

Client Alert

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Retroactive Application of Dodd-Frank in SEC Enforcement Proceedings

On March 1, 2011, the United States Securities and Exchange Commission (“SEC”) brought an administrative action against Rajat Gupta alleging that he provided material nonpublic information to Raj Rajaratnam (the founder of the hedge fund Galleon Management LP) that Gupta had obtained in the course of his duties as a member of the Boards of Directors of The Goldman Sachs Group, Inc. and The Procter & Gamble Company. On March 18, Gupta struck back against the SEC by filing a declaratory judgment action seeking an order that would (1) prevent the SEC from proceeding against him before an Administrative Law Judge (“ALJ”), and (2) declare that the enhanced civil penalty provisions of the Dodd-Frank Act may not be applied against him in a proceeding brought before an ALJ.

The SEC’s Expanded Administrative Powers

Prior to the enactment of Dodd-Frank, the SEC could not seek civil penalties in administrative cease and desist proceedings brought against unregistered individuals. Section 929P of Dodd-Frank expanded the SEC’s options, and in its first attempt to exercise its new powers against a high-profile defendant in an action related to the most significant insider trading case brought in decades, the SEC invited a firestorm of criticism. Because Gupta’s alleged conduct occurred prior to the effective date of Dodd-Frank, the SEC’s election to proceed administratively also squarely framed the issue of whether Section 929P may be applied retroactively.

Although there has been considerable commentary about the reasons underlying the SEC’s decision to bring the Gupta action as an administrative proceeding rather than by a civil complaint in federal District Court, the reasons for doing so are clear. First, the SEC would retain numerous procedural advantages in the administrative forum including: limited discovery; the unavailability of a jury; expansive admissibility of evidence due to the inapplicability of the Federal Rules of Evidence; a fast-track determination of the merits; and a friendly “court” at the first level of appeal – the very SEC Commissioners that authorized the administrative proceeding. Second, as Columbia Law School’s John C. Coffee, Jr. observed in an article published just one day before Gupta’s declaratory judgment action was filed,¹ by proceeding administratively, the SEC successfully avoided appearing in the courtroom of United States District Judge Jed S. Rakoff

¹ John C. Coffee, Jr. *The 'Inside Baseball' of Insider Trading*, N.Y.L.J. March 17, 2011, at 5.

who last year sharply criticized the SEC for its handling of a settlement with Bank of America.²

Gupta has now put the SEC in exactly the forum it sought to avoid – Judge Rakoff’s courtroom – and has teed up the issue of the retroactive applicability of Section 929P of Dodd-Frank in an appealing package.

Gupta makes a compelling argument. He notes that the SEC filed all other Galleon-related actions as federal court complaints before Judge Rakoff, and argues that the SEC has unconstitutionally singled him out by proceeding in a forum that denies him a right to a jury trial and the other procedural safeguards described above.³ Gupta alleges further unfairness by the SEC, which apparently invited Gupta to make a “Wells submission” without informing him that the SEC intended to proceed against him administratively and in a manner different from all other Galleon defendants, thereby denying him the opportunity to address the SEC’s forum shopping prior to being charged.

The merits of Gupta’s claim are less clear. To date, no court has determined whether Section 929P may be applied retroactively to conduct that pre-dates the effective date of Dodd-Frank. Neither the statute nor the legislative history is clear, and recent decisions addressing other parts of Dodd-Frank are not uniform in result.

On March 1, 2011, U.S. District Judge Douglas P. Woodlock issued an order in *Pezza v. Investors Capital Corp., et al.*, Civ. No. 10-10113, in which he determined that the ban on pre-dispute arbitration agreements imposed by Dodd-Frank regarding Sarbanes-Oxley whistleblower protection does apply retroactively. In *Pezza*, the plaintiff brought an action in federal court claiming that his former employer had retaliated against him in violation of the Sarbanes-Oxley Act’s whistleblower protection. Defendants claimed that his employment agreement required that he arbitrate such a claim, and moved to compel arbitration. While that motion was pending, Section 922 of the Dodd-Frank Act enacted a bar to such pre-dispute arbitration agreements, and the plaintiff raised that bar as a defense to defendants’ motion. The Court conducted a retroactivity analysis following the Supreme Court’s decision in *Fernandez-Vargas v. Gonzales*, 548 U.S. 30, 37-38 (2006) and determined that: (1) Congress had not made its intent clear; and (2) retroactive application would not prejudice the defendants merely because *Pezza*’s claim would be heard by a court rather than by a FINRA arbitration panel. In so ruling, the Court explicitly rejected an argument that had been accepted in *Riddle v. Dyncorp. Int’l, Inc.*, 733 F. Supp. 2d 743, 747-48 (N.D. Tex. 2010)—that Congress had made clear its intent that

² See *SEC v. Bank of America Corp.*, 653 F. Supp. 2d 507, 510 (S.D.N.Y. 2009).

³ Gupta points out that both immediately before and immediately after filing the administrative action against him, the SEC had filed insider trading complaints in federal court.

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Dodd-Frank only apply prospectively by specifying that the Act would not take effect until one day after its enactment.⁴

On balance, in light of the diminution of his rights were the SEC permitted to proceed administratively, it appears that Gupta may have the better of the argument. Moreover, in the absence of clear authority to the contrary, one might expect the Court to err on the side of requiring that this high-profile case, which is closely related to other matters pending before the Court, be brought as a related civil proceeding. No matter what the Court decides with respect to Dodd-Frank's retroactivity, Gupta has used this action to cloak himself in the role of victim, to undermine the SEC in the eyes of Judge Rakoff, and to plant seeds of doubt in the court of public opinion about the strength of the evidence against him.

Implications

Before Dodd-Frank, the SEC was required to proceed in federal court to seek penalties against an unregistered individual (anyone who did not work at a brokerage firm, investment bank, or mutual fund already regulated by the SEC). The SEC is now able to bring such cases before its own administrative law judges and can also seek monetary penalties—not just disgorgement of illicit profits. The regulator can also go after any public company—and its current and former officers—that the SEC believes has violated federal securities laws. The lawsuit filed on March 18 will determine whether the SEC may use its expanded administrative powers to redress conduct that occurred even before Dodd-Frank was enacted.

If you have clients who are or may be under investigation by the SEC, or for further information about the firm's experience and practitioners who specialize in SEC enforcement matters in federal courts and administrative proceedings, please contact the Baker & McKenzie attorney with whom you work or Marc Litt at marc.litt@bakermckenzie.com or Barrie Brejcha at barrie.brejcha@bakermckenzie.com.

⁴ Interestingly, an Administrative Law Judge relied precisely on that language to hold that the SEC's Office of Compliance Inspections and Examinations could not rely on Section 929I of Dodd-Frank to resist production of documents in response to an administrative subpoena issued before the effective date of Dodd-Frank. See *In the Matter of Morgan Asset Management, Inc., et al.*, Admin. Proc. Rulings Release No. 659, Aug. 3, 2010, at 2.