

The Growing Use of SEC Administrative Proceedings: An Historical Perspective from Congress and the Agency

by

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Thank you, Brad [Bondi], for that kind introduction. Your own leadership and dedication at the SEC are exceptionally admirable. Thank you for your public service in Washington, and most recently, for your hard work and energy in making today's Forum such a huge success.

This is a remarkable assemblage of securities enforcement talent. It is especially a pleasure to see so many SEC alums from my time as Chairman, including of course Brad Bondi, Michele Wein Layne, Marc Fagel, Randall Lee, and Helane Morisson – not to mention my partners and colleagues since I rejoined the private sector who are presenters today, including Hardy Callcott and Susan Resley. And of course I should single out Joe Grundfest, who casts a long shadow across America's securities practitioners from his posting here on the West Coast – and who was a Commissioner way back in the 80s when I worked in the White House. Joe has been a constant source of support for the agency ever since.

I applaud all of you who are here today, and in particular those of you who organized this Forum. It's a vitally important topic at a vitally important time. And, I should add, in a vitally important place. Seventy-five million people live west of the Mississippi, and sometimes Washington, DC seems light years away. It is entirely appropriate that these fora are conducted here in California, just as they routinely are in Washington and New York.

This kind of high-level interchange among the securities bar, the SEC's current leadership, and its loyal alumni can be an exceptionally valuable way for all sides in enforcement litigation to learn from one another. That's particularly true since the SEC has grown so substantially in just the last few years, as have its statutory authorities.

In my brief remarks this afternoon, I'm going to address a topic that I know everyone here is interested in: the questions that have arisen over the SEC's expanded use of administrative proceedings.

These questions are interesting both because they are practical in nature – all of the practitioners here are keenly aware of recent developments in this area – and because they raise fundamental issues of law and policy that go to the heart of what is meant by separation of powers in our constitutional system.

The most interesting and practical questions about APs are not constitutional in nature, however, but normative. What *should* be the role for the agency's own adjudicatory proceedings? When are we comfortable with APs supplanting the normal workings of the U.S. civil justice system?

In expanding the role and authority of an agency with such broad reach as the SEC, policy makers need a framework. But it is fair to say that Congress, at least, has not thought deeply about this (at least not until very recently). Administrative agencies started cropping up in the late 19th century – the Interstate Commerce Commission being the original one, during the first Cleveland administration. The ICC itself is now long gone: as a Member of Congress, I voted to abolish it in 1995. But across the board, the role of administrative agencies has been growing uninterrupted for over a century. Their most notable impact has been their ever-increasing assumption of the role previously played by the courts.

Along with the expansion of the administrative state during the 20th century, and through the first decade-and-a-half of the 21st, we've seen the development of administrative actions that take the place of trials. These proceedings bear little resemblance to civil courts, and their accustomed rules of civil procedure.

The impetus for this significant shift of enforcement activity away from the federal courts has for the most part come from within the agencies themselves. Congress has been largely absent from the field, as agencies have used their rulemaking powers to maximum effect. What's more, the agencies themselves have provided the thought leadership. It is they who have constructed the rationales, and satisfied themselves with the tradeoffs between efficiency and fairness.

When Congress has played a role, it has typically been to graft some discrete incremental authority onto what's already there, usually at the agency's own request. There has been little in the way of policy development through educational hearings, or considered congressional

analysis of how the Article III courts should interact with the quasi-judicial functions of the so-called fourth branch.

For example, as we have seen with the SEC, Congress has on occasion added new remedies on the administrative side. So, in 2002, Congress added Section 1105 to the Sarbanes-Oxley Act, authorizing the SEC to obtain officer and director bars in administrative proceedings. Likewise, in 2010, Congress added Section 929P(a) of Dodd-Frank, expanding the SEC's authority to impose monetary penalties in an administrative proceeding. This particular provision of Dodd-Frank was not even debated in either the House or the Senate consideration of the bill. It was simply the rote enactment of one of several items on the SEC's legislative wish list. There is no evidence that this was part of a carefully considered congressional architecture thoughtfully allocating responsibility between agencies and the courts.

There is an institutional reason for this. In both the House and the Senate, jurisdiction over the U.S. civil justice system rests with the Judiciary Committees. Authority over the SEC, on the other hand, rests with the Banking and Financial Services Committees. If Congress were actually to have a plan to transfer responsibility from Article III courts to administrative agencies, the Judiciary Committees would have a lead role. But as we well know, the repeated statutory expansions of the SEC's power to use administrative proceedings have not been the product of those committees.

The most significant expansion of AP authority in the SEC's 81-year history – the aforementioned Section 929P(a) – was largely the work of the Banking and Financial Services Committees. The Chairmen of those Committees, in turn, served as Co-Chairs of the House-Senate Conference Committee. When the House appointed conferees on Dodd-Frank to work out differences with the Senate, the representatives from the Judiciary Committee weren't even given authority to negotiate over Sec 929P(a). It was outside their scope. Yet the enactment of this provision created the potential for the wholesale substitution of administrative proceedings for civil actions whenever the SEC is seeking monetary penalties.

And that is true even if the person charged is not a regulated entity, but just an individual U.S. citizen. Of course, in such individual cases, what is often at stake are a person's entire reputation and livelihood, not to mention the potentially enormous sums that can be demanded of her or him by way of penalties. We typically think of all of the protections that our civil justice system affords litigants as safeguards that will protect a

person's reputation, livelihood, and property if she or he is innocent. Such essentials of justice as the right to a trial by jury and the right to depose witnesses have previously been thought to be the bedrock of our conviction that parties sued by the government will ultimately be treated fairly. Those particular protections, of course, are denied to every litigant in an administrative proceeding.

There are some signs that Congress is now paying attention to how Section 929P(a) could be abused in practice if it is relied upon as a matter of routine. In the wake of the recent highly publicized actions of the SEC in bulking up on ALJs, and shifting more enforcement actions to APs instead of federal court, Congress has begun to ask questions. And it is using the hearing process to begin to explore these issues.

At a recent Senate hearing, the SEC Chair was asked whether a framework for the use of APs in lieu of civil actions could be made public. With either remarkable alacrity or superbly serendipitous timing, this past week the agency offered its first cut at an explanation. It came in the form of a four-page memo from the Enforcement Division staff, so it is not Commission-level policy, but it is an important start.

An examination of recent congressional hearings suggests this growing interest in the appropriate use of administrative proceedings isn't likely to abate. On at least a half dozen occasions since March of this year, Members on both sides of the aisle have leveled criticisms concerning the use of APs against non-registered individuals and entities.

But of course it was Congress itself that created this situation, by tucking Section 929P(a) into Dodd-Frank's 2,300 pages. So it has every reason to revisit that decision in the cold light of day. When it does so, it will confront the fact that the rapid growth in the number and kinds of administrative proceedings at the SEC has brought into sharp relief the fact that as an administrative agency, it uniquely exercises all three constitutionally divided powers.

It effectively legislates, through its congressionally delegated rulemaking authority. It also has plenary authority to investigate, execute, and enforce its rules. And to the extent it can adjudicate its own enforcement actions through administrative proceedings, it can interpret and enforce compliance with its own rules as fully as could the judicial branch.

When Alexander Hamilton described the judicial branch as the "least dangerous," he reasoned that it was such because the courts do not

have the powers of either the executive or the legislative branches. So the judiciary, as he put it, "has neither FORCE nor WILL, but merely judgment." The judicial branch "must ultimately depend upon ... the executive ... even for the efficacy of its judgments." One imagines that Hamilton, who was nothing if not a fan of government efficiency, would nonetheless be surprised indeed to see what has become of his theories.

Congress has not always neglected these questions when legislating the boundaries between the power of agencies and the courts. In particular, I recall as a Member of the House the legislative process that led to the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 – what today we all know as the "Remedies Act." This law significantly expanded the enforcement remedies available to the Commission in administrative proceedings. It gave the SEC the power to seek civil penalties through administrative proceedings, against persons and entities directly regulated by the Commission, such as broker-dealers and investment advisors. It also gave administrative law judges the power to impose those penalties.

What was key to that legislation, however, and what Section 929P(a) more recently has changed, is that when the Remedies Act gave the SEC the power to seek civil monetary penalties from issuers, it required that this be done in federal court. The final legislation did not include such penalty authority in administrative proceedings, precisely because Congress wanted to ensure that Article III judges would serve as an independent check. And that independent check, it was believed, was necessary not only to the agency's decision to seek a penalty but also to the amount that was being sought.

The issue for members of Congress – and, we were told, an issue within the SEC at the time – was that if the agency could obtain the same results in an administrative proceeding that it could get in federal court, then this would create a powerful incentive for the agency to conduct enforcement actions in-house, rather than bringing its cases before a federal judge. In that event, the independent check and balance would be lost.

It's also important to realize that Congress was then, and is now, well aware that even in those cases where the SEC *is* required to bring its complaints before a federal judge, its settled actions rarely receive any serious judicial scrutiny. So Congress was skeptical of wiping out what little independence remained in the process, recognizing that a significant shift of enforcement cases from the courtroom to

administrative proceedings would remove even the patina of separation from the SEC's internal machinery that then existed.

The fact that the settled action is the SEC's preferred technique in enforcement matters is highly relevant to this discussion. To fully appreciate the internal dynamic at the SEC when it comes to choice of forum, it is important to appreciate that it is settled actions, not trials, that are the norm. For this reason, many of the arguments about efficiency – and in particular, the argument that an AP will take only 300 days, while a federal trial can take three years – speak to the exceptional case, not the vast majority of them.

Already, the SEC's expanded use of APs is tipping the balance so that in the very near future, we can predict that over half of all enforcement actions could avoid the federal courts. The agency's reason for doing this is straightforward: it's faster. And that is absolutely true. In an AP, the whole thing normally does get wrapped up within 300 days, which would be very difficult to achieve in a civil trial.

In theory, a more efficient process for deciding cases should be better for both sides – because it's very costly for private litigants to defend themselves through the long period of time it can take to get to trial in federal court. This is undoubtedly true not just in theory but in practice in many cases, and in fact the Enforcement Division has been making this very argument for some months now. But of course it is not always so. Sometimes a litigant can feel strongly that she or he needs the protection of normal rules in court. Depriving a litigant of a jury trial is undoubtedly efficient, but it may not seem desirable to an individual who feels wrongly accused.

For Congress and the public, these are not so much constitutional issues of due process, as they are questions of the confidence Americans repose in the SEC's process. Most of the focus of this part of the argument has been on the perceived lack of independence of judges who work for the SEC itself. In fact, however, the administrative law judges unfailingly strive to be independent. The process by which they are hired is meant to insulate the Chairman, Commissioners, and agency management from direct involvement. This contributes to interesting and unresolved questions about whether ALJs are "officers of the United States," which could ultimately affect the viability of the arrangement. But that is a technical question, and not one of bias.

The more serious issue when it comes to the ALJs is what can be done about the perception. Because as critics from Judge Rakoff to various SEC Commissioners have pointed out, appearances matter. However independent they may strive to be, the ALJs are employed by the SEC, draw their paychecks from the SEC, work at SEC Headquarters, and have friends among the enforcement staff. None of these is necessarily disqualifying in a legal sense. But cumulatively they create appearance problems that will only grow as the agency leans more heavily on APs as a substitute for cases in federal court.

There is another aspect of the AP process that those who have not sat as appellate judges in SEC administrative proceedings may not fully appreciate. All of the women and men who have a vote on the appeal, and all of the people who prepare them to hear that appeal, wear the jersey of the home team. Most of them, like the ALJs themselves, try to put aside their pride in the agency and their confidence that the SEC is probably right, in order to objectively understand and present both sides of the case. But a federal judge, and the law clerks who work in the judge's chambers, don't have to strain at independence. They actually *are* independent. Unlike the Commissioners of the SEC, they have not previously voted on the record to bring this case in the first place.

A Chairman of the SEC, who hires and supervises the very enforcement team that is responsible for bringing the case, naturally reposes confidence in their judgment, and sincerely wishes for them to succeed. At staff meetings, the Chairman and Enforcement Division Director greet news of litigation victories with pride and enthusiasm – just as my partners at Morgan Lewis do now when we win a case. These are not just normal human reactions, but in major part the very job of executives leading a federal agency.

Litigants who choose to appeal an adverse judgment in an AP therefore get a very different experience than they would find in federal court. At a minimum, it *appears* to them and to the outside world that the process is much less fair.

Eventually, of course, a litigant who has been charged in an AP does get its day in court – on appeal from the appeal to the Commission. But then, it is too late to argue either the facts or the evidence. When it reviews a decision of the Commission on appeal from an initial decision of an ALJ, the federal appellate court accepts all findings of fact, unless they are not supported by substantial evidence – a very high bar indeed. The federal appellate court also accepts the SEC's own interpretation of the statutes it administers, and the agency's

interpretation of its own rules and regulations. The penalties imposed by the Commission are reviewed under the abuse of discretion standard – also a high bar.

One way to resolve these real and perceived issues of fairness – and the tensions between administrative efficiency, on the one hand, and the need for integrity and impartiality in enforcement, on the other – would be to take the underlying rationale for the expanded use of APs at face value. It is posited that the more spartan procedures in an AP – the limited discovery, shortened timeline, and skimpy rules of evidence – are good for both sides. It makes things faster. If that is so, then presumably both parties would agree to use an administrative forum, because both would be advantaged.

In that case, a party who is not a regulated person or entity and who is charged in an administrative proceeding could safely be given the right to remove to federal court. A party would not exercise this right unless it disagreed that the administrative forum was a benefit. Were such a system in place, the likely result would be a middle ground between the pre-Section 929P(a) world, and the brave new world of vastly expanded APs we are now expecting. Only if all non-regulated party litigants in APs were to elect removal would we wind up exactly where we started before enactment of Section 929P(a). But in practice, some of these litigants would – just as the SEC predicts – prefer the administrative route.

Such a procedure, of course, can only be designed by Congress. And that is one of several possible approaches the legislative branch may choose as it begins now to seriously examine this issue. In the meantime, it is up to the SEC to decide how to use its discretion. And that is why the recent staff guidance is such an important beginning, even if it leaves much to the imagination.

No one thinks APs should go away. Or at least, almost no one. They have been used for discrete purposes to good effect, for many decades. The pedigree of administrative actions and remedies in the context of regulated entities is long and venerable. The challenge arises when APs are used outside the realm of regulated entities.

The difference between the two categories isn't just the identity of the defendants. What traditionally has most clearly distinguished the AP from cases that until now have had to go to federal court is the remedy. Administrative remedies have historically been tailored to the regulatory needs and aims of the agency. In effect, form has followed function. As

a result, administrative remedies have for the most part been clearly distinct from the remedies available in federal court.

This distinction is especially important when it comes to the SEC, because of its routine reliance on settled actions in those cases when it does file in federal court. When the SEC uses the device of the settled action, in effect it is porting over to the agency the powers of the Article III branch. The case is resolved simultaneously with its filing, with only pro forma judicial involvement. This use of the civil courts is therefore itself a quasi-administrative proceeding, permitting the SEC to obtain judicial remedies without first having to go through a judicial proceeding.

Last week's staff memo impliedly acknowledges the important issues raised by the substitution of APs for civil trials, but it does not directly address them. The purpose of such staff guidance is presumably to clarify for the public what exactly will guide the agency in deciding to bring a case before an ALJ or a federal judge. But what the guidance actually says is that there is no formula dictating the choice of forum. That is essentially word for word from the memo.

There are a handful of factors listed which may or may not be taken into account. But we're then told that "Not all factors will apply in every case." Furthermore, the listing of some factors doesn't exclude other factors which aren't listed. So the actual factors that matter most in your case might not appear in this guidance at all.

It is not as if committing to the factors listed in the memo would pin the agency down. One of the factors, for example, is which "forum is best for [a] fair, consistent, and effective resolution." That is less an answer to the question at hand than a restatement of the question itself. There are still more equivocations. In any particular case, we are told, some factors may deserve more weight than others. So we should not be surprised, the memo warns us, if one factor is given more weight in case A and less in case B.

Finally, the guidance alerts us, we should be prepared to see some cases where a single factor all by itself is enough for the agency to choose an ALJ instead of a federal judge. Of course, given the previous caveats, that factor may not even be one of those listed in the guidance.

This is all straight out of the four-page memo. Perhaps there is within the agency a recondite source of inner guidance that will in fact routinize these decisions. If so, then that undisclosed template for

decision making should be made public. And if not, then the staff memo really amounts to an admission that there is thus far no objective standard for determining when cases that formerly would have gone to federal court will now be brought as APs.

Despite the fact there is virtually nothing in the staff memo that we can call a clear, objective standard, and therefore nothing that can help us confidently predict when the agency will choose one forum over another, the exercise was not without value. We have learned, for starters, that the SEC is only beginning to grapple with these questions. There is an internal discussion underway, as there always will be in an agency of so many lawyers. Undoubtedly some within the Enforcement Division would favor a resolution of these questions that is constructed from the accretion of cases that the agency will bring over the years under Section 929P(a). It is equally certain that others, including some members of the Commission who have spoken publicly on the question, would prefer a more transparent approach that avoids keeping the public in the dark for the indefinite future.

Because I know from experience the strengths and the limits of the administrative process, I personally hope the agency elects to reassure the public that APs will not be the “new normal.” It is simply a fact that administrative proceedings provide fewer protections to litigants than cases in federal court – and that substituting SEC internal proceedings for decisions by judges and juries will contribute further to the appearance of partiality that is already a genuine issue.

To summarize: The more slender protections for litigants in APs represent a tradeoff.

Experience shows that in entire categories of cases, such as with regulated persons and entities, the tradeoff can be worth it.

But now that Congress has given the agency virtually unbounded discretion to avoid having to try its cases in court, it is incumbent on the agency to show it can exercise that discretion wisely.

Despite its new guidance, it is likely that the SEC will continue to face these questions in the public square, in the Congress, and in the courts. The debate comes at a time when the securities regulator's role in policing the markets and protecting investors has never been more critical.

I know that the dedicated women and men of the SEC's enforcement staff are working around the clock to investigate and punish wrongdoing. I want to take this opportunity to thank those of you who are here today for what you do year in and year out to protect investors and our markets — and for making the extraordinary commitment of time and travel to participate in this important event. Through this continued cooperation, I'm certain that the SEC will be better able to fulfill its missions of investor protection and restoring market confidence.

So thank you, and congratulations on what's being accomplished here today. I look forward to seeing how these developments play out, and I have no doubt the results will be positive for investors, markets, and public confidence in the SEC itself.

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