The SEC's increased use of administrative proceedings in enforcement actions: background, controversies, and future outlook

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Abstract

Purpose – *To explain the background, controversy and possible future developments related to the US Securities and Exchange Commission's (SEC's) increased use of administrative proceedings (APs), rather than court actions, in bringing enforcement matters.*

Design/methodology/approach – *Discusses the SEC's historic forum selection process, the home court advantage APs may give to the SEC, changes the SEC has proposed to the Rules of Practice governing APs, arguments challenging the constitutionality of APs, a jurisdictional hurdle faced by respondents challenging APs before federal courts, and possible future developments.*

Findings – *Critics consider the SEC's expanded use of APs to be procedurally biased, unconstitutional, and unfairly advantageous to the SEC. In response, the SEC has offered guidance explaining its forum selection process, proposed procedural changes, and its belief that its systems are fair.*

Originality/value – *Practical guidance from experienced financial services and securities litigation lawyers.*

Keywords *Securities and Exchange Commission (SEC), Dodd-Frank Act, Administrative law judge (ALJ), Administrative proceedings (APs)*

Paper type *Technical paper*

Over the last two or so years, the US Securities and Exchange Commission (SEC) has found itself the target of mounting criticism surrounding its increased utilization of administrative proceedings ("APs"), rather than court actions, when it brings enforcement matters. In a number of recent federal court cases, respondents from across the country have challenged the procedural fairness of APs, the independence of the administrative law judges who run those proceedings, and the constitutionality of the forum itself. A lucky few have even found a billionaire benefactor in Mark Cuban who, after successfully defending himself – in court – against insider trading violations brought by the SEC, has seemingly dedicated himself (and his legal counsel) to filing amicus briefs in support of individuals who find themselves in a similar predicament in APs (but, presumably, lack billions of dollars to defend themselves). On the heels of these challenges, Congress summoned the SEC to testify about its use of APs and explain its forum-selection procedures.

In light of this recent flurry of scrutiny, it is easy to forget that the SEC has utilized administrative proceedings for decades. So, one may wonder why this relatively sleepy administrative forum has suddenly become the object of widespread controversy. The answer: the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). Before Dodd-Frank, the SEC could only bring limited types of claims against certain types of persons (essentially, persons registered with the SEC) in APs. That all

changed as a result of a provision buried in the 2,000-plus-page Act. To paraphrase greatly, Dodd-Frank allowed the SEC to initiate an AP against a much broader array of respondents, to allege a more diverse range of claims against them, and, in pursuit of those claims, to ask for new and greater penalties. Taking advantage of its new abilities post-Dodd-Frank, the SEC's use of APs rose rapidly – as, more importantly, did its win rate, which hovers around 90 per cent in APs (except in 2014, when it was 100 per cent).

Suddenly, the AP, which was originally designed to be a mechanism for quickly resolving smaller matters that, excuse the pun, no one wanted to make a federal case out of, became the forum of choice for bigger, longer, and more complicated disputes.

Critics challenge the SEC's expanded use of APs in several respects. Generally speaking, they are alleged to be procedurally unfair, biased, unconstitutional, or otherwise to provide the SEC's Division of Enforcement with a "home court advantage" over its opponent. The SEC, in response, has offered guidance explaining its forum selection process, proposing procedural changes, and reaffirming its belief that its systems are fair.

To understand the issue better – and help assess the SEC's response to the challenges raised – a brief overview of this history of the SEC's enforcement procedures helps to set the stage.

Forum selection, a brief history

Prior to 2010, the SEC could use administrative proceedings only to seek penalties against SEC-regulated persons or entities. As to any other type of defendant, its authority was limited to obtaining orders prohibiting future law or rule violations and/or seeking disgorgement (the return of improperly received funds). Statistically, prior to 2010, the SEC used APs for some of its smaller actions (like a books and records violations, for example). These types of rule violations were more conducive to administrative proceedings than federal court. APs offer respondents limited discovery and operate on an extremely truncated timetable – progressing from initial complaint to final order in less than a year – which far outpaces the average speed of a federal proceeding. For the most part, the limited need for (and procedures allowing) discovery and the fast resolution benefited both the Division of Enforcement (fast resolution) and the respondent (comparatively inexpensive).

In 2010, with the enactment of the Dodd-Frank Act, Congress vastly expanded the authority of the administrative tribunal. For example, the SEC has been empowered to impose financial penalties on any respondent (regardless of whether they are SEC-regulated persons or entities) and to seek "collateral bars" (barring someone from the entire securities industry). Yet, while the number of cases, the size of the cases, and the importance of the cases brought before APs have all increased, the format of the proceeding itself – with its fast-paced trial schedule and limited discovery mechanisms – has remained unchanged.

What *has* changed is the SEC's preference. A decade ago, the majority of SEC cases were brought before a federal court. Today, the opposite is true, and the bulk of SEC actions are APs. The question is: has opening the door to a flood of bigger cases, without updating the applicable procedures, led to a lopsided system?

Home court advantage?

Many would say the answer to that question is, "yes." The AP arguably creates a number of tactical advantages for the SEC.

The first has to do with the timetable for APs. Under the current rules, the administrative law judge ("ALJ") who presides over the AP must issue his or her decision within 300 days of the filing of the initial complaint (actually called an Order Initiating Proceedings, or OIP). And, the last 60 days of that 300-day period are expressly reserved for the ALJ to review the record and write his or her opinion. So, that means the respondent has approximately

four months in which to file an answer to the OIP, review documents, identify witnesses, prepare for hearing, complete and submit pre-hearing briefs, and conduct the evidentiary hearing itself.

Four months is a very aggressive preparation schedule – and one which only truly applies to the respondent. Remember, the SEC has had months, maybe years, to collect and sift through documents, depose potential witnesses, and slowly build its case prior to filing the OIP. By the time the OIP is filed, the SEC has its case virtually complete. The respondent, on the other hand, is only beginning its trial preparation, and must work ferociously just to catch up. For traditional "small" cases, that may not be a problem; but, for the big cases that the SEC now brings in APs, it is huge.

Second, APs lack many, perhaps most, of the pre-hearing discovery mechanisms and dispositive motions available to parties in federal court. For example, the Federal Rules of Civil Procedure provide the defendant the opportunity to file dispositive motions that challenge the sufficiency of the claims. A successful dispositive motion dismisses the defendant out of the action, and no further proceeding (or trial) is necessary. Under the AP Rules of Practice, by comparison, there are essentially no pre-hearing dispositive motions. The rules provide for them, but you must request and obtain leave to file one and, more importantly, statistically speaking, even if you get leave, your motion will be denied. The practical effect of this is that a respondent named in an AP will nearly always have to proceed to hearing (and to incur the stress, time and expense involved).

Similarly, APs also lack the traditional discovery procedures – depositions, interrogatories, document requests – allowed under the Federal Rules that govern court actions. During the SEC's investigation, and prior to the OIP, the SEC will almost certainly have already deposed anyone with knowledge of the facts. While the respondents will be provided a copy of that testimony (under the rules, the respondent receives a copy of Enforcement's investigative file, which would contain such transcripts), the respondent cannot take its own depositions (unless the target witness will be unavailable to testify live at the hearing).

Finally, there is the curious administrative and appellate structure that governs APs. A federal court action is initiated by the filing of a complaint. The case is administered and heard by a federal judge who has been appointed by the president of the United States. Federal rulings are appealable to the United States Court of Appeals.

APs take a much more circular route. They begin with a recommendation by the SEC's Division of Enforcement to the SEC commissioners that a proceeding be initiated against a particular respondent. The Division of Enforcement sets forth the claims it intends to bring and the facts on which those claims are based. The Commissioners review the information and decide whether to authorize the OIP. If they do authorize it, the AP is heard by an ALJ, who has been hired by and actually works for the Commission. Adverse rulings by the ALJ are appealable *back* to the commissioners (i.e., the same individuals who both authorized the case to be filed in the first place and hired the judge that heard it). Perhaps unsurprisingly, ALJ findings against respondents who appeal to the Commission are rarely reversed; in fact, respondents are far more likely to see their sanctions or penalties *increased* on appeal, rather than reduced.

Proposed amendments

This disparity in pre-hearing options has prompted the SEC to propose some changes to the Rules of Practice that govern APs. For example, directly addressing the AP's current "rocket docket," the proposed amendment seeks to extend the 300-day proceeding timeline and provide more time, specifically, between the initiation of the case (the OIP) and the start of the hearing. Respondents would have eight months under the proposed rule – double the current prep time – to prepare. Additionally, the time parameters could be tolled, i.e., suspended, entirely if the parties entered into settlement discussions.

This additional time will be necessary so that the respondents can take advantage of the increased discovery that has been proposed. The amendments would allow the respondent to take a limited number of witness depositions as part of the discovery process. This includes the ability to serve document requests and depose expert witnesses.

Then, once discovery is complete and the hearing begins, there will be changes to the evidentiary rules employed at the hearing itself. Under the Federal Rules of Evidence, certain types of evidence that are deemed unreliable or overly prejudicial are not admissible at trial (like hearsay, for example). Those Rules do not currently apply to APs. Instead, the current standard is only "relevance." The proposed amendments would still maintain the "relevance" threshold, but specifically exclude evidence that is deemed to be "unreliable."

There are a few other elements to the proposed changes, but the foregoing are the three most substantive, by far. While certainly a step in the right direction, they are not without limitation. Depositions are limited at either three or five per side (depending on the case), and, from the SEC's perspective, this does not include the unlimited number of pre-OIP depositions that the Division of Enforcement may take during the examination. The Rule also limits depositions to persons with knowledge of the underlying events that gave rise to the underlying claims. That is, respondents do not get to depose the SEC examiners (they'll still have to save their questions for cross-examination at the hearing).

The proposals also do not address some of the deeper, more foundational challenges that have arisen in recent months. Are these proceedings even constitutional?

Constitutional challenges

There are a few different arguments that have been raised challenging the constitutionality of the administrative forum. AP respondents have argued that the proceedings violate the Due Process Clause, the Equal Protection Clause, and the Seventh Amendment. None of these arguments, although compelling in theory, has gained much traction with the courts.

A different and less glamourous constitutional theory has, however, had some significant success. One of the most compelling and direct challenges to the use of APs arises under Article II of the Constitution – the Appointments Clause. In short, under the Appointments Clause, the president holds the exclusive authority to appoint "officers" of the United States. Congress has the authority to vest appointment authority for "inferior officers" in the president, the courts, or in the "heads of departments."

To synthesize the issue as it applies here, currently, ALJs are hired by the SEC's Human Resources Department, like any other employee. They are not appointed by the commissioners themselves. If the ALJs are properly categorized as "employees" of the Commission, this is entirely proper. If, on the other hand, they are "inferior officers," as that term has been defined by constitutional precedent, then they have *not* been properly appointed to their positions. To be properly appointed, the commissioners themselves would have to make the appointment (not HR).

The SEC (not surprisingly) maintains that the ALJs are mere employees. Litigants who have filed federal challenges take the opposite stance, and argue the judges are indeed "inferior officers." So far, the results have been mixed. The D.C. Circuit held they were not "inferior officers," while the Southern District of New York and Northern District of Georgia held they *were*. Both rulings have been appealed and, as of this writing, we continue to await a final ruling on the issue.

While we wait, it is interesting to consider the predicament the SEC is in. Conceivably, the SEC could solve this problem today: it would simply have to ratify its HR Department's retention of the judges (the Federal Trade Commission, faced with similar challenges, took that exact step last fall). But were it to do that today, tomorrow it could face motions from

every respondent in every pending administrative proceeding, seeking to have his case thrown out. Even scarier from the SEC perspective, it would risk actions by past respondents, seeking to have closed cases thrown out (as unconstitutional proceedings).

So, the SEC has resolved to fight this matter in the courts. If it is successful, and the ALJs are determined to be "employees," the SEC will have avoided one of the most serious constitutional attacks on the forum ever raised. But if the challengers win, it will be forced officially to "appoint" the judges. Whatever impact that would have on past and present cases we can only speculate.

Jurisdictional Hurdle

Even though the federal challenges in Georgia and New York are still on appeal, to get as far as they have, they have had to overcome a significant jurisdictional issue. Normally, before a respondent can challenge an administrative proceeding before a federal court, he or she must first "exhaust" the remedies available within the administrative forum itself. That means that before someone can challenge the constitutionality of the AP in court, he or she must first go through all the motions – prepare the case, attend the hearing, and get a judgment. Absent those steps, courts are often quick to dismiss federal challenges, stating that they lack jurisdiction over the claim due to failure to exhaust administrative remedies.

This is what happened to a recent challenger, Laurie Bebo. The SEC initiated an AP against Ms Bebo in late 2015. Ms Bebo filed a lawsuit in federal court in Wisconsin seeking to enjoin the action on constitutional grounds. The federal court dismissed her action, stating it lacked jurisdiction to hear her claim because she failed to exhaust her administrative remedies. She appealed that decision to the Seventh Circuit, and that court affirmed the lower court's finding. The Seventh Circuit held that Ms Bebo was required to participate in the entire AP process – preparing her case, trying her case, losing, and then appealing the unfavorable award to the Commission – before she could challenge that proceeding in court.

Ms Bebo appealed that finding to the Supreme Court, which declined to hear the case. But, when she filed her appeal, she gained the backing of Mark Cuban, whose attorneys filed an Amicus Brief on her behalf. Cuban argued, as he has for other litigants in Ms Bebo's situation, that the Seventh Circuit's reasoning was nonsensical. Says Mr Cuban:

> Bringing those challenges first to an ALJ and then to the Commission is futile, imposes a crushing cost burden, and delays the opportunity for a fair federal court hearing for years. What that means in practical terms is that forcing these collateral issues through an administrative proceeding will often mean no judicial review happens at all because litigants will be forced to capitulate before they can raise their constitutional claims to a neutral arbiter – a federal court.

Essentially, what the Seventh Circuit held (and what has angered Mr Cuban and many others) is that a respondent named in a potentially unconstitutional proceeding has no right to challenge the constitutionality in a court of law until he or she has first tried the case and exhausted the administrative appeals. So, using Ms Bebo as an example, she would have to complete the initial AP. That would take less than a year, but could cost hundreds of thousands of dollars, if not more, to litigate. Assuming she loses, she then would have to appeal an adverse ruling, spending additional money on the appeal. Then, she would have to wait for the Commission to hear her appeal and render its decision. The appeal itself can take over a year. While the Commission sets a "goal" to issue a decision within seven months, it actually takes them between 15 and 18 months (according to the statistics people) to render their decision.

So, many years and perhaps millions of dollars later, Ms Bebo would finally be able to challenge the constitutionality of the AP in federal court. Assuming, of course, she had any money left to file one more lawsuit.

Conclusion

If you had the choice of bringing a complaint in two different places, and you knew that if you filed it in one versus the other, you would win over 90 per cent of the time, I imagine that that's where you would file it. That is how the SEC feels about APs, and it is hard to blame them. But, the cost to the SEC of its increased utilization of APs – in terms of bad press, congressional scrutiny, legal challenges funded by a billionaire who's happy to spend his money on this endeavor, and at least some federal court judges sympathetic to those challenges – has made it clear that things may change, and soon. Hopefully, all of this will result in something that no one can argue with: a fairer system, administered by truly impartial factfinders, with reasonable timeframes, and, ultimately, results that are actually based on the facts and the law presented at the hearing.

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