Sept. 26, 2013), available at www.sec.gov/News/Speech/Detail/Speech/1370539841202.

[3] SEC Speech, Chair Mary Jo White, The Importance of Trials to the Law and Public Accountability (Nov. 14, 2013), available at www.sec.gov/News/Speech/Detail/Speech/1370540374908.

[4] Public Statement, Statement on the Tourre Verdict (Aug. 1, 2013), available at www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370539749266.

[5] SEC v. Cuban, Case No. 08-CV-02050 (N.D. Tex. Oct. 16, 2013).

[6] SEC v. Cuban, 634 F. Supp. 2d 713 (N.D.Tex. 2009), vacated and remanded, 2010 U.S. App. LEXIS 19563 (5th Cir. 2010).

[7] SEC Press Release, SEC Charges Government Website Provider and Four Executives with Failure to Disclose CEO Perks (Jan. 12, 2011), available at www.sec.gov/news/press/2011/2011-8.htm.

[8] SEC v. Kovzan, Case No. 11-CV-02017 (D. Kan Dec. 2, 2013).

[9] SEC Litigation Release, SEC Charges Two Senior Executives with Accounting Fraud at Southern California-Based Water Treatment Company (June 27, 2011), available at www.sec.gov/litigation/litreleases/2011/lr22014.htm.

[10] SEC v. Jensen, Case No. 11-CV-05316 (C.D. Cal. Dec. 10, 2013).

[11] SEC Press Release, SEC Charges Close Friend of Staffing Company CEO with Insider Trading Around Acquisition (July 25, 2012), available at www.sec.gov/News/PressRelease/Detail/PressRelease/1365171483454.

[12] SEC v. Schvacho, Case No. 12-CV-02557 (N.D. Ga. Jan. 7, 2014).

[13] SEC Press Release, SEC Freezes Accounts of Six Chinese Citizens and One Offshore Entity Charged with Insider Trading (Apr. 6, 2012), available at www.sec.gov/News/PressRelease/Detail/PressRelease/1365171488062.

[14] See Lance Duroni, Jury Mulls SEC Insider Trading Case Against Chinese Adviser (Jan. 13, 2014), Law360.

[15] SEC v. Yang, Case No. 12-CV-02473 (N.D. Ill. Jan. 13, 2014); see also Lance Duroni, Jury Clears Chinese Adviser on SEC Insider Trading Claims (Jan. 14, 2014), Law360.

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