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before the

Subcommittee on
Capital Markets and Government Sponsored Enterprises

Committee on Financial Services
United States House of Representatives

Fair or Foul? SEC Administrative Proceedings and

Prospects for Reform Through Removal Legislation

December 2, 2015

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Chairman Garrett, Ranking Member Maloney, and distinguished members of the Committee, thank you for this opportunity to testify on an important matter relating to the enforcement of our nation's securities laws.

H.R. 3798, the Due Process Restoration Act of 2015, addresses a significant perceived inequity in the United States Securities and Exchange Commission's ("SEC" or "Commission") administration of justice. I welcome this opportunity to address the concerns that animate this valuable legislative initiative. This testimony describes criticisms of the fairness of SEC administrative proceedings, discusses how a removal statute might address those concerns, considers the approach of the Due Process Restoration Act, and offers an alternative removal strategy that Congress might also consider.

I. Consternation over the SEC's Administrative Procedures

The SEC can choose between two forums in which to initiate enforcement proceedings. It can sue in federal court, where defendants have the right to a jury trial, can take deposition testimony, testimony is subject to the Federal Rules of Evidence, and judges are entirely independent of the agency and have been nominated by the President and confirmed by the United States Senate. Or, it can file an administrative proceeding that is conducted in-house before administrative law judges ("ALJ"s), where there is no jury, where discovery is restricted, where hearings proceed on a rapid schedule that can advantage the Commission's staff, where the Federal Rules of Evidence do not apply, where prosecutors and judges are all in the employ of the Commission, and where the initial appeal is to the same body that issued the order instituting the proceedings.

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Critics also complain that the ALJs, who purportedly wield administrative expertise, generally have little or no experience with the federal securities laws prior to their appointment. Critics also assert that ALJs are biased in favor of their employer, and at least one former ALJ has made statements consistent with the existence of such bias. Further, critics point to data suggesting that the Commission has a higher success rate in its in-house litigation than in litigation before federal courts. These data are, however, contestable and significant further research is appropriate before these comparisons can be made with confidence.

In addition, critics complain that appeals from ALJ decisions are to the same body that authorized the complaint. The five Commissioners thus act both as prosecutor and judge: prosecutors when authorizing the complaint and judges when ruling on the appeal from the ALJ decision resolving the complaint they initially authorized. While respondents have the right to appeal any Commission ruling to a federal court of appeals, the Kafka-esque quality of an appeal to the body that authorized the prosecution cannot be denied.

The Commission's appellate review also often concludes long after the initial ALJ decision. Indeed, these delays can be so lengthy that whatever speed is gained by the administrative "rocket docket" is lost while waiting for Commission review. Respondents thus experience a "hurry up and wait" regime that delays review by Article III judges nominated by a President and confirmed by the Senate.

Separate and apart from these complaints about the fairness of the agency's proceedings, the agency's push to administrative proceedings raises a concern that it is on a mission systematically to substitute its interpretation of the federal securities laws for that of the federal judiciary. The Commission's statements in a recent administrative proceeding provide a basis for these concerns.[1] Because the Commission's interpretation of the federal securities laws can often conflict with decisions reached by federal courts, the substitution of the Commission's interpretations for the courts' can have material consequences for the evolution of the law. At least one federal judge has warned of this development,[2] and the Commission appears to expect that its interpretation of the federal securities laws will, under the doctrine of *Chevron* deference, take precedence over conflicting interpretations by the federal courts. Whether the courts will accede to the Commission's view remains to be seen.

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[1] *See In the Matter of John P. Flannery and James D. Hopkins,* Securities Act Release No. 33-9689 (Dec. 15, 2014) (citing the "agency's experience and expertise in administering securities law," the Commission opinion set out its own legal interpretation to resolve what it termed "confusion" and "inconsistencies" among the federal district courts concerning the scope of primary liability for fraud under the federal securities laws).

[2] The Honorable Jed S. Rakoff, United States District Court for the Southern District of New York, Keynote Address to the Practicing Law Institute, Securities Regulation Institute, *Is the SEC Becoming a Law Unto Itself?* (Nov. 5, 2014).

Litigation is also afoot challenging the constitutionality of the process by which ALJs are appointed and can be removed. The resolution of these constitutional disputes, significant as they are, will not affect the debate about the fairness of the agency's administrative procedures. The concerns that animate the Due Process Restoration Act of 2015 are likely to survive the resolution of any associated Constitutional controversies.

II. The Commission's Response

The Commission is well aware of these criticisms but has nonetheless announced its intent to increase its reliance on its administrative proceedings while bringing fewer cases in federal court. In its defense, the Commission asserts that its administrative proceedings are fair and efficient. It explains that in administrative proceedings it is required to produce its entire investigative file, and that respondents have the protection of the Jenks Act and of the Supreme Court's decision in *Brady v. Maryland*.[3] It also emphasizes its investor protection mission. But even so, critics are not appeased. They emphasize that these protections are far from sufficient given the realities of modern litigation against the agency. Moreover, while the agency certainly has an investor protection mission, basic principles of procedural fairness need not and should not be sacrificed so that the agency can pursue its goal. Balance is necessary and appropriate.

The Commission has not, however, been entirely deaf to critiques of its administrative processes, and has recently responded with three distinct strategies.

First, the Commission has issued a statement describing four factors it considers when deciding whether to initiate proceedings in an administrative forum or in federal court. These factors have been criticized as exceptionally malleable and as not placing any meaningful limit on the Commission's exercise of discretion.

Second, the Commission has improved the format by which it reports its annual enforcement statistics. This improvement is a significant step forward over the prior regime, but room for improvement remains, particularly with regard to the methods used to describe the Commission's exercise of its forum selection option.

Third, the Commission has proposed to amend some rules governing its administrative proceedings. In particular, it has proposed to allow the staff and respondents to take up to three depositions each in cases in which there is only one respondent, and up to five when there is more than one respondent.

The criticism of this proposal was swift and sharp. To be sure, three or five depositions are better than none, but where do the magic numbers of three and five come from? What is the basis for these limitations, or are they arbitrary and capricious because the limitations are not related to the need for depositions in any

[3] 373 US 83 (1963).

particular case, and thus in violation of the Administrative Procedure Act? And, not only are three and five a small number of depositions in complex matters, "but figuring out which witnesses to depose may involve a large degree of guesswork if the agency took testimony from a number of people in its investigation, as is often the case."[4] Perhaps the better approach would be to allow a potentially unlimited number of depositions at the discretion of the ALJ, where the number is commensurate with the complexity of the matters at issue.

The Commission has also proposed to lengthen the time period during which respondents can prepare for a hearing and take the depositions that the Commission proposes to permit. But critics observe that "the time within which an administrative case would be completed is still fairly short,"[5] particularly when the matter is complex and involves hundreds of thousands of documents. The effect of the rocket docket can also be asymmetric because the Commission's staff will often have had years with which to prepare its case and take witness testimony. In contrast, respondents have to prepare furiously within a relatively short time frame. Again, perhaps the better approach would be to allow for greater exercise of discretion by ALJs in matters that raise a sufficient degree of complexity.

The Commission also proposes to formalize the admissibility of hearsay evidence provided that it "bears satisfactory indicia of reliability so that its use is fair."[6] Commenters were quick to observe that this standard is more permissive than the rule in federal court, but it should also be observed that these amendments are no worse than the *status quo*. Under the proposed rule, "some out of court statements, like the investigative testimony of witnesses could be considered without having to call them to attend the hearing, which avoids the risk they might say something different or lose credibility on cross examination."[7] And, with a limit of three or five depositions, and with the prospect of dozens of investigative witnesses having their testimony admitted without any right to depose or cross examine, the agency's willingness to allow such a limited number of depositions seems a drop in the bucket, particularly in large, complex matters. This issue could be addressed by applying specific provisions of the Federal Rules of Evidence in administrative proceedings, and, again, by permitting discretionary increases in the number of depositions and in the length of proceedings in complex matters.

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[4] Peter J. Henning, *A Small Step in Changing SEC Administrative Proceedings*, N.Y. TIMES (Sept. 28, 2015), http://www.nytimes.com/2015/09/29/business/dealbook/a-small-step-in-changing-sec-administrative-proceedings.html.

[5] *Id.*

[6] Proposed Amendments to the Commission's Rules of Practice 18, Exchange Act Release No. 34-75976 (Sept. 24, 2015) (hereinafter, "Proposed 2015 Procedural Amendments").

[7] Henning, *Small Step, supra* note 2.

In the aggregate, as a leading legal columnist writing for the New York Times has observed, these measures are "at best small steps in responding to criticism about truncated rights."[8]

III. Removal Statutes: Strategic Considerations

If Congress wants to address the matter head on, it could rewrite the Commission's internal rules of procedure or could specify minimum standards that more closely align the procedural fairness of APs with district court litigation. An alternative approach would have Congress consider the possibility of a removal statute as a mechanism that can induce the agency to make its proceedings more fair and equitable. Put another way, a removal statute can perform a valuable equilibrating function even if few cases are ever actually removed to federal court.

When considering a removal statute, Congress will have to weigh several competing considerations. First, removal increases the docket load before an already burdened federal judiciary. Congress should not lightly embark on any initiative that exacerbates that problem. Therefore, fashioning a removal mechanism that induces the agency to reform its own internal procedures may be more important than legislation that generates a large number of removals.

Second, the Commission's administrative process need not mimic every jot and tittle of the Federal Rules of Civil Procedure or of the Federal Rules of Evidence. There is also no constitutional requirement that a respondent in an administrative process have the right to a jury trial. The challenge in drafting a removal statute is to induce the agency to strike the proper balance in its internal processes while assuring access to federal courts whenever the interests of justice are best served by the application of the full panoply of rights available only in federal courts.

Third, Congress should recognize that the vast majority of SEC proceedings, whether filed administratively or in federal court, are settled, as is the case with the vast majority of all other civil and criminal actions. The dominant effect of a removal statute may therefore be to influence the terms of these settlements or the rules by which an administrative proceeding will occur. The prospect of litigating in an administrative forum in which the respondent has greater rights might induce the agency to drop some weaker cases and to focus on situations where evidence of harm is stronger. Greater procedural rights might also persuade the Commission to settle matters on terms more favorable to respondents. This observation underscores the fact that rational respondents will today agree to settlement terms that reflect the agency's strong procedural advantage in administrative proceedings, and not just the actual merits of the litigation at issue. In other words, the Commission might sometimes be able to extract more onerous settlement terms not

[8] Peter J. Henning, *Reforming the SEC's Administrative Process*, N.Y. TIMES (Oct. 26, 2015), http://www.nytimes.com/2015/10/27/business/dealbook/reforming-the-secs-administrative-process.html.

because its case is strong, but because respondent rights are weak. And, in cases that are not simultaneously filed and settled, a removal statute might incentivize the agency to agree to a larger number of depositions or longer periods for preparation in order to persuade a court that removal is neither necessary nor appropriate.

It follows that a removal mechanism that allows for the federal judiciary to perform a valuable monitoring and filtering function could serve a constructive role. Federal judges may be best situated to determine whether a case should responsibly remain with the agency to be adjudicated under truncated procedures, or whether the interests of justice call for the greater procedural guarantees provided in federal court. Federal judges are also best positioned to balance the burden that additional proceeding place on their dockets.

IV. Removal Statutes: Tactical Considerations

Congress can employ many different mechanisms when drafting a removal statute. The simplest approach designates a category of proceedings as to which respondents have an unconditional right of removal. Congress can expand or contract the set of removable actions to balance the potential additional burdens imposed on the federal courts.

H.R. 3798 falls in this category. The pending bill would allow any respondent in any administrative proceeding in which the Commission seeks "an order imposing a cease and desist order and a penalty … [to] require the Commission to terminate the proceeding." The Commission would then be authorized to bring a civil action "against that person for the same remedy that might be imposed." The bill would also change the standard of proof in SEC administrative proceedings to require "clear and convincing evidence that the person has violated the relevant provisions of law."

The pending bill has many virtues. Simplicity is one. There is no ambiguity as to which causes of action can be removed, how they can be removed, and the consequences of removal. Predictability is another. The most important SEC enforcement actions typically call for cease and desist orders and monetary penalties. A very large percentage of these cases will likely shift to federal court if the legislation is enacted as proposed. Further, the standard of proof in civil actions requires a "preponderance of the evidence." H.R. 3798 would alter the standard in administrative proceedings to a more exacting "clear and convincing evidence" test. The proposed legislation would thereby create an evidentiary incentive for the SEC to prefer federal court to administrative proceedings. Because the higher evidentiary standard would also apply to proceedings that cannot be removed to federal court, the Commission would find it more difficult to prevail in all of its administrative proceedings.

But as is the case with all legislative initiatives, there are costs that also warrant consideration. H.R. 3798 would increase the federal judiciary's caseload

with a set of potentially complex matters without considering the optimal forum for each matter. It would also make it systematically more difficult for the agency to prevail in all of its administrative proceedings. It would also not provide the agency with effective incentives to engage in appropriate self-reform designed to improve procedural safeguards without increasing the burden on the federal docket. As observers have suggested, H.R. 3798 could effectively eliminate administrative proceedings as a mechanism for resolving all significant securities fraud matters.

An alternative design of a removal statute might recognize that there are three categories of cases that can be brought as administrative proceedings.

The first set of cases involve technical or other *pro forma* matters that, whether or not they involve cease and desist orders or penalties, are best determined by the Commission and need not, under any circumstances, clutter the federal courts' dockets.[9]

A second category would be composed of cases as to which respondents would have an unqualified right of removal, much as suggested by HR 3798. These cases would involve fact patterns or applications of law, where, in the determination of Congress, the procedural guarantees associated with federal court proceedings, as well as the availability of a jury and the presence of an Article III judge, warrant the additional imposition on the federal docket.[10]

As for all other cases, the statute could provide for a right to petition a federal court for an order removing the case from the Commission and assigning it to federal court. Removal would be at the discretion of the District Court judge to whom the petition is assigned. The entire process could also be modeled on existing Federal Rule of Civil Procedure 23(f) that creates a discretionary interlocutory appeal from a district court ruling on a motion for class certification. Indeed, the very rationale for the adoption of Rule 12(f) mirrors the rationale for the adoption of a removal statute.[11] Further, to facilitate the district courts' consideration of petitions for removal, the statute could define specific "core factors" for the district courts to consider when evaluating these motions, much as the courts have evolved

[9] Examples of these cases might be late filing cases or complaints alleging violations of the Commission's complex net capital rules. As to these cases, the removal statute would not allow any right of removal at all.

[10] Examples of these cases might include alleged violations of the anti-fraud provisions, insider trading laws, or the anti-bribery provisions of the Foreign Corrupt Practices Act.

[11] The drafters of Rule 23(f) recognized that the decision on a class certification motion could, as a practical matter, be outcome determinative without any regard to the merits of the underlying action. Therefore, granting the Courts of Appeal the discretionary right to engage in interlocutory review promoted the interests of justice. By the same token, the decision as to whether a case should proceed as an administrative matter or as a dispute in federal court can also be outcome determinative. Therefore, granting the federal district courts the discretionary right to order removal to federal court can also promote the interests of justice.

"core factors" that govern the decision as to whether to grant a Rule 23(f) motion.[12] To be sure, the creation of a discretionary right to petition for removal raises a host of operational complexities that would have to be addressed, but all of these issues should be manageable.

As outlined, the goal of this discretionary removal provision is not to cause a massive migration of litigation from the SEC's administrative process to the federal courts. It is, instead, to give the agency powerful incentives to reform its internal procedures so that the courts do not feel compelled to grant a large number of these petitions. Indeed, to the extent that a removal statute can stimulate the Commission to reform its internal processes so that they are perceived as fair and efficient by the courts and by Congress, and not just by the Commission, removal legislation can promote the interests of justice without over-burdening federal court dockets.

V. Conclusion

The Commission faces a crisis of confidence over the fairness of its internal administrative procedures. The Commission can respond by changing its internal policies, and preliminary data suggest that some changes may already be afoot. Properly designed legislation that grants respondents the right to petition for removal to federal court can also act as a powerful incentive for the Commission to reform its internal procedures. The goal would be to have a set of procedures that are perceived as fair and efficient by Congress and by the courts, and not just by the Commission itself. Properly designed legislation would also be sensitive to the burdens that a removal can impose on federal caseloads. Most importantly, perhaps, properly designed legislation can promote the interests of justice by assuring that litigation matters are responsibly sorted so that cases that warrant the full protection of a jury trial and of the Federal Rules of Civil Procedure and of the Federal Rules of Evidence are heard in federal court, whereas cases that are more appropriately resolved in the administrative forum remain before the agency.

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[12] These factors might include:

1. The presence of complex regulatory matters that are better resolved by an administrative law judge than by a jury or Article III judge;
2. The value of fact-finding by a jury and not by an administrative law judge;
3. Whether the respondent is a regulated entity;
4. Whether the litigation involves a level of complexity that cannot be fairly resolved given the procedural rules employed by the Commission as of the date of the order instituting proceedings;
5. The implications of the remedy sought by the Commission for the respondents' businesses and careers; and
6. The presence of significant questions of law that would benefit from resolution by the federal judiciary, rather than by the Commission seeking *Chevron* deference to its interpretation of the federal securities laws.