Crypto Exec's Case Against SEC Shows Limits Of Admin Law

By **Steven Gordon** (November 4, 2021)

Steven Gordon

A South Korean executive made headlines when he and his company sued the U.S. Securities and Exchange Commission in Terraform v. SEC, seeking to quash two administrative subpoenas that were served on him at a cryptocurrency summit in New York City. This suit raises an interesting issue about whether the SEC violated its own rules in serving the subpoenas.

Ultimately, however, the suit illustrates why the Administrative Procedure Act often cannot be used to challenge actions by modern regulatory agencies like the SEC.

Background

Do Kwon is the co-founder and CEO of Terraform Labs Pte. Ltd., a company located in Singapore. Terraform Labs developed a public blockchain network and the Mirror Protocol, which enables trading of synthetic assets that mirror real-world assets, like stocks.

The SEC opened a formal investigation of the Mirror Protocol and contacted Kwon in May, seeking his voluntary cooperation with its investigation.[1] The SEC could not compel cooperation from Kwon or Terraform Labs because its subpoena power is limited to the U.S.[2]

Kwon and Terraform Labs retained U.S. counsel, Dentons, to represent both of them in connection with the investigation. Dentons asserted that the SEC lacks jurisdiction over Kwon and Terraform Labs. Nevertheless, Dentons negotiated an agreement with the SEC pursuant to which the agency interviewed Kwon via the internet in July.

Following the interview, the SEC requested that Kwon and Terraform Labs voluntarily produce documents. Dentons and the SEC had protracted discussions about the scope of the agency's document requests and about the status of Kwon and Terraform Labs.

SEC attorneys advised Dentons that they believed some sort of enforcement action against Terraform Labs was warranted and that cooperation would result in a lesser sanction. But they were unwilling to be specific about what sanction and remedial actions they had in mind.

On Sept. 17, Dentons contacted an SEC attorney and proposed that the parties set aside the issue of sanction and focus on the remedial actions that the SEC envisioned and whether they were technically feasible given the decentralized nature of the Mirror Protocol. The SEC attorney said he would discuss this proposal with his colleagues and get back to Dentons.

The SEC attorney did not advise Dentons that earlier that day he had signed subpoenas for Terraform Labs and Kwon, who was then visiting the U.S. On Sept. 20, these subpoenas were served on Kwon at the "Mainnet 2021" cryptocurrency summit in New York City where he was speaking.

Kwon and Terraform Labs responded by filing suit against the SEC in the U.S. District Court

for the Southern District of New York.

Their complaint alleges three claims under the APA:

1. That serving the subpoenas directly on Kwon violated the SEC's own rules regarding subpoenas and so is void;

2. That serving the subpoena on Kwon in public violated the SEC's rules about confidential investigations; and

3.That the SEC's conduct violated Kwon's and Terraform Labs' due process rights under the Constitution.

The suit seeks to have the subpoenas quashed and declared null and void.

Analysis

Foreign nationals who enter the U.S. are subject to jurisdiction here if they are tagged with process or a subpoena during the course of their visit.[3] However, while tagging a corporate officer confers jurisdiction over that individual, it does not confer jurisdiction over the corporation.[4]

Thus, if service of the subpoenas on Kwon was valid, the SEC has secured jurisdiction over him personally, but not over Terraform Labs.

There is a substantial issue whether service of the subpoenas was valid.

The suit's lead claim is that service of the subpoenas was invalid because it violated the SEC's own rules. Service of subpoenas is governed by Rules 232 and 150(b), which in combination provide that whenever a person is represented by counsel who has filed a notice of appearance, service shall be made upon counsel, unless service upon the person represented is ordered by the commission or a hearing officer.[5]

The suit alleges that these rules were violated because Kwon and Terraform Labs were represented by Dentons, and because the commission itself did not order that service be made directly upon Kwon. This would appear to invalidate the service because it is hornbook law that an agency must follow its own regulations and that actions in excess of an agency's authority are void.

The SEC might counter that this claim applies the rules at issue in too literal a fashion, without regard to their evident purpose. The rules presuppose that counsel is authorized to accept the subpoena on a client's behalf. Otherwise, they would be commanding a futile action. Where, as here, the attorney is not authorized to accept service, these rules do not apply.

While the outcome of the suit's lead claim might be debatable, it raises a substantial issue. The suit's other two claims, however, have less substance.

The second count alleges that the SEC violated its rule protecting the confidentiality of investigations by serving Kwon in a public locale. That rule says that "[u]nless otherwise ordered by the Commission, all formal investigative proceedings shall be non-public."[6]

Courts have held that the rule is an exercise of the SEC's discretion to decide how much

information to disclose about its investigations and that it confers no rights on other parties.[7]

The third count alleges simply that the SEC's conduct violated the due process clause. This claim adds nothing to the first two claims because the process that Kwon and Terraform Labs are due here is determined by the SEC's rules.

The suit is nonetheless subject to dismissal.

Regardless of the merits of the suit's claims, however, it faces dismissal. This is because SEC enforcement actions are not amenable to judicial review under the APA.

The APA waives the sovereign immunity of the U.S. and provides a cause of action for individuals aggrieved by agency actions to seek judicial review. It authorizes federal courts to invalidate actions that are inconsistent with an agency's authority, or are otherwise contrary to law or are arbitrary and capricious. But judicial review under the APA is unavailable when another statute precludes such review either expressly or by implication.[8]

The U.S. Court of Appeals for the Second Circuit explained that this exclusion limits the APA's applicability to modern regulatory agencies. In the 1983 decision in Sprecher v. Graber, the court said "The legislation establishing the authority of such agencies usually defines the scope of judicial review over their actions and sovereign immunity will generally continue to bar other kinds of lawsuits against them."[9]

Only where there are omissions or gaps is the judicial review provisions for these agencies would the APA apply.[10] In contrast, the APA applies generally to the older executive departments, such as the U.S. Department of State, U.S. Department of Defense, U.S. Department of the Treasury, U.S. Department of Justice, U.S. Department of the Interior and U.S. Department of Agriculture, which lack their own judicial review provisions.[11]

The case before the Second Circuit involved an attempt to challenge an SEC subpoena pursuant to the APA. The court noted that the agency's statutory scheme made its subpoenas unenforceable absent a court order.[12] Congress provided for judicial review of SEC subpoenas if and when the agency asks a court to enforce them.

Consequently, this is the exclusive method by which the validity of SEC investigations and subpoenas may be tested in the federal courts.[13] Accordingly, the court affirmed the dismissal of the APA claims in that case.

In the current case, the SEC has not yet attempted to enforce the subpoenas it served on Kwon. If and when it does, Kwon and Terraform Labs can contest the validity of the manner in which the subpoenas were served. But until then, they cannot invoke the APA to expedite their challenge to the subpoenas.

This case illustrates why the APA is seldom invoked as a method of contesting SEC investigative steps. More generally, it illustrates an important limit on the applicability of the APA as a tool for challenging agency actions.

Anyone contemplating an APA suit against a federal agency must consider whether Congress has provided for judicial review of the agency's actions in a manner that precludes review under the APA.

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[1] Complaint, Terraform Labs Pte. Ltd. v. U.S. Securities and Exchange Commission, Case No. 1:21-cv-08701 (S.D.N.Y.).

[2] 15 U.S.C. § 78u(b).

[3] See First American Corp. v. Price Waterhouse LLP , 154 F.3d 16, 20 (2d Cir. 1998).

[4] See Martinez v. Aero Caribbean , 764 F.3d 1062, 1068-69 (9th Cir. 2014).

[5] 17 CFR §§ 201.232(c), 201.150(b).

[6] 17 CFR § 203.5.

[7] See Marshall v. Galvanoni , 2019 WL 803895, at *2-3 (E.D. Cal. 2019).

[8] 5 U.S.C. § 702.

[9] Sprecher v. Graber , 716 F.2d 968, 974 (2d Cir. 1983).

[10] Id.

[11] Id. (quoting the legislative history).

[12] See 15 U.S.C. § 78u(c).

[13] Id. at 975.