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The Odds Are Stacked Against Insider Trading Defendants

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On Jan. 29, 2015, the U.S. Securities and Exchange Commission dismissed charges against Jordan Peixoto, an investor charged with "insider" trading in the stock of Herbalife Ltd. based on "inside" information about hedge fund manager William Ackman's (Pershing Square) negative position about the company. The commission's order granting the Division of Enforcement's motion to dismiss the proceeding against Peixoto cited the "unavailability" of material witnesses as a basis. Without question, Jordan Peixoto was relieved by the commission's decision. He firmly believed his actions did not violate the law. Like any falsely accused defendant, the process had been an ordeal.

The subsequent dismissal, approximately two months after proceedings were instituted, compels considering Peixoto in a broader context: whether the SEC administrative hearing process is appropriate for complex fraud claims. The small handful of courageous lawsuits filed in federal district court in the Southern District of New York against the SEC in 2014, including Stilwell v. Securities and Exchange Commission and Chau v. Securities and Exchange Commission, as well as Peixoto, brought a glaring light to the problem.

As a result, it appears that at least one commissioner, namely Michael Piwowar, in February 2015, acknowledged that there is a perception the SEC is taking "tougher cases to its in-house judges ... [and, therefore] should set out and implement guidelines for determining which cases are brought in administrative proceedings and which in federal courts."[1] In the words of Piwowar, the SEC enforcement program could benefit from "a look through the lens of fairness."

Whether that rebalancing occurs through congressional action or whether the commission is left to its own devices to effect more equitable changes in enforcement policy, or a combination of both, no effective public policy can be established without an honest evaluation of what has occurred. Piexoto illustrates the extent to which enforcement, at least pre-Newman, invented its own version of the law for insider trading cases, and used the administrative forum as a mechanism to stack the tables against defendants when it could not win under fundamental constitutional principles.

As Piwowar pointed out, announcement of the plan to increase the use of the administrative proceedings in insider trading cases followed the commission's loss in two insider trading cases in district courts. Regardless of

whether the circumstances are linked, the uproar that ensued is rooted in the fact that many experienced defense lawyers viewed the administrative hearing forum as inappropriate for insider trading cases, where the inherent need to ensure constitutional safeguards against the threat of overzealous government action is especially tested.

The administrative law judge must render a decision within 300 days from the complaint. The rules of evidence do not apply, which means hearsay can be admissible. Further, the defendant's right to discovery is more limited than in federal district court. The defendant whose life is about to be ruined, if not already by the mere commencement of the action, does not have equal rights to information that might prove his innocence. Practically everything about the administrative hearing is geared toward minimizing process, which is precisely the opposite of what is needed for punitive adjudications.

Insult is added to injury when Enforcement offers as rebuttal that an aggrieved defendant can submit claims of unfair treatment to the commission and, then, to district court after the case is over, in accordance with SEC's statutory process for "further review." This refrain rings hollow for any defendant bringing constitutional claims premised on equal protection of the laws, and the SEC knows it to be so.

In the Matter of Jordan Peixoto

On Sept. 30, 2014, Enforcement, following a multi-year investigation into potential insider trading in connection with the securities of Herbalife, filed an enforcement action against Jordan Peixoto as an administrative proceeding. The allegation was that Peixoto was tipped by his friend, FS, about Ackman's December 2012 public presentation regarding Pershing Square's negative view of Herbalife.

The SEC alleged that FS' roommate, an analyst at Pershing Square, was the source of the information. The roommate was not culpable; he had a "relationship of confidence and trust" through which the information was shared. FS breached that duty of trust with the analyst. In turn, Peixoto knew or should have known that FS breached a duty of trust when the information about Herbalife was shared with him. The SEC further alleged that FS received a personal benefit by gifting confidential information to his friend, Peixoto, and it was alleged that Peixoto obtained $47,100 in profits from trading on the information.

Analysis of insider trading actions commenced by the SEC since the enactment of Dodd-Frank in July 2010 (which empowered the SEC to seek civil penalties against nonregulated persons in administrative proceedings) showed that Peixoto was being treated differently. Since 2010, the SEC had filed every litigated insider trading case against "nonregulated" persons — like Peixoto — in district court, with only two exceptions.

First, in the SEC case against Rajat Gupta, the SEC withdrew the administrative case after the defendant challenged the SEC's choice of forum in district court in the SDNY. There, Judge Jed Rakoff denied the SEC's motion to dismiss and, over the SEC's objection, held that the court had jurisdiction to hear the claim. In the second exception, the defendant settled the SEC's charges before the matter went to a hearing. The remaining 156 nonregulated persons charged with insider trading and from whom the SEC sought civil penalties were all sued in district court. Based on the data, there was no rational basis for the SEC's disparate treatment of Peixoto, regardless of legal theory of insider trading liability, the defendant's citizenship, or amounts of money at issue.

The surge in SEC prosecutions filed as administrative proceedings, including Peixoto, appeared to be motivated solely to increase Enforcement's litigation advantage. Experienced counsel, including former SEC attorneys, complained that the use of the administrative hearing for complex cases had constitutional implications.[2] Ironically, informal discussions with counsel revealed that few were willing to litigate this issue with the SEC.

Attorneys were concerned that the SEC administrative law judges would penalize their clients for raising constitutional claims outside of the administrative hearing process prior to conclusion of the case. After all, in court filings, the SEC had repeated endlessly that defendants, regardless of circumstance, must exhaust the statutory administrative process before they can seek judicial review, and only then to a federal court of appeals.[3]

On the law, the SEC defense of the statutory scheme must be viewed with a jaundiced eye. The SEC does not have exclusive jurisdiction over challenges to SEC-related actions. A lawsuit challenging any action by the SEC may be brought in any court of competent jurisdiction if the statutorily provided review of final SEC orders by the court of appeals is in some relevant way inadequate: (1) where the administrative process forecloses all meaningful judicial review; (2) the claim is wholly collateral to the subject statute's review provisions; and (3) the claims are outside of the agency's expertise.

This framework for review by an Article III judge is critical to due process because the SEC Rules of Practice do not provide for a counterclaim. An SEC ALJ cannot provide defendants with relief on constitutional claims, even if the defendant makes a record by raising those claims as an affirmative defense. These claims can only meaningfully be heard in federal court. Nevertheless, this fact has not prevented the SEC from espousing the sanctity of the statutory scheme, and doing so in response to the 2014 SDNY cases challenging the constitutionality of the administrative hearing process.

Evidence at the commission itself highlights that the likelihood of meaningful judicial review on constitutional claims raised during the administrative hearing to be improbable. In fact, in Peixoto, the ALJ — Judge Cameron Elliot — had already made clear in a prior proceeding in 2013 that an equal protection claim is not justiciable in the administrative proceeding.[4]

In Bandimere, the defendant raised an equal protection claim as an affirmative defense. Critically, in his decision, Judge Elliott wrote: "I have found no cases where the Commission or a Commission administrative law judge has found merit in an equal protection claim ... Such a finding presupposes that I have the authority to second-guess the Commission's decision to issue the OIP. I doubt that my authority extends that far ... I reject Bandimere's equal protection claim on the basis that I lack authority to afford him any relief on it."

If the defendant cannot get relief from the ALJ on a constitutional claim, or anywhere else within the statutory scheme, what sort of meaningful review is possible for a constitutional claim against the SEC that is brought within the administrative process? None.

Jordan Peixoto v. Securities and Exchange Commission

Few defendants can battle the SEC on two fronts simultaneously: both in the administrative process and in federal court. On the other hand, raising a constitutional claim against the SEC leaves the defendant with no alternative.

The Rules of Practice do not expressly permit an ALJ to stay the administrative proceeding, although an ALJ might do so in two circumstances: (1) where the parties have jointly requested one after agreeing to the terms of a settlement; or (2) a criminal prosecutor requests a stay. Otherwise, a motion for a stay must be filed with the five-member commission.[5] As a practical matter, a stay application to the commission under most circumstances is a "dead end."

Jordan Peixoto's only option for justice was to wage battle in two forums, and on Nov. 20, 2014, he

commenced an action against the SEC in the SDNY alleging two constitutional claims: (a) an Article II claim and (b) an equal protection claim. On Dec. 15, 2014, Enforcement filed its motion to dismiss the AP; prosecution of the first major insider trading case filed as an administrative proceeding in the post-Dodd Frank era had failed. The reasons for Enforcement's motion, aside from the stated reason, will never be fully known, including whether the SEC believed it might lose the Peixoto case under a Newman analysis.

On the other hand, Peixoto, like Stillwell and Chau, underscores the degree to which litigating against the SEC is a dramatically unfair fight. Even though there is no evidence that constitutional claims can be effectively heard, the SEC has repeatedly sought to uphold the statutory process that prevents claims from being removed from the administrative hearing forum.

Regardless of whether the administrative process has adequate rules and guidelines to manage complex fraud cases, the SEC publicly insists that it is a fair forum. At least one SEC commissioner has stepped forward as a lone voice pushing against the tide of an SEC administration that is earnestly seeking to boost its statistics.

The lesson for defense counsel is clear: complex fraud cases must be heard in district court until the SEC Rules of Practice change, and the only chance of that occurring is by filing a declaratory judgment action in federal district court alleging well-pled constitutional violations once an administrative proceeding is commenced.

—By Derrelle M. Janey and Robert C. Gottlieb, Gottlieb & Gordon LLP

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DISCLOSURE: Gottlieb & Gordon represented Jordan Peixoto in the SEC administrative proceeding alleging insider trading and, in turn, filed a case against the SEC in the SDNY alleging constitutional violations on behalf of Peixoto, including an equal protection claim.

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[1] Commissioner Michael S. Piwowar, Remarks at the SEC Speaks Conference 2015: A Fair, Orderly and Efficient SEC, Feb. 20, 2015, Washington, D.C.

[2] Russell G. Ryan, "The SEC as Prosecutor and Judge," The Wall Street Journal, Aug. 4, 2014 7:36 p.m. ET.

[3] See, e.g., In Wing F. Chau and Harding Advisory LLC v. Securities and Exchange Commission.

[4] In the Matter of David F. Bandimere and John O. Young, Release No. 507, 2013 WL 5553898 (Oct. 8, 2013).

[5] See SEC Rules of Practice, Rule 401.

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