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Testimony
Before the U.S. House Committee on Financial Services
Subcommittee on Capital Markets
Hearing on "SEC Enforcement: Balancing Deterrence with Due Process"

Nicolas Morgan
Founder and President
Investor Choice Advocates Network

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Chair Wagner, Ranking Member Sherman, and distinguished members of the Subcommittee on Capital Markets, my name is Nicolas Morgan, and I am the founder and President of Investor Choice Advocates Network, or ICAN. ICAN provides pro bono representation to small investors and entrepreneurs who could not otherwise afford counsel in SEC proceedings. I appreciate the opportunity to provide some observations about the way the SEC enforces the federal securities laws.

From my years as Senior Trial Counsel in the SEC's Los Angeles office, I appreciate the importance of the SEC's mission to protect investors. I was responsible for litigating some of the largest securities fraud cases on behalf of the agency up and down the west coast, including cases in Seattle, Portland, San Diego, and of course Los Angeles. From my years as a partner in the securities enforcement practice of two different multinational law firms, I gained further perspective, which led me to found ICAN, leave my law firm partnership, and devote myself to serving people at no cost who are facing SEC enforcement proceedings but who cannot afford counsel. There is a large demand for ICAN's pro bono legal services.

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I will discuss what is often[1] referred[2] to as regulation by enforcement,[3] but that might more properly be called shadow rulemaking because it involves changes in policy on a piecemeal, case-by-case basis without the transparency and public input that accompany rulemaking.

But I will not remark on the legality of regulation by enforcement or its impact on companies or industries – although those are genuine concerns that should be addressed. Instead, I will address regulation by enforcement through the experience of ordinary people not accused of fraud or of harming investors, specifically two of ICAN's clients, Eric and Joseph. Both Eric and Joseph are facing the harmful legal uncertainty created by the SEC's regulation by enforcement policy. Specifically, federal appellate courts in New York and the District of Columbia have ruled against certain SEC policies in cases brought in those circuits. But because Eric and Joseph live in Los Angeles, the SEC is pursuing its rejected policies against them, and the SEC will continue to shop its rejected policies around to

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[1] Chris Brummer, Yesha Yadav & David Zaring, *Regulation by Enforcement*, S. Cal. L. Rev. 1297, Vol. 96, No. 6 (2024).

[2] Peter Chan and A. Valerie Mirko, Recommendations to the SEC to Modify its Procedural Framework to Prevent Regulation by Enforcement, The Financial Services Institute (Jan. 2024), available at https://financialservices.org/fsi-releases-recommendations-to-sec-on-preventing-regulation-by-enforcement/

[3] Tom Brown, *SEC v Coinbase—the Black Knight, Bosses, and the Limits of Regulation by Enforcement*, The Financial Columnist, (2024) (discussing how a recent court decision demonstrates the limit of the SEC's effort to achieve regulatory objectives in the digital asset industry through enforcement), available at https://financialcolumnist.com/?view=article&id=17&catid=17.

different courts in an effort to obtain a ruling more to the SEC's liking. ICAN submits that if a federal appellate court rejects an SEC policy, the SEC should not continue to pursue that policy in other courts until it finds a judge who will rule in its favor.

Eric's Story[4]

Eric's encounter with the SEC began over 10 years ago and is a story of an average financial services professional whose life has been destroyed after he inadvertently ran afoul of the SEC while simply doing his job. Eric's is a story of how the SEC has spent more than 10 years and untold millions of tax dollars investigating and pursuing a case that involves no allegations of investor harm or fraud by him. It is a story that illustrates the dangers of an unrestrained government agency that is increasingly willing to use its inexhaustible resources and punitive powers to expand its scope and reach.

To understand how regulation by enforcement has impacted Eric's life, we first have to go back more than 30 years to a time decades before the SEC sued Eric when a new financial instrument[5] was becoming popular. At the time in 2012, the SEC was trying to determine whether or not it had jurisdiction over this particular instrument. The SEC's jurisdiction turned on whether the instrument was a security. Rather than propose a rule, in 2012 the SEC filed a lawsuit. The case found its way to the D.C. Circuit Court of Appeals,

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[4] *Beware of Double Jeopardy in SEC Proceedings*, ThinkAdvisor, (May 2, 2024), available at https://www.thinkadvisor.com/2024/05/02/beware-of-double-jeopardy-in-sec-proceedings-sec-roundup/?cmp_share.

[5] The instruments were fractional life settlement arrangements, but similar stories could be told about other financial instruments.

and, in a lengthy decision, the D.C. Circuit determined the SEC did not have jurisdiction over this financial instrument. The SEC asked the D.C. Circuit Court of Appeals to reconsider, but the court denied the SEC's petition for rehearing on the issue, affirming that the SEC did not have jurisdiction over the instrument.[6] Case closed.

But the beauty of regulation by enforcement from the SEC's perspective is that if one court (even a court as distinguished and important as the D.C. Circuit Court of Appeals in an opinion written by a Supreme Court nominee) tells you you don't have jurisdiction, you can simply shop your case around to different forums until you find a judge who agrees with you. And that's what the SEC did with Eric years later.

Flash forward to 2014, when Eric worked as a sale agent for a company selling the same financial instrument the D.C. Circuit Court of Appeals previously told the SEC it had no jurisdiction over. In 2015, after a lengthy investigation, the SEC sued the company, its founder, and other personnel, including Eric, in federal court in Los Angeles, asserting jurisdiction over the instruments, alleging that the instruments should have been registered under the federal securities laws and that Eric should have been registered as a securities broker.

In filing suit, the SEC did not allege that any investors were harmed by Eric or that any investor had complained about Eric. The SEC did not allege that Eric committed fraud. As a sales agent, Eric (a non-lawyer certified to sell insurance products under California

[6] *S.E.C. v. Life Partners*, 102 F.3d 587, 588 (D.C. Cir. 1996).

law) had no reason to believe he was violating any law. In fact, his employer and the employer's counsel told Eric the instruments were not securities and did not need to be registered. In its lawsuit against Eric, the SEC was seeking nearly $1 million from Eric in disgorgement and prejudgment interest[7], which would be financially ruinous for any person of ordinary means, and Eric did not have the luxury of settling to escape the ire of the SEC because of the financial and professional impact such a settlement would require.

Although the federal judge initially assigned to the case denied the SEC's request for a preliminary injunction at an early stage of the case (citing the D.C. Circuit's ruling from years earlier), ultimately, after eight years of litigation, the SEC's regulation by enforcement forum shopping strategy paid off. Acknowledging that Eric did not act with fraudulent intent and acknowledging the 30-year-old ruling from the D.C. Circuit finding the SEC did not have jurisdiction over the instruments, in 2023 the federal court nevertheless found Eric liable for non-fraud registration violations and entered a permanent injunction against him. Thankfully, the judge did not totally agree with the SEC's request for monetary relief, and "only" required Eric to pay a quarter of a million dollars in disgorgement and penalties. As a 60-year-old whose career and employment prospects had been decimated by his years-long litigation with the SEC (and who is financially responsible for his children and elderly mother), Eric did not have the means to pay even a fraction of that amount. Moreover, the

[7] While the SEC did not specify what penalty amount the District Court should impose, the SEC encouraged the Court to apply the maximum $7500 first tier penalty to each of "scores" of individual transactions, creating a potential penalty exposure of hundreds of thousands of additional dollars.

federal court injunction caused Eric to be designated a "bad actor" under the federal securities laws, restricting the capital-raising ability of any company that might want to employ Eric.

For those and other reasons, Eric had little choice but to appeal the federal court decision. That appeal is pending.

But the SEC was not yet done with Eric. Shortly after the federal court entered its obey-the-law injunction against Eric, the SEC began what the SEC calls a "follow-on" administrative proceeding in the SEC's own administrative "court."

Although the SEC could have asked (but chose not to ask) the federal court to include in its injunction restrictions on Eric's professional conduct, in the SEC's administrative home court the SEC Division of Enforcement has now asked the Commission to permanently bar Eric from associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized rating organization. For good measure, the Enforcement Division also asks the Commission to bar Eric from participating in the offering of any penny stock. Such bars (and the professional stigma of such bars) would obviously be the end of Eric's professional career in the financial services industry – a career that has spanned 30 years without incident until the SEC's lawsuit in 2015.

The doctrine of *res judicata* should preclude the SEC from pursuing bars that it failed to seek in federal court based on the exact same conduct. Beyond that objection, the administrative proceeding is a patently unfair denial of Eric's Due Process rights.

Imagine this: the critical issue in the proceeding will be whether barring Eric is in the "public interest." The judge who will decide this issue might under other circumstances have been an SEC-employed administrative law judge, but the SEC has not assigned an ALJ to Eric's matter probably due in part to the pending Supreme Court case, *SEC v Jarkesy*, in which the Court is considering, among other things, the constitutionality of SEC ALJs. As a result, the "judge" who will decide whether or not barring Eric is in the public interest is the SEC itself--the same SEC that approved the federal court litigation in 2015; the same SEC that has been Eric's adversary in federal court litigation for the last nine years; the same SEC that is currently Eric's adversary in his appeal; and the same SEC, sitting within the District of Columbia, that was divested of jurisdiction over the financial instrument at issue 30 years ago by the D.C. Circuit Court of Appeals. A "fair trial in a fair tribunal is a basic requirement of due process." *In re Murchison*, 349 U.S. 133, 136 (1955). The administrative proceeding against Eric is not a fair trial in a fair tribunal.

Joseph's Story

Joseph and his company are a frightening example of how easily a small entrepreneur can find themselves tangled up in the regulatory labyrinth of an overzealous SEC, and the power of that government agency to destroy lives over technical infractions.

Joseph is a Los Angeles entrepreneur who set out in 2014 to create a production studio that would provide film and television content for an underserved diverse urban audience. When, in 2016, the Obama administration announced its intentions to expand opportunities for startup businesses to raise much-needed capital through the JOBS Act,

Joseph was one of the first entrepreneurs to seize the chance to grow his business while giving members of his community the opportunity to put their money to work as investors.

A key provision of the JOBS Act waived the normally prohibitively high accreditation bar for investors wanting to support certain types of private startup businesses like Joseph's company. This meant average men and women would have the opportunity to invest in the early stages of a promising private venture, a privilege SEC rules had long limited to high-net-worth individuals. At first, Joseph's efforts provided a shining example of what is possible when small entrepreneurs and small investors aren't held back by unnecessarily onerous government regulation. In a relatively short period, Joseph was able to raise funds from hundreds of small investors – many of them middle-income Los Angeles residents who believed in the project's value and wanted to contribute to its success.

Then the SEC got involved. Because of an unintentional technical violation of an SEC registration requirement, which Joseph himself brought to the SEC's attention, the regulator threw the proverbial book at him. Without ever alleging that Joseph or his company had committed any type of fraud, harmed investors, or misused investor funds, the SEC ultimately took Joseph to federal court seeking a ruinous $1.6 million judgment that included the funds the company had raised, plus penalties and interest.

Despite facing the full force and weight of the federal government, Joseph did not back down. He fought the charges for years, spending thousands on legal fees. But by last year, he ran out of money. As a result, he lost his legal representation. The SEC quickly

moved to have the case terminated with a summary judgment that would have given the government a quick win without a trial. Without counsel, Joseph had little recourse. By December 2023, the judge in the case was prepared to rule in favor of the SEC, a move that would have bankrupted Joseph and his company with no input from the company's investors regarding the best use of their investment.

At the 11th hour, ICAN was able to step in and halt the SEC steamroller. Joseph will now have the opportunity to continue his fight with experienced legal counsel at his side.

In Joseph's case, the issue of regulation by enforcement arises in the way the SEC pursues disgorgement in the context of non-fraud allegations like those made against Joseph. Recently, courts, including the United States Supreme Court, have been critical of the SEC's usual approach to disgorgement,[8] particularly in cases (like Joseph's case) in which the SEC does not allege or prove that any investors suffered financial harm. In fact, last year the 2nd Circuit Court of Appeals specifically ruled against the SEC when it requested disgorgement from a defendant who had not caused any pecuniary harm to investors.[9]

But Joseph lives in Los Angeles rather than within the 2nd Circuit, so the SEC has taken the position that it remains free to ask the Court to impose a judgment requiring Joseph and his company to pay $1.2 million in disgorgement (and a further $132,000 in prejudgment interest) even though the SEC never alleged investor harm in its complaint,

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[8] *See, e.g., Liu v SEC*, 140 S. Ct. 1936 (2020).
[9] *SEC v. Govil*, 86 F.4th 89, 98 (2d Cir. 2023).

and never presented any evidence of investor harm in its motion for summary judgment or its remedies motion.

Rather than developing a uniform policy with regard to disgorgement in non-financial harm cases through rulemaking, the SEC appears perfectly willing to address the issue through piecemeal litigation on a case-by-case basis, where it is free to ignore adverse rulings in some jurisdictions to seek more favorable results in other jurisdictions. This completely arbitrary and unfair circumstance is a direct result of the SEC's enforcement by regulation approach to policy. The legal uncertainty created by the SEC's policy forces people like Joseph to engage in costly litigation that they cannot afford or otherwise face financial and professional ruin despite never having been accused of fraud or causing investor harm.

Conclusion

Among many problems, the SEC's regulation by enforcement policy causes legal uncertainty for ordinary people – including people not accused of fraud – who are forced to litigate policy matters on a case-by-case basis. Even when a federal appellate court rules against the SEC on a particular policy (such as whether an instrument is a security or whether disgorgement is available in the absence of pecuniary harm to investors), the SEC currently considers itself unconstrained to pursue such rejected policies in other federal courts until it finds judges who will rule differently. Ordinary Americans like Eric and Joseph pay the price for this forum shopping, and the rest of us face legal uncertainty and a lack of

transparency while we wait (sometimes decades) for the forum shopping to come to an end.

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Thank you for the opportunity to provide this information about the need for reform at the SEC to increase the agency's accountability and transparency, to ensure adequate input and analysis on its policies, and to hold the agency to high standards in the exercise of its functions. I welcome any questions that you may have.