SEC Administrative Proceedings: Backlash and Reform

*By Alexander I. Platt**

The Securities and Exchange Commission's aggressive prosecution of securities violations inside administrative proceedings (APs) has generated backlash. Key stakeholders are now attacking the agency's enforcement program as illegitimate and a growing number of respondents charged in APs have launched broad constitutional challenges. Though these suits target deeply entrenched features of administrative adjudication, they have already begun to prove successful, and threaten significant transformations to the SEC and beyond.

Historically, the SEC's enforcement architecture embodied respect for the principle that, holding all else equal, procedures ought to be commensurate with the stakes of the adjudication. After Dodd-Frank, the agency abandoned this principle. The backlash is, at least in part, attributable to and justified by this reversal.

The SEC should have done after Dodd-Frank what it had done after previous expansions of its administrative penalty powers: reestablish the equilibrium between penalties and procedures by revising its rules of practice that govern APs. The SEC's recently proposed amendments to these rules are too little, too late. A bolder approach is required.

The Securities and Exchange Commission (SEC or Commission or agency) is under attack. The agency has been confronted with a wave of broad constitutional challenges to its prosecution of securities violations in administrative proceedings (APs).[1] This forum, which lacks many of the fundamental procedural protections offered in federal court, has been in use in some form as long as the agency itself. Dodd-Frank enhanced the agency's penalty authority in these proceedings and the Commission has taken advantage of its new penalty authority, bringing more—as well as more *important*—cases as APs.

In response, key stakeholders have begun challenging the legitimacy of the agency's enforcement regime, and the regulated industry and its attorneys have filed broad constitutional challenges attacking the SEC's AP expansionism. Though these challenges target practices that are ubiquitous across administrative agencies, they have a realistic chance of success—particularly if and when

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1. *See generally infra* Table 1 (listing cases).

they make it to the U.S. Supreme Court. Two district judges have already found that certain features of APs likely violate the U.S. Constitution,[2] and another described the constitutional challenges as "compelling and meritorious."[3]

Much is at stake in these suits. The challenges invite courts to strike down features of administrative adjudication utilized (in variation) by regulatory agencies across the executive branch. The broad support these challenges have received from courts and commentators reflects a significant blow to the legitimacy of the agency's enforcement program. Even if the agency ultimately escapes constitutional liability, other harms may well follow from this wave of backlash.

This Article examines and interprets the backlash through the lens of recent SEC history. The SEC's enforcement architecture has embodied steady respect for the principle that, holding all else equal, procedures should be commensurate with the stakes of the adjudication. When Congress expanded the SEC's administrative penalty power in the past, the agency responded by recalibrating the procedures governing APs to ensure a continuing equilibrium between penalties and procedures. Dodd-Frank undermined the principle by equalizing penalties across district courts and APs, each with very distinct levels of procedural protection. But the agency made it worse: after receiving these broad new administrative powers, it failed to undertake any reforms to reestablish the equilibrium. The result has been a growing (and justified) sense that the AP system had become fundamentally unfair.

The SEC could have prevented some of the damage to the legitimacy of its enforcement program by doing immediately after Dodd-Frank what it had done previously after receiving new administrative penalty powers: reestablishing the equilibrium between procedures and penalties by comprehensively amending its rules of practice. But it declined to do so, allowing the backlash to mount. Finally, after years of ignoring or rebuffing attacks on the legitimacy of its enforcement regime, in 2015 the agency began showing signs that it recognized it had overreached. In May, the Enforcement Division published a brief statement explaining its approach to forum selection,[4] and in September the SEC announced several proposed reforms to its rules of practice.[5] These changes—particularly the proposals related to expanded discovery rights and liberalized timelines for proceedings—would surely be a step in the right direction if adopted. But

2. *See* Duka v. SEC, No. 15-cv-357 (S.D.N.Y. Aug. 3, 2015) (Berman, J.) (decision and order), ECF No. 57; Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Aug. 4, 2015) (May, J.) (order), ECF No. 56; Timbervest, LLC v. SEC, No. 15-cv-2106 (N.D. Ga. Aug. 4, 2015) (May, J.) (order), ECF No. 25; Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088 (N.D. Ga. June 8, 2015) (May, J.).

3. Bebo v. SEC, No. 15-cv-3, 2015 WL 905349, at *2 (E.D. Wis. Mar. 3, 2015); *see also* SEC v. Citigroup Global Mkts., Inc., 24 F. Supp. 3d 379, 380 n.8 (S.D.N.Y. 2014) (Rakoff, J.) (stating, regarding the SEC's broad AP authority, "[o]ne might wonder: from where does the constitutional warrant for such unchecked and unbalanced administrative power derive?").

4. *Division of Enforcement Approach to Forum Selection in Contested Actions*, U.S. Sec. & Exch. Comm'n (May 8, 2015), https://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf [hereinafter Division of Enforcement Approach].

5. Securities and Exchange Commission, Proposed Rule, Amendments to the Commission's Rules of Practice, 80 Fed. Reg. 60082 (Oct. 5, 2015); Securities and Exchange Commission, Proposed Rule, Amendments to the Commission's Rules of Practice, 80 Fed. Reg. 60091 (Oct. 5, 2015).

they are too little, too late. Challengers will not be deterred and critics will not be won over unless the SEC undertakes a broader, deeper review and recalibration of its procedural regime.

This Article proceeds as follows. Part I reviews the structure of APs, the expansion of SEC administrative penalty authority by Dodd-Frank, and the agency's increased reliance on APs to prosecute securities violations. Part II analyzes the wave of constitutional lawsuits filed against the SEC and the related criticism that the SEC is unfairly using APs to *make* law. Part III discusses how the agency has used procedural reform to ensure a balance between procedures and penalties, shoring up its legitimacy after past legislative expansions, and criticizes the agency for failing to undertake similar reforms immediately after Dodd-Frank. Part IV reviews and criticizes the agency's recent proposed reforms, and proposes an alternate package of procedural reforms that might go farther to reestablish this balance and shore up the agency's legitimacy.

I. Background

A. The Structure of APs

After an investigation reveals a securities law violation, the SEC can refer a matter to the U.S. Department of Justice (DOJ) for consideration of criminal charges, file a civil lawsuit in federal district court, or commence an AP.[6] APs are governed by the SEC's own rules of practice.[7] An AP is initiated with an Order Instituting Proceedings (OIP), the equivalent of an indictment or complaint, which outlines the charges against the respondent and the factual basis for those charges.[8] Though the SEC's Enforcement Division prosecutes the case, the OIP is issued by the Commission.[9]

Actually, much action takes place before the OIP is issued. The agency typically notifies the target that it is considering filing charges ahead of time and provides an opportunity to contest the contemplated charges in writing.[10] If the target chooses to make such a submission, it will be forwarded along with the recommendation of the Enforcement Division to the Commission, which makes the ultimate decision of whether to initiate a proceeding.[11] The leadership of the Enforcement Division is appointed by and accountable to the Commission.

6. 17 C.F.R. § 202.5(b) (2015); *see also* 2 Harold S. Bloomenthal & Samuel Wolf, Securities Law Handbook § 26:56 (2014 ed.). For convenience, I use "AP" to encompass various types of administrative hearings conducted under the securities laws, including various types of disciplinary hearings and cease-and-desist proceedings. For a detailed overview of APs, see Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67 Bus. Law. 679 (2012).

7. 17 C.F.R. §§ 201.100–.1106 (2015).

8. *Id.* § 201.200.

9. *E.g.*, *id.* § 201.101(a)(7).

10. *See id.* § 202.5; *see also* 2 Bloomenthal & Wolf, *supra* note 6, § 26:56.

11. 2 Bloomenthal & Wolf, *supra* note 6, § 26:56; *see also* 17 C.F.R. § 201.101(a)(7) & (9)(i); *cf.* 2 Bloomenthal & Wolf, *supra* note 6, § 26:57 ("Although the entire structure of the Rules of Practice is built around this assumption, curiously, no Rule explicitly provides for the issuance of such order.").

Settlements are also often negotiated at the pre-OIP stage. A successful negotiation will result in the publication of charges and terms of the settlement in the same document. The Commission must approve any settlement.

Once filed, an AP is assigned by the chief administrative law judge[12] to herself or one of the other four administrative law judges (ALJs).[13] All ALJs are hired by the Commission's Office of Human Resources with input from the chief ALJ and the U.S. Office of Personnel Management, but with no direct role for the Commission itself.[14] Once appointed, the Commission "may remove . . . an administrative law judge only for good cause established and determined by the [Merit Systems Protection Board (MSPB)[15]] on the record and after opportunity for a hearing before the Board."[16] Of the five active ALJs, three have been appointed since 2011.[17]

The chief ALJ also fixes the time and place for the hearing.[18] The Rules of Practice provide for fixed timelines.[19] The most extended timeline (reserved for the most complex actions) requires that the ALJ's filing decision be issued within 300 days after the OIP is filed—with "approximately 4 months from the order instituting the proceeding to the hearing, approximately 2 months for the parties to obtain the transcript and submit briefs, and approximately

12. Brenda Murray has served as chief ALJ for over twenty years. Recent allegations suggest that Chief Judge Murray has pressured ALJs to rule in favor of the agency. *See infra* Part II.A.3.

13. 17 C.F.R. §§ 201.110, 200.30-10(a)(2) (2015); *see also* 5 U.S.C. § 3105 (2012) (requiring that ALJs "shall be assigned to cases in rotation so far as practicable").

14. Affidavit of Jayne L. Seidman, *In re* Timbervest, LLC, SEC Admin. Proceeding No. 3-15519 (June 4, 2015); Notice of Filing by U.S. Sec. & Exch. Comm'n Div. of Enforcement, *In re* Timbervest, LLC, SEC Admin. Proceeding No. 3-15519 (June 4, 2015); *see also* Alison Frankel, *Why the SEC Can't Easily Solve Appointments Clause Problem with ALJs*, Reuters (June 17, 2015), http://blogs.reuters.com/alison-frankel/2015/06/17/why-the-sec-cant-easily-solve-appointments-clause-problem-with-aljs/ (ALJs are "named through a bureaucratic process and not by the commissioners.").

15. "The Merit Systems Protection Board is an independent, quasi-judicial agency in the Executive branch that serves as the guardian of Federal merit systems. . . . The mission of the MSPB is to 'Protect the Merit System Principles and promote an effective Federal workforce free of Prohibited Personnel Practices.'" *See About the Merit Systems Protection Board*, Merit Sys. Protection Board, http://www.mspb.gov/About/about.htm (last visited Sept. 27, 2015).

16. 5 U.S.C. § 7521 (2012); *see also* 5 C.F.R. § 1201 (2015) (procedures for MSPB hearing).

17. The five ALJs (and years appointed) are: Jason Patil (2014), James Grimes (2014), Cameron Elliot (2011), Carol Fox Foelak (1996), and Chief Brenda Murray (1994). *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Arrival of New Administrative Law Judge Cameron Elliot (Apr. 25, 2011), https://www.sec.gov/news/press/2011/2011-96.htm; Sarah N. Lynch, *SEC Judge Who Took on the "Big Four" Known for Bold Moves*, Reuters (Feb. 2, 2014), http://www.reuters.com/article/2014/02/02/us-sec-china-elliot-idUSBREA1107P20140202; Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces New Hires in the Office of Administrative Law Judges (June 30, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542202073#.VRv_TuHlx5Y; Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Arrival of New Administrative Law Judge (Sept. 22, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543014965; Cara Salvatore, *SEC Announces Arrival of 2nd New ALJ*, Law360 (Sept. 22, 2014), http://www.law360.com/articles/579842/sec-announces-arrival-of-2nd-new-alj; Sarah N. Lynch, *SEC Judge in Cohen Case No Stranger to High-Profile Cases*, Reuters (July 24, 2013), http://www.reuters.com/article/2013/07/24/us-sec-cohen-judge-idUSBRE96N1G820130724; Craig Quintana, *FCC to Volusia: Revamp System or Lose All Channels*, Orlando Sentinel (Mar. 4, 1992), http://articles.orlandosentinel.com/1992-03-04/news/9203041087_1_volusia-county-county-officials-bob-vog.

18. 17 C.F.R. § 200.30-10(a)(1).

19. *But see infra* Part IV.A (discussing SEC's proposed changes to these timelines).

4 months after briefing for the hearing officer to issue an initial decision."[20] The rules "strongly disfavor[]" variance from these timelines.[21]

Once the action is commenced, the Enforcement Division is required to disclose most of its investigative file.[22] The respondent can request additional documents by subpoena (approved by the ALJ),[23] and can informally interview potential witnesses, but cannot take depositions except to preserve testimony that will be unavailable at trial.[24]

Pre-trial dispositive motions are generally unavailable to respondents.[25] Under the rules, the respondent can file a motion for summary disposition seeking dismissal,[26] but may do so before trial only with leave from the ALJ.[27] In practice, motions for summary disposition filed by respondents are almost never granted.[28] Denials of such leave are not appealable.[29] If the respondent files such a motion after the Enforcement Division has presented its case, the ALJ must consider it, but the trial will ordinarily proceed pursuant to schedule even while such a motion is pending, because stays and extensions are strongly

20. *Id.* § 201.360(a); *see also* Andrew Ceresney, Dir., U.S. Sec. & Exch. Comm'n Div. of Enforcement, Remarks to the ABA Business Law Section Fall Meeting (Nov. 21, 2014) [hereinafter Ceresney, ABA Speech] ("An ALJ normally has 300 days from when a matter is instituted to issue an initial decision. . . . For cases we file in district court, we can often go 300 days and still be just at the motion to dismiss stage or part of the way through discovery, with any trial still far down the road.").

21. *See* 17 C.F.R. § 201.161(b); *see also* Rules of Practice, 68 Fed. Reg. 35787 (June 17, 2003) (adopting mandatory timelines).

22. 17 C.F.R. § 201.230. The investigative files can be quite large, and so can be overwhelming for respondents' attorneys to work through in the short time allotted between disclosure and trial. *E.g.*, Plaintiff's Motion for Preliminary Injunction at 2, Chau v. SEC, No. 14-cv-1903 (S.D.N.Y. June 5, 2014), ECF No. 20 (complaining about the short time allotted to review twenty-two million documents disclosed in the agency's investigative file); Plaintiff's Motion for Preliminary Injunction at 4, Bebo v. SEC, No. 15-cv-3 (E.D. Wis. Jan. 23, 2015), ECF No. 14 (complaining about the short time allotted to review "millions of documents" disclosed in the agency's investigative file).

23. 17 C.F.R. § 201.232.

24. *Id.* § 201.233.

25. *See* Luke T. Cadigan, *Litigating an SEC Administrative Proceeding*, Boston Bar J. (Jan. 7, 2014), http://bostonbarjournal.com/2014/01/07/litigating-an-sec-administrative-proceeding/ ("As a practical matter, there are also no dispositive motions prior to the hearing."); William F. Johnson & Amelia R. Medina, *SEC's Administrative Enforcement Intensifies Fairness Debate*, 252 N.Y. L.J. (Nov. 6, 2014), http://www.newyorklawjournal.com/id=1202675574765/SECs-Administrative-Enforcement-Intensifies-Fairness-Debate?slreturn=20150826104029 ("no dispositive motion practice prior to the hearing, with rare exceptions"); *see also* Complaint at para. 29, Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Feb. 19, 2015); Complaint at para. 23, Duka v. SEC, No. 15-cv-357 (S.D.N.Y. Jan. 16, 2015); Complaint at para. 37, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Oct. 20, 2014).

26. 17 C.F.R. § 201.250.

27. *Id.* In a 2011 order denying leave, Chief Administrative Law Judge Brenda Murray wrote: "I know of no guidance, and the parties have not cited any, as to what factors should be considered in granting leave to file a motion for summary disposition beyond that specified in the Comments to Rule 250 when adopted in 1995: 'Such leave shall be granted only for good cause shown, and if consideration of the motion will not delay the scheduled start of the hearing.'" *In re* Flannery, SEC Admin. Proceeding No. 3-14081 (Jan. 10, 2011).

28. *See* Alexander I. Platt, Unstacking the Deck: Administrative Summary Judgment and Political Control (working draft, on file with author) (reporting the results of an empirical study of every use of summary disposition in SEC APs from 1996 to 2014). In contrast, the Enforcement Division often wins summary disposition. *See id.*

29. 17 C.F.R. § 201.250(b).

discouraged. Interlocutory appeal of denials of motions for summary disposition is "disfavored" and only available in "extraordinary circumstances."[30]

At trial, the Enforcement Division must prove its case only by a preponderance of the evidence, far lower than the beyond a reasonable doubt standard required in criminal prosecutions (but the same as required in district court civil proceedings).[31] The rules of evidence do not apply, and the ALJ will consider any evidence that is not "irrelevant, immaterial or unduly repetitious."[32] A respondent may appeal a post-trial decision by the ALJ to the Commission.[33] But the same Commission signed off on the initiation of proceedings at the outset.[34]

A respondent may appeal a Commission decision to the U.S. Court of Appeals,[35] which will review the agency's factual determinations under the substantial evidence standard and legal determinations under the applicable level of deference.

B. The Utility of APs

APs have provided the SEC with an alternative forum to district court civil actions and criminal referrals for as long as the SEC has existed.[36] From the perspective of the agency, this forum offers several advantages, including the streamlined procedures surveyed above, the use of specialized factfinders,[37] and the speed with which each case is resolved either by litigation or settlement.[38]

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30. *Id.* § 201.400.

31. Steadman v. SEC, 450 U.S. 91 (1981).

32. 17 C.F.R. § 201.320; *see also* Ceresney, ABA Speech, *supra* note 20 ("In practice, what this means is that ALJs are guided by, but not obligated to strictly apply, the Federal Rules of Evidence").

33. 17 C.F.R. § 201.411.

34. *E.g.*, Complaint at para. 41, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Oct. 20, 2014) ("Any appeal from the SEC ALJ's decision goes to the SEC itself: the very body which, prior to the AP, determined that an enforcement action was necessary."); Complaint at para. 37, Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Feb. 19, 2015) (same); Complaint at para. 40, Stilwell v. SEC, No. 14-cv-7931 (S.D.N.Y. Oct. 1, 2014) (same); Plaintiff's Motion For Preliminary Injunction at 1, Bebo v. SEC, No. 15-cv-3 (E.D. Wis. Jan. 23, 2015), ECF No. 14 (similar).

35. *See* Securities Act § 9(a), 15 U.S.C. § 77i (2012); Exchange Act § 25(a)(1), 15 U.S.C. § 78(y) (2012); Investment Advisers Act § 213(a), 15 U.S.C. § 80b-13(a) (2012); Investment Company Act § 43(a), 15 U.S.C. § 80a-42 (2012).

36. *See, e.g.*, Securities Exchange Act of 1934, Pub. L. No. 73-290, § 4, 48 Stat. 881, 885 (creating U.S. Securities and Exchange Commission); *id.* §§ 19(a), 22, 48 Stat. at 898, 901 (authorizing the Commission to deny, suspend, or withdraw registrations "[a]fter appropriate notice and opportunity for hearing"); *see also* Ceresney, ABA Speech, *supra* note 20 ("[W]e have been using administrative proceedings throughout the 42-year history of the Division of Enforcement, and the Commission used them even before its enforcement activities were consolidated in one division.").

37. Ceresney, ABA Speech, *supra* note 20 (noting that ALJs "develop expert knowledge of the securities laws, and the types of entities, instruments, and practices that frequently appear in our cases").

38. *Id.* (noting that "administrative actions produce prompt decisions" and "from the standpoint of deterrence and investor protection, I think we can all agree that it is better to have rulings earlier rather than later"). From the agency's perspective, another benefit is the ability to streamline these proceedings even further by filing for summary disposition—a technique the Enforcement Division has made increasing use of in the past decade. *See* Platt, *supra* note 28.

This forum also offers advantages to the regulated industry at least in some cases. The flexibility, uniformity, and speed offered by the forum—for litigation and settlement—provide a meaningful advantage over district court actions to some respondents charged with relatively minor and clear violations. APs offer such respondents an opportunity to quickly settle or litigate the case and move on without undergoing the same litigation costs that might be incurred in a federal court action.[39]

Of course, the exercise of adjudicatory power by executive officers also extends far beyond the SEC. Apparently this function dates to the very first Congress,[40] and it is today utilized (with tremendous variation) across the federal bureaucracy in the administration of many federal benefit and regulatory programs.

C. Dodd-Frank: Increasing Administrative Penalty Powers

Dodd-Frank expanded the SEC's penalty authority in APs in several ways. First, it gave the SEC authority to impose civil penalties against persons associated with unregistered entities.[41] (Under prior law, the SEC had authority to impose civil monetary penalties in APs only against persons associated with entities directly regulated by the Commission;[42] to reach persons associated with unregistered entities, the SEC had to go to district court.)

Second, Dodd-Frank gave the SEC authority to impose so-called "collateral bars"—i.e., bans on associating across the entire securities industry.[43] This form of penalty is extremely severe, and it has been described by some courts as "the securities industry equivalent of capital punishment."[44] (Under prior law, the agency had authority to bar a respondent from associating with the securities industry sector he had previously associated with and which led to the charged misconduct—i.e., an investment adviser could be barred from associating with other investment advisers, but not with brokers, dealers, etc.[45]).[46]

39. *Cf.* Ceresney, ABA Speech, *supra* note 20 (respondents "can benefit when witnessess' recollections are fresher" and "the relaxed rules of evidence may likewise give [respondents] more flexibility in offering evidence").

40. Jerry L. Mashaw, Richard A. Merrill & Peter M. Shane, Administrative Law: The American Public Law System 310 (2003) (citing Richard H. Fallon, *Of Legislative Courts, Administrative Agencies, and Article III*, 101 Harv. L. Rev. 915, 919 (1988)).

41. Dodd-Frank § 929P, 15 U.S.C. §§ 77h-1, 78u-2(a), 80a-9(d)(1), 80b-3(i)(1) (2012). However, certain calculation methods remained exclusively in the district court.

42. This authority, itself, was created in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931. *See infra* Part III.A.

43. Dodd-Frank § 925, 15 U.S.C. §§ 78o, 78o-4, 78q-1, 80b-3 (2012); *see also* Chad Howell, *Back to the Future: Applying the Collateral Bars of Section 925 of the Dodd-Frank Act to Previous Bad Acts*, 7 J. Bus. & Tech. L. 285, 288 (2012) ("Essentially, the Commission is now authorized to put an individual completely out of the regulated securities business, even out of areas that had nothing to do with the violation of the securities law for which the individual was charged.").

44. *See, e.g.,* PAZ Sec., Inc. v. SEC, 494 F.3d 1059, 1065 (D.C. Cir. 2007).

45. *See generally* Teicher v. SEC, 177 F.3d 1016 (D.C. Cir. 1999).

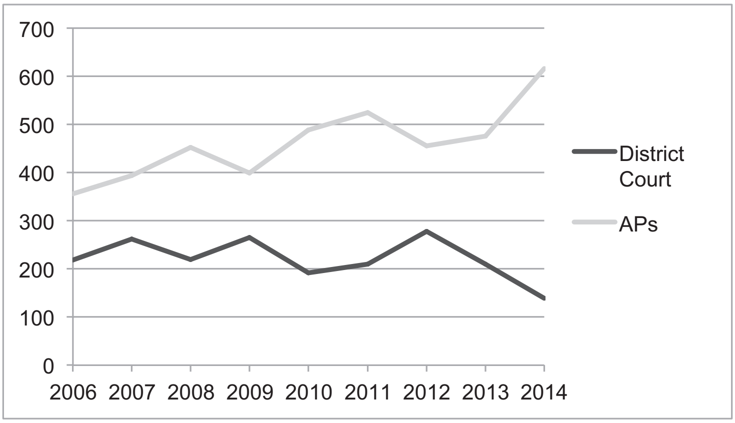
46. Earlier legislation gave the SEC the authority to use an AP to bar a respondent from serving as an officer or director of a public company. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1105, 116 Stat. 745, 809 (codified as amended at 15 U.S.C. §§ 78u-3, 77h-1 (2012)).

D. The Rise of APs

Commentators suggested that Dodd-Frank would alter the agency's incentives regarding its choice of forum going forward and predicted a shift towards APs.[47] Indeed, the data seems to confirm that the SEC has increased its relative use of APs since Dodd-Frank.

Figure 1

SEC Enforcement, Pre- and Post-Dodd-Frank[48]



Senior SEC personnel have acknowledged the post-Dodd-Frank shift.[49] The SEC also recently expanded its ALJ staff to accommodate the increased case-

47. *E.g.*, *The Dodd-Frank Act Reinforces and Expands SEC Enforcement Powers*, Gibson Dunn (July 21, 2010), http://www.gibsondunn.com/publications/pages/Dodd-FrankActReinforcesAndExpandsSECEnforcementPowers.aspx (suggesting Dodd-Frank "gives the SEC and its Enforcement Division a powerful incentive to bring more cases as administrative actions"); Joseph De Simone, Hector Gonzalez & John J. Tharp, Jr., *The Dodd-Frank Act's Impact on Securities Litigation and Enforcement*, Mayer Brown (Oct. 2010), https://www.mayerbrown.com/public_docs/doddfrank5907.pdf (suggesting that the changes created "more incentive for the SEC to bring cases as Administrative Actions"); *Dodd-Frank Beefs Up SEC and CFTC Enforcement*, Covington & Burling (July 21, 2010), https://goo.gl/dmau5O (suggesting that the changes "could radically affect the rights of companies and individuals outside the securities industry who become subject to SEC enforcement action").

48. The data in this figure is from SEC annual reports, PACER, and Susan Resley et al., *Dealing with the SEC's Administrative Proceeding Trend*, Law360 (Jan. 13, 2015), http://www.law360.com/articles/610688/dealing-with-the-sec-s-administrative-proceeding-trend. The last few years of data represent calendar year, not fiscal year. *See also* Jean Eaglesham, *SEC Is Steering More Trials to Judges It Appoints*, Wall St. J. (Oct. 21, 2014), http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it-appoints-1413849590 [hereinafter Eaglesham, *Steering Trials*] (collecting data).

49. *See* Sarah N. Lynch, *U.S. SEC to File Some Insider Trading Cases in Its In-House Court*, Reuters (June 11, 2014) http://www.reuters.com/article/2014/06/11/sec-insidertrading-idUSL2N0OS1AT20140611 (quoting Andrew Ceresney: "I do think we will bring more insider-trading cases as administrative proceedings in appropriate cases."); Gretchen Morgenson, *At the SEC, a Question of Home-Court Edge*, N.Y. Times (Oct. 5, 2013), http://www.nytimes.com/2013/10/06/business/at-the-sec-a-question-of-home-court-edge.html?_r=0 (quoting Andrew Ceresney: "Our expectation is that we will be bringing more administrative proceedings given the recent statutory

load.[50] The director of enforcement has acknowledged that the shift toward APs was a response to the new penalty powers: "[W]hat we are doing now is simply making use of the administrative forum in cases where we previously could only obtain penalties in district court."[51]

And, as many have noticed, the post-Dodd-Frank shift seems to be driven in part by a desire to move away from the district court.[52] From September 2013 to September 2014, the SEC won all six of its litigated APs, but only eleven out of the eighteen federal court trials.[53] Moreover, the agency's trial failures included some high-profile actions, such as the case against Mark Cuban. Such salient losses might have caused the agency to shift even further toward APs.[54] At a minimum, the timing of the shift creates an unfavorable impression that the agency is "running away from federal court" toward its home forum.

E. The Rise of APs: A Broader Lens

Commentators have understandably focused on Dodd-Frank's effect on the SEC's enforcement patterns. But Dodd-Frank was not the first time Congress has altered the SEC's enforcement patterns by giving it new penalty authority in APs. A review of the SEC's choice of forum since 1972[55] reveals that the agency's recent increased preference for APs relative to district court actions is not unique to this moment. Rather, the SEC's relative preference for APs seems to have also jumped in the early 1990s, and then again in the early 2000s.

changes."); Eaglesham, *Steering Trials*, *supra* note 48 (quoting Kara Brockmeyer, head of the SEC's FCPA practice: "It's fair to say it's the new normal. Just like the rest of the enforcement division, we're moving towards using administrative proceedings.").

50. *See supra* note 17.

51. Ceresney, ABA Speech, *supra* note 20.

52. *See* William McLucas & Matthew Martens, *How to Rein in the SEC*, Wall St. J. (June 2, 2015), http://www.wsj.com/articles/how-to-rein-in-the-sec-1433285747 ("The timing of the agency's decision in late 2013 to move toward more in-house proceedings couldn't have been worse. . . . One need not be a conspiracy theorist to wonder whether at least part of the SEC's rationale was to avoid the federal courts.").

53. Eaglesham, *Steering Trials*, *supra* note 48; *see also* Resley et al., *supra* note 48; Keystone Address of Jed S. Rakoff at the PLI Securities Regulation Institute, Is the S.E.C. Becoming a Law Unto Itself? (Nov. 5, 2014) [hereinafter Rakoff, Law Unto Itself]; Morgenson, *supra* note 49; *see also* Complaint at para. 36, Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Feb. 19, 2015) ("The SEC's apparently unstoppable series of 'wins' in Administrative Proceedings brings to mind long-ago discredited systems like monarchical Star Chambers and hardline regimes' show trials.").

54. Rakoff, Law Unto Itself, *supra* note 53 (discussing the agency's "stinging defeats" in district court as a reason the agency shifted towards APs); David A. Wilson, *Coming to an Administrative Law Judge Near You: Insider-Trading Cases*, Westlaw J. Derivatives, Dec. 19, 2014, at 1, 21, No. 2 WJDER 1 (Westlaw) ("Given some recent high-profile failures in federal court cases, and the SEC's near-perfect record before administrative law judges, it is expected that the agency will bring more of those cases before its own ALJs."); Johnson & Medina, *supra* note 25 (suggesting the SEC's "underwhelming" trial results motivated the SEC's "recent practices in forum selection"). *But see* Ceresney, ABA Speech, *supra* note 20 (rejecting the "notion that we are running away from cases in district court").

55. In 1972, the SEC consolidated all prosecutorial functions in a single enforcement division.

Figure 2
SEC Enforcement 1972–2014[56]

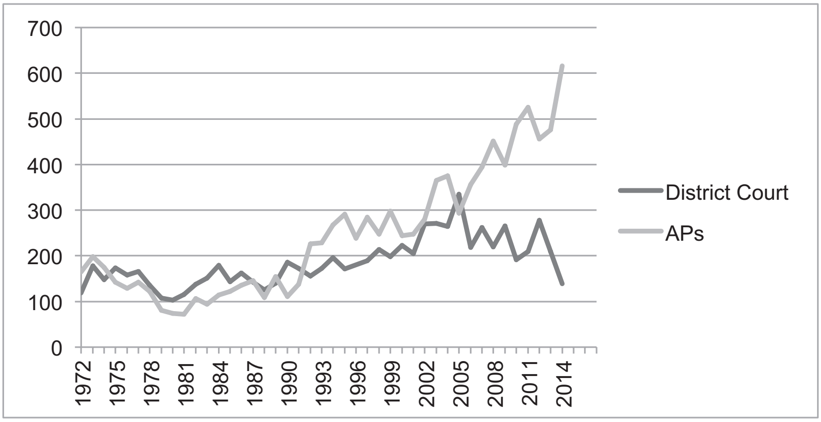
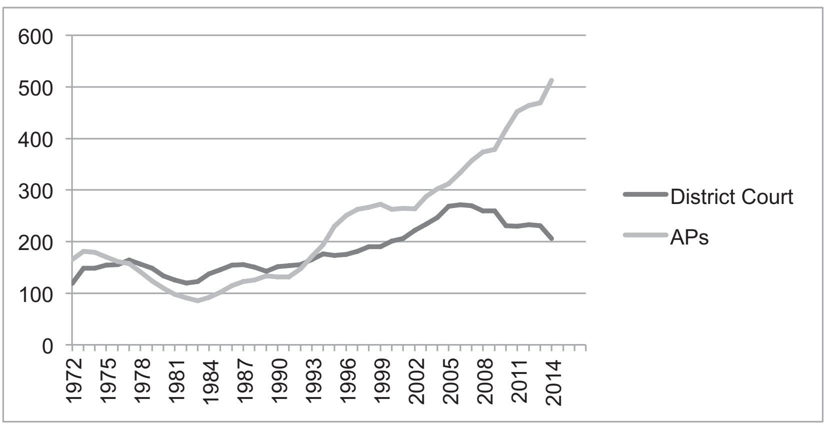


Figure 3
SEC Enforcement 1972–2014 (5-year Rolling Average)



Both of these earlier jumps seem to correspond roughly with earlier legislation that, like Dodd-Frank, boosted the SEC's penalty authority in APs: the 1990 Remedies Act and the 2002 Sarbanes-Oxley Act. Accordingly, this data invites closer scrutiny of those two episodes. How did the industry react to the SEC's expanded authority? What, if anything, did the SEC do to secure its legitimacy

56. For an explanation of the data, see *supra* note 48.

in those episodes?[57] This Article returns to consider those prior episodes in Part III.

II. Backlash

The post-Dodd-Frank shift toward APs has provoked backlash in the regulated industry and by its attorneys. This backlash has taken two forms. Targets of SEC prosecutions have filed a series of constitutional challenges, attacking procedural features of APs. At the same time, opinion leaders have leveled criticisms about the agency's use of APs as an obstruction to the proper development of the securities laws. Together, they amount to a significant challenge to the legitimacy of the SEC's enforcement regime.

A. Constitutional Challenges

As of this writing, a dozen challenges have been filed across four judicial circuits by individuals facing charges in APs. These suits attack various features of APs under various constitutional provisions and theories.[58] They include broad assaults on familiar features of administrative adjudication like the use of ALJs, the comingling of prosecutorial and adjudicative functions, the availability of monetary penalties and other sanctions, and the use of procedures less protective than the Federal Rules of Civil Procedure. Two district judges have already ruled for the plaintiffs on some of the claims, and others have credited the claims in other ways.

Regardless of whether these claims ultimately prevail, they signal significant opposition among key stakeholders to the agency's enforcement strategy since Dodd-Frank, and a growing sense that this strategy is illegitimate and unfair. This Part reviews the arguments advanced in these constitutional challenges, not to offer a comprehensive analysis or to prognosticate about the prospects for success, but only to show that the SEC is facing a tidal wave of opposition triggered by its recent enforcement efforts and a realistic chance of significant disruption as a result.

57. There are reasons to be cautious about drawing strong inferences from this data. First, there is much noise contained in the data about APs that has nothing to do with the thesis that the agency is substituting APs for district ourt actions. When the agency settles a case before filing, that case is often registered as an AP. *See* Ceresney, ABA Speech, *supra* note 20 ("For settled matters, we often, but not always, choose to file in an administrative forum, largely because of efficiency. The filing quickly ends the matter on a settled basis, among parties that have agreed to a settlement, and there is no need to have implementation of the parties' agreement subject to the competing demands of busy district court dockets."). Similarly, the agency often brings "follow-on" proceedings, that are also registered as APs. APs also include relatively minor actions, such as delinquent filings. *See, e.g.*, Mark J. Fagel, *What the SEC Enforcement Stats Really Tell Us*, Law360 (Mar. 3, 2015), http://www.law360.com/articles/627323/what-the-sec-enforcement-stats-really-tell-us (arguing that the "SEC's stats are a poor indicator of the division's actual productivity or accomplishments" because, in part, they include cases against issuers for delinquent filings).

58. *See infra* Table 1 (listing cases).

Table 1

Pl.	No.	D.J.	Ct.	Filed	Status	Def.'s Att'ys	Claims
Gupta	11-cv-1900	Rakoff	S.D.N.Y.	Mar. 18, 2011	Voluntarily dismissed.[59]	SEC	Equal Protection
Jarkesy	14-cv-114	Howell	D.D.C.	Jan. 29, 2014	Dismissed for lack of jurisdiction;[60] D.C. Circuit affirmed.[61]	SEC	Due Process (Separation of Functions); Equal Protection; Seventh Amendment; Nondelegation
Chau	14-cv-1903	Kaplan	S.D.N.Y.	Mar. 18, 2014	Dismissed for lack of jurisdiction;[62] Second Circuit appeal fully briefed Sept. 11, 2015.[63]	SEC	Procedural Due Process; Equal Protection
Stilwell	14-cv-7931	Forrest	S.D.N.Y.	Oct. 1, 2014	Voluntarily dismissed.[64]	DOJ	Removal; Nondelegation
Peixoto	14-cv-8364	Pauley	S.D.N.Y.	Oct. 20, 2014	Voluntarily dismissed.[65]	DOJ	Removal; Equal Protection; Seventh Amendment
Bebo	15-cv-3	Randa	E.D. Wis.	Jan. 2, 2015	Dismissed for lack of jurisdiction;[66] Seventh Circuit affirmed.[67]	DOJ	Removal; Equal Protection; Procedural Due Process; Seventh Amendment
Duka	15-cv-357	Berman	S.D.N.Y.	Jan. 16, 2015	Motion to dismiss denied as to appointment;[68] Second Circuit briefing set to be complete Dec. 22, 2015.[69]	DOJ	Removal; Appointment

59. Joint Stipulation of Dismissal, Gupta v. SEC, No. 11-cv-1900 (S.D.N.Y. Aug. 8, 2011), ECF No. 27.
60. No. 14-cv-114, 2014 WL 2584403 (D.D.C. June 10, 2014).
61. No. 14-5196, 2015 WL 5692065 (D.C. Cir. Sept. 29, 2015).
62. No. 14-cv-1903, 2014 WL 6984236 (S.D.N.Y. Dec. 11, 2014).
63. *See* Docket, Chau v. SEC, No. 15-461 (2d Cir.).
64. Notice of Voluntary Dismissal, Stilwell v. SEC, No. 14-cv-7931 (S.D.N.Y. Mar. 16, 2015), ECF No. 35.
65. Notice of Voluntary Dismissal, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Jan. 30, 2014), ECF No. 19.
66. No. 15-cv-3, 2015 WL 905349 (E.D. Wis. Mar. 3, 2015).
67. 799 F.3d 765 (7th Cir. 2015).
68. Duka v. SEC, No. 15-cv-357 (S.D.N.Y. Aug. 3, 2015) (decision and order), ECF No. 57; *see also* Duka v. SEC, No. 15-cv-357, 2015 WL 1943245 (S.D.N.Y. Apr. 15, 2015) (denying motion to dismiss as to jurisdiction).
69. *See* Docket, Duka v. SEC, No. 15-2732 (2d Cir.).

Pl.	No.	D.J.	Ct.	Filed	Status	Def.'s Att'ys	Claims
Gray Financial Group	15-cv-492	May	N.D. Ga.	Feb. 19, 2015	Preliminary injunction granted as to appointment;[70] Eleventh Circuit briefing completed Oct. 13, 2015.[71]	DOJ	Appointment; Removal
Tilton	15-cv-2472	Abrams	S.D.N.Y.	Apr. 1, 2015	Dismissed for lack of jurisdiction;[72] Second Circuit appeal argued Sept. 16, 2015.[73]	DOJ	Appointment; Removal
Hill	15-cv-1801	May	N.D. Ga.	May 19, 2015	Preliminary injunction granted;[74] Eleventh Circuit briefing complete Oct. 2, 2015.[75]	DOJ	Nondelegation; Seventh Amendment; Appointment; Removal
Spring Hill Capital Partners	15-cv-4542	Ramos	S.D.N.Y.	June 11, 2015	Dismissed for lack of jurisdiction.[76]	DOJ	Appointment
Timbervest, LLC	15-cv-2106	May	N.D. Ga.	June 12, 2015	Constitutional violation found likely, but preliminary injunction denied.[77]	DOJ	Appointment; Removal

70. Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Aug. 4, 2015) (order), ECF No. 56.
71. *See* Docket, Gray Fin. Grp., Inc., v. SEC, No. 15-13738 (11th Cir.), *consolidated with* Hill v. SEC, No. 15-12831 (11th Cir.).
72. Tilton v. SEC, No. 15-cv-2472, 2015 WL 4006165 (S.D.N.Y. June 30, 2015).
73. *See* Docket, Tilton v. SEC, No. 15-2103 (2d Cir.).
74. Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088 (N.D. Ga. June 8, 2015).
75. *See* Docket, Hill v. SEC, No. 15-12831 (11th Cir.).
76. Spring Hill Capital Partners, LLC v. SEC, No. 15-cv-4542 (S.D.N.Y. June 26, 2015) (order), ECF No. 23; *see also* Transcript of Proceedings at 63–73, Spring Hill Capital Partners, LLC v. SEC, No. 15-cv-4542 (S.D.N.Y. July 8, 2015), ECF No. 26 (providing reasons for decision).
77. Timbervest, LLC v. SEC, No. 15-cv-2106 (N.D. Ga. Aug. 4, 2015) (order), ECF No. 25.

Table 2

Argument	Targeted Feature	Cases
Removal	ALJs' insulation from presidential control.	*Stilwell, Gray Financial Group, Peixoto, Duka, Bebo, Tilton, Hill, Timbervest*
Appointment	ALJs' appointment by office other than the "head of department."	*Gray Financial Group*, *Tilton*, *Hill*, *Spring Hill*, *Timbervest*, *Duka*
Seventh Amendment	Severe penalties on unregistered persons.	*Jarkesy, Bebo, Peixoto, Hill*
Nondelegation	Choice of forum.	*Jarkesy, Stilwell, Hill*
Due Process/Separation of Functions	Comingling of prosecution and adjudication.	*Jarkesy*
Procedural Due Process	Severe penalties on unregistered persons.	*Chau, Bebo*
Equal Protection	Choice of forum.	*Gupta, Jarkesy, Bebo, Peixoto, Chau*

1. Article II—Appointments and Removal

Two of plaintiffs' strongest challenges arise under Article II of the Constitution. Section 2 of that Article provides that the President "shall appoint . . . all . . . Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law," but that "Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments."[78] Plaintiffs argue that SEC ALJs violate this provision because (as the SEC concedes) they are appointed by the SEC's Office of Human Resources, not the "head" of the "department"—i.e., the Commission itself.[79] Plaintiffs also claim that the multiple layers of tenure protection enjoyed by ALJs[80] unconstitutionally impedes the President's control over them under the U.S. Supreme Court's decision in *Free Enterprise Fund v. PCOAB*.[81]

The threshold issue for both claims is whether ALJs are properly classified as "inferior officers" or mere "employees," since only the former trigger the constitutional rules governing appointments and removal.[82] The touchstone is whether they exercise "significant authority"[83]—a standard that requires close

78. U.S. CONST. art. II, § 2.

79. *See* Free Enter. Fund v. PCOAB, 561 U.S. 477, 511–12 (2010) (finding that SEC commissioners jointly constitute the "head" of the SEC for appointment purposes).

80. ALJs can only be removed "for cause" by the Commission, who may only be removed by the President for cause. *See Free Enter. Fund*, 561 U.S. at 487. Separately (and in addition), ALJs may only be removed after a hearing before the MSPB who, themselves, may only be removed by the President for cause. *See* 5 U.S.C. § 7512(a) (2012); *id.* § 1202(d).

81. 561 U.S. 477.

82. Freytag v. CIR, 501 U.S. 868, 880 (1991) ("'lesser functionaries' need not be selected in compliance with the strict requirements of Article II"); *Free Enter. Fund*, 561 U.S. at 484, 506.

83. *Freytag*, 501 U.S. at 881 (quoting Buckley v. Valeo, 424 U.S. 1, 126 (1976)).

scrutiny of the precise contours of ALJs' powers and careful comparisons.[84] In *Freytag v. CIR*, the U.S. Supreme Court held that special trial judges of the Tax Court were, indeed, "inferior officers" because (unlike special masters) their positions and roles were fixed by statute, and they exercised "significant discretion" in carrying out their duties and functions, which included "tak[ing] testimony, conduct[ing] trials, rul[ing] on the admissibility of evidence, and . . . enforc[ing] compliance with discovery orders."[85] But, in *Landry v. FDIC*, the D.C. Circuit found that FDIC ALJs were not "inferior officers" because, while their positions and roles were fixed by statute, they lacked authority to make "final" decisions, and instead were limited only to making "recommended" ones.[86]

So far, two district judges have found that SEC ALJs are, indeed, "inferior officers." Judge Leigh Martin May found that "like the STJs in *Freytag*, SEC ALJs exercise 'significant authority'" because they "take testimony, conduct trial, rule on the admissibility of evidence, and can issue sanctions, up to and including excluding people (including attorneys) from hearings and entering default."[87] She conceded that ALJs (like the judges in *Landry*) lacked authority to issue "final orders,"[88] but found that this factor was not dispositive and that the D.C. Circuit's position to the contrary in *Landry* was incorrect.[89] Judge Richard Berman ruled similarly.[90]

If SEC ALJs *are* "inferior officers," the appointments violation follows relatively automatically[91]: the SEC has acknowledged that its ALJs are hired by the Commission's Office of Human Resources with input from the Chief ALJ and the U.S. Office of Personnel Management, but no direct role for the Commission (the "head of the department") itself.[92]

84. *See, e.g.*, Landry v. FDIC, 204 F.3d 1125, 1132 (D.C. Cir. 2000) (collecting sources) ("The line between 'mere' employees and inferior officers is anything but bright.").

85. *Freytag*, 501 U.S. at 881; *see also id.* at 892 (Scalia, J., concurring) (finding that ALJs are "officers").

86. 204 F.3d 1125; *but see id.* at 252 (Randolph, J., concurring in part and concurring in the judgment) ("There are no relevant differences between the ALJ in this case and the special trial judge in *Freytag*.").

87. Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088, at *17 (N.D. Ga. June 8, 2015).

88. Judge May explained:

> Plaintiff argues that SEC ALJs can issue final orders because if the respondent does not petition the SEC to review the ALJ's initial order and the SEC does not decide to review the matter on its own, the action of the ALJ will be "deemed the action of the Commission." The SEC argues that the SEC retains plenary authority over ALJs and the regulations make clear that only when the SEC itself issues an order does the decision become final. This Court agrees with the SEC. Because the regulations specify that the SEC itself must issue the final order essentially "confirming the initial order, the Court finds that SEC ALJs do not have final order authority."

Id. at *17 n.10.

89. *Id.* at *17.

90. Duka v. SEC, No. 15-cv-357 (S.D.N.Y. Aug. 3, 2015), ECF No. 57.

91. *See id.*; *Hill*, 2015 WL 4307088, at *19.

92. Affidavit of Jayne L. Seidman, *In re* Timbervest, LLC, SEC Admin. Proceeding No. 3-15519 (June 4, 2015); Notice of Filing by U.S. Sec. & Exch. Comm'n Div. of Enforcement, *In re* Timbervest, LLC, SEC Admin. Proceeding No. 3-15519 (June 4, 2015); *see also* Frankel, *supra* note 14 (ALJs are "named through a bureaucratic process and not by the commissioners.").

The removal issue is a bit more complicated. In *Free Enterprise Fund v. PCOAB*,[93] the U.S. Supreme Court found that an administrative scheme providing two layers of for-cause removal protection for certain officers constituted an impermissible restriction on the President's removal authority.[94] The case concerned the Public Company Accounting Oversight Board, which Congress created in 2002 to oversee accounting firms involved in the auditing of public companies under the securities laws. Among other things, the Board was empowered to "promulgate[] auditing and ethics standards, perform[] routine inspections of all accounting firms, demand[] documents and testimony, and initiate[] formal investigations and disciplinary proceedings."[95] The Board's members were appointed by the SEC, and they could only be removed by that body "for good cause shown" subject to certain procedures.[96] Members of the SEC, in turn, cannot be removed by the President except for "inefficiency, neglect of duty, or malfeasance in office."[97] The *Free Enterprise Fund* Court held that this two-layered insulation from presidential removal was an unconstitutional hindrance on the President's constitutional duty to oversee his officers.[98]

Plaintiffs read *Free Enterprise Fund* as articulating a formalistic rule: "officers" cannot be insulated from presidential control by more than one layer of for-cause removal. But some courts have read *Free Enterprise Fund* in functionalist terms: what matters is not the number of layers of protection *per se*, but whether those protections interfere with the President's ability to perform his duties.[99]

93. 561 U.S. 477 (2010).

94. The U.S. Constitution vests "[t]he executive Power . . . in a President of the United States of America," who must "take Care that the Laws be faithfully executed." Art. II, § 1, cl. 1; *id.* § 3. The Constitution also provides for the appointment of executive "officers" to "'assist the supreme Magistrate in discharging the duties of his trust.'" *Free Enter. Fund*, 561 U.S. at 483 (quoting 30 Writings of George Washington 334 (J. Fitzpatrick ed. 1939)). But "[t]he President cannot 'take Care that the Laws be faithfully executed' if he cannot oversee the faithfulness of the officers who execute them." *Id.* at 484. Thus, the Court has protected the President's authority to remove officers against legislative encroachment. *Id.*; *see also, e.g.*, Myers v. United States, 272 U.S. 52 (1926); Morrison v. Olson, 487 U.S. 654 (1988).

95. *Free Enter. Fund*, 561 U.S. at 485.

96. *Id.*

97. *Id.* at 487.

98. *E.g.*, *id.* at 497 ("The officers of such an agency—safely encased within a Matryoshka doll of tenure protections—would be immune from Presidential oversight, even as they exercised power in the people's name.").

99. *E.g.*, Duka v. SEC, No. 15-cv-357, 2015 WL 1943245, at *17 (S.D.N.Y. Apr. 15, 2015) ("*Free Enterprise* clearly did not establish . . . a categorical rule forbidding 'two levels of "good-cause" tenure protection.'"); *id.* ("Supreme Court precedent supports a functional test to determine whether and when statutory limitations on the President's power to remove executive officers violate Article II."); *see also* Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088, at *19 n.12 (N.D. Ga. June 8, 2015) (expressing "serious doubts" that the two-layer tenure protections violate Article II because they "do not interfere with the President's ability to perform his duties").

ALJs are utilized across the federal bureaucracy.[100] A judicial ruling finding them unconstitutional because the wrong person signed off on their appointment, or because they are entitled to job protections under the MSPB, would be potentially transformative.[101] Nonetheless, both Article II challenges have a realistic probability of success before appellate courts and ultimately the U.S. Supreme Court. (It is notable that in cases raising the Article II challenges, the SEC has been represented by DOJ attorneys rather than its own attorneys, suggesting that the government recognizes the strength of this argument.[102])

2. Seventh Amendment

Another strong line of attack is based on the right to jury trial under the Seventh Amendment[103] and the structural limits on Congress's ability to interfere with the "judicial Power of the United States."[104] Any such attack will have to overcome the Court's "public rights" doctrine—the rule that "when Congress creates new statutory 'public rights,' it may assign their adjudication to an administrative agency with which a jury trial would be incompatible'"[105]—which has been used to uphold Article I adjudications since the New Deal.[106] In *Tull v. United States*, the U.S. Supreme Court found that the Seventh Amendment guarantee of a jury trial applied in an action by the government seeking millions of dollars in fines under the Clean Water Act.[107] The Court reasoned that the government's action here was analogous to an "action in debt" at common law, and (further) that the penalties provided by the statute were "intended to punish culpable individuals" not merely "to extract compensation or restore the status quo."[108] Because such punitive remedies were "traditionally available in a court of law," the jury right was applicable.[109]

In addition to trying to analogize the SEC's action and penalty powers to those at issue in *Tull*, plaintiffs may protest that the severe penalties can now be

100. *E.g.*, Paul R. Verkuil, *Reflections Upon the Federal Administrative Judiciary*, 39 UCLA L. Rev. 1341 (1992).

101. In the DOJ's words, "the Executive Branch's use of tenure-protected ALJs for nearly seventy years establishes a gloss on the Constitution that supports the current removal framework." Government Opposition at 39, Bebo v. SEC, No. 15-cv-3 (E.D. Wis. Feb. 3, 2015), ECF No. 15; *see also Free Enter. Fund*, 561 U.S. at 537–38 (Breyer, J., dissenting).

102. *See supra* Table 1; *cf.* U.S. Attorney's Manual § 4-6.100 (1997) (explaining that Main Justice attorneys, rather than Assistant U.S. Attorneys, handle cases which "involve serious or novel constitutional or statutory challenges to federal programs, cases challenging a nationwide program with potentially far-reaching implications, [or] cases in which . . . the client agency . . . has requested assistance").

103. "In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved." U.S. Const. amend. VII.

104. *See* CFTC v. Schor, 478 U.S. 833 (1986).

105. Atlas Roofing Co. v. Occupational Safety & Health Review Comm'n, 430 U.S. 442, 455 (1977). For instance, in *Atlas Roofing*, the Court upheld the OSHRC adjudication of civil penalties because it was a "public right." *See also* Crowell v. Benson, 285 U.S. 22 (1932).

106. *E.g.*, *Atlas Roofing*, 430 U.S. 442.

107. Tull v. United States, 481 U.S. 412 (1987).

108. *Id.* at 422.

109. *Id.* at 422–23; *see also* N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982).

applied to individuals exempt from registration with the Commission. The securities laws require certain individuals and entities to register with the Commission as broker-dealers, investment advisers, stock exchanges, and other SEC-regulated persons. While unregistered securities professionals and firms have always been subject to some regulation,[110] the mine-run of disclosure and other regulatory requirements imposed by the securities laws have been reserved for those required to register. Thus, prior to Dodd-Frank, many hedge fund investment advisers tailored their business model specifically to qualify for the exemption from registration in order to avoid the broader regulatory and disclosure obligations imposed on registered firms.[111] The Court has recognized voluntary submission to agency jurisdiction as an important factor in the constitutionality of non-Article III adjudications.[112] Plaintiffs may argue that unregistered persons have not consented to the agency's jurisdiction, and so it is particularly unfair to subject these individuals and firms to these proceedings.[113]

These arguments may well ultimately be sufficient to distinguish these proceedings from "public rights" adjudications that the Court has upheld in the past.[114] On the other hand, the SEC has consistently insisted that its penalties are remedial in nature—designed to protect the public, not punish the respondent—and so do not trigger any right to a jury trial. And again, similar procedures and penalties are so broadly employed across the administrative state that any ruling for plaintiffs will either have to draw some sort of distinguishing characteristic that makes APs uniquely bad, or risk undermining a vast amount of administrative practice.

3. Due Process/Equal Protection

The other major lines of attack also cannot be ruled out. Some plaintiffs claim that APs violate procedural due process by threatening to deprive them of important liberty and property interests without adequate procedural protections.[115] Others argue that the commingling of prosecutorial and adjudicative functions in the Commission violates the principle of separation of functions embedded

110. For instance, the antifraud provision of the Investment Advisers Act applies to unregistered advisers. *E.g.*, IAA § 206, 15 U.S.C. § 80b-6 (2012).

111. *Cf.* Goldstein v. SEC, 451 F.3d 873, 875–77 (D.C. Cir. 2006).

112. CFTC v. Schor, 478 U.S. 833, 855 (1986) ("Congress gave the CFTC the authority to adjudicate such matters, but the decision to invoke this forum is left entirely to the parties and the power of the federal judiciary to, take jurisdiction of these matters is unaffected.").

113. *E.g.*, Respondents Opening Brief, In re John Thomas Capital Mgmt. Grp. LLC, Admin. File No. 3-15255 (Jan. 13, 2015) ("Dodd-Frank transformed the SEC administrative enforcement program for ordinary, unregistered persons like Respondents into a penalty-collection program that is indistinguishable from the Water Act penalty program before the Supreme Court in *Tull*.").

114. Judge May, who ruled for plaintiffs on the Article II Appointment issue, found that they were not. *See* Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088, at *13–15 (N.D. Ga. June 8, 2015); *see also In re Steven Wise*, Admin. Proceeding File No. 3-11247 (Feb. 17, 2005) (order denying motion to dismiss claim for civil monetary penalties) (rejecting Seventh Amendment challenge to civil monetary penalties by unregistered adviser).

115. *See* Matthews v. Eldridge, 424 U.S. 319 (1976).

in the Due Process Clause.[116] And others argue that the SEC's choice to prosecute them in APs rather than in district court constitutes irrational discrimination under the equal protection principle of the Fifth Amendment.

Each of these arguments faces substantial hurdles. For instance, there seems to be nothing limiting the separation-of-functions attack to the specifics of the SEC APs, rather than to all of the similarly structured agencies which have long been recognized as constitutional. On equal protection, the agency need only provide a "rational" basis for agency action—a low bar.[117]

Like the Seventh Amendment argument, the procedural due process argument appears to call for a balancing of the penalties, procedures, and alternatives. Such case-by-case balancing could, conceivably, allow a court to rule against the SEC without thereby jeopardizing all similarly structured adjudications.

Some plaintiffs have recently bolstered their due process arguments with specific allegations suggesting that ALJs have been subjected to pressure to rule for the agency. In May 2015, the *Wall Street Journal* published a report based on an interview of a former ALJ (Lillian McEwan) who claimed that, while on the bench, Chief ALJ Brenda Murray criticized her for ruling against the agency, questioned her "loyalty to the SEC," and pressured her to rule in favor of the agency more often.[118] Ms. McEwan explained that, while an ALJ, she felt that she was "expected to work on the assumption that 'the burden was on the people who were accused to show that they didn't do what the agency said they did.'"[119] This report led one group of respondents to seek discovery regarding the possible bias of the ALJ hearing their case, Cameron Elliot. The Commission responded with an order "inviting" the ALJ in question to file an affidavit "addressing whether he has had any communications or experienced any pressure similar

116. Due process requires a judge must recuse himself from hearing a case if he has "a direct, personal, substantial pecuniary interest" in the outcome. Tumey v. State of Ohio, 273 U.S. 510, 523 (1927); *see also* Caperton v. A.T. Massey Coal Co., 556 U.S. 868 (2009). Rather than inquiring into "actual bias," "the Court has asked whether, under a realistic appraisal of psychological tendencies and human weakness, the interest poses such a risk of actual bias or prejudgment that the practice must be forbidden if the guarantee of due process is to be adequately implemented." *Caperton*, 556 U.S. at 883–84 (quotations and citations omitted). Some plaintiffs have claimed that ALJs and commissioners violate this rule by engaging in ex parte conversations with the prosecutors and (in the Commission's case) authorizing the prosecution in the first case. *E.g.*, Jarkesy v. SEC, No. 14-cv-114, 2014 WL 2584403, at *2 (D.D.C. June 10, 2014) ("[The] Commission has conclusively prejudged the case . . . and engaged in impermissible ex parte communications with the [Enforcement] Division staff in connection with the settlement [of a related case.]"). Of course, these circumstances are common to many administrative adjudication schemes and have been long regarded as permissible without crossing any due process lines. *E.g.*, FTC v. Cement Inst., 333 U.S. 683 (1948).

117. True, this argument is one of the few that has actually made it past jurisdictional hurdles. *See* Gupta v. SEC, 796 F. Supp. 2d 503 (S.D.N.Y. 2011). But that says nothing about its likelihood of prevailing on the merits.

The Division of Enforcement recently released guidelines regarding forum selection which suggest that wherever "similar charges" have been brought against "similarly situated parties" in the "same or closely related matters," "it may be preferable" to "recommend charges" in the same forum. Division of Enforcement Approach, *supra* note 4. Though this generally seems to support the equal protection theory, it is couched in such caveated language that it may not be much help to plaintiffs.

118. Jean Eaglesham, *SEC Wins with In-House Judges*, Wall St. J. (May 6, 2015), http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

119. *Id.*

to that alleged in the . . . *Wall Street Journal* article . . . and whether he is aware of any specific instances in which any other Commission ALJ has had such communications or experienced such pressure."[120] Judge Elliott declined to do so without comment.[121]

These allegations raise serious due process concerns and may provide a subject for discovery for a plaintiff in a district court action. They do serious harm to the legitimacy of the agency's enforcement program, casting doubt on past rulings and raising doubts about the future.

4. Nondelegation

Some cases have developed a nondelegation challenge,[122] and a few others have alluded vaguely to it.[123] The crux of the argument is that, by equalizing penalties across district courts and APs, Congress effectively stripped the "intelligible principle" out from the delegation to the SEC to choose which forum to prosecute its cases in.[124] Before Dodd-Frank, the penalty differential between fora provided an inchoate but still intelligible principle for the SEC's forum selection. As SEC Chairman Breeden explained at the time: "The Commission expects that it would bring civil actions in federal court in those cases in which defendants have received illegal gains substantially in excess of these maximum amounts [permitted in APs.]"[125] After Dodd-Frank, the agency explained that it chooses a forum based on the following:

> In certain cases, we need certain types of discovery that we can only get in district court. For example, where we file our case on an expedited basis to stop an ongoing fraud, a district court might be the only option that allows us to act quickly while still being able to gather evidence. In certain cases, we need emergency relief, such as an asset freeze or receiver, and that requires an order from a district court. We also may believe that we can obtain summary judgment in district court. The bottom line is that we make a case by case determination of which forum is appropriate based on the particular facts of the case.[126]

120. *In re* Timbervest, LLC, SEC Admin. Proceeding No. 3-15519 (June 4, 2015) (order concerning additional submission and protective order); *see also* Jean Eaglesham, *SEC Judge Declines to Submit Affidavit of No Bias*, Wall St. J. (June 11, 2015), http://blogs.wsj.com/moneybeat/2015/06/11/sec-judge-declines-to-submit-affidavit-of-no-bias/ [Eaglesham, *Declines to Submit Affidavit*] (quoting professor Kent Barnett as describing the request as "unprecedented" and "bizarre").

121. Eaglesham, *Declines to Submit Affidavit*, *supra* note 120.

122. *See* Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088, at *10–11 (N.D. Ga. June 8, 2015); Appellant's Brief, Jarkesy v. SEC, No. 14-5196 (D.C. Cir. Dec. 24, 2014).

123. Complaint at para. 28, Stilwell v. SEC, No. 14-cv-7931 (S.D.N.Y. Oct. 1, 2014) ("The securities laws provide the SEC with discretion—guided by no statute, regulation, or established practice—to bring enforcement action either in federal district court or internal SEC administrative proceedings."); Complaint at para. 24, Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Feb. 19, 2015).

124. When Congress delegates legislative power to agencies, it must "lay down by legislative act an intelligible principle to which the person or body authorized to [act] is directed to conform." Whitman v. Am. Trucking Ass'ns, 531 U.S. 457, 472 (2001).

125. *Securities Law Enforcement Remedies Act of 1989: Hearings on S. 647 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 101st Cong., 2d Sess. 38–46 (1990) (statement of Richard C. Breeden, Chairman, Securities and Exchange Commission).

126. Ceresney, ABA Speech, *supra* note 20.

More recently, the Enforcement Division released a four-page document outlining its considerations in choosing a forum. The document explained that there was no "rigid formula," but rather a "number of factors" including "[t]he availability of the desired claims, legal theories, and forms of relief"; "[w]hether any charged party is a registered entity or an individual associated with a registered entity"; "[t]he cost-, resource-, and time-effectiveness of litigation in each forum"; and "[f]air, consistent, and effective resolution of securities law issues and matters."[127] The Court has set the bar for "intelligible principle" so low that this set of considerations may qualify.[128]

More importantly, the target of the claim is the agency's choice of forum which may not be an exercise of undelegable *legislative* authority, but rather an exercise of prosecutorial discretion that is normally exercised by executive agencies.[129] Thus, even if plaintiffs have a good argument that the choice of forum determination now lacks any "intelligible principle," the nondelegation challenge may still not prevail.[130]

Then again, insofar as APs are being used as a forum to develop novel, untested theories of the securities laws (discussed below) as a substitute for rulemaking, plaintiffs may be able to argue that the choice of this forum is itself a quasi-legislative act, requiring an "intelligible principle."[131]

* * *

It should be noted that courts have dismissed several of these claims on jurisdictional grounds, without reaching the merits.[132] But it is clear that these claims will get their day in court—either by courts that reject the agency's arguments about jurisdiction,[133] or by appellate courts hearing claims on appeal from the AP process itself, where jurisdictional hurdles cannot interfere.[134]

It is also true that some of these claims have been voluntarily dismissed after the parties struck settlement bargains with the SEC.[135] But if the SEC is perceived as giving parties who filed suits additional benefits in the settlements in exchange for voluntarily dismissing these suits, this will only lead to more suits being filed.

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127. *Division of Enforcement Approach*, *supra* note 4.

128. *See generally Whitman*, 531 U.S. 457.

129. *See* United States v. Batchelder, 442 U.S. 114, 126 (1979) (rejecting a nondelegation challenge where "the power that Congress has delegated to those officials is no broader than the authority they routinely exercise in enforcing the criminal laws").

130. Judge May rejected the claim on these grounds. *See* Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088, at *10–11 (N.D. Ga. June 8, 2015).

131. *See infra* Part II.B.

132. *E.g.*, Tilton v. SEC, No. 15-cv-2472, 2015 WL 4006165 (S.D.N.Y. June 30, 2015); Bebo v. SEC, No. 15-cv-3, 2015 WL 905349 (E.D. Wis. Mar. 3, 2015), *aff'd*, 799 F.3d 765 (7th Cir. 2015); Chau v. SEC, No. 14-cv-1903, 2014 WL 6984236 (S.D.N.Y. Dec. 11, 2014); Jarkesy v. SEC, No. 14-cv-114, 2014 WL 2584403 (D.D.C. June 10, 2014), *aff'd* No. 14-5196, 2015 WL 5692065 (D.C. Cir. Sept. 29, 2015).

133. Duka v. SEC, No. 15-cv-357, 2015 WL 1943245 (S.D.N.Y. Apr. 15, 2015).

134. *In re* Timbervest, LLC, SEC Admin. Proceeding No. 3-15519 (Jan. 20, 2015) (ordering briefing on the Article II issue).

135. *See supra* Table 1.

There is a realistic possibility that one of these challenges will ultimately succeed—perhaps in front of the U.S. Supreme Court. But regardless, they signal a significant breach of faith regarding the agency's enforcement mission among key stakeholders, only a few years after Congress entrusted the agency with broad new powers.

B. The Development of the Securities Laws

Before turning to explanations, this Article first turns to consider a distinct criticism that has been leveled against APs by some opinion leaders—that the SEC is using APs to *make* the law, rather than merely enforce it. Though often repeated,[136] this criticism has yet to be carefully examined.

1. Incentives Fostering Regulation by Prosecution in APs

Individuals charged by the SEC have a right to judicial review. But that right is much costlier to exercise in an AP. In district court, a defendant may attack the agency's legal theories *immediately* by filing a motion to dismiss the suit under the Federal Rules of Civil Procedure. APs afford respondents far more limited rights to raise legal challenges. A respondent may file a motion for summary disposition before the trial only with leave from the ALJ. Denial of leave is unreviewable, and denial of the motion is not appealable to the Commission as of right—respondents must move the ALJ to certify the issue for interlocutory review or appeal directly to the Commission for such review. And such motions have been granted rarely; between 1996 and 2014, only five respondents have persuaded an ALJ to grant summary disposition in their favor—and one of those cases was reversed by the Commission.[137] Meanwhile, the AP is likely to continue to proceed along a fast track to trial, as departures from rigid preferred timelines are "strongly discouraged." Of course, a Commission that has already signed off on the legal theory underlying the prosecution—as well as, in some cases, rejected a respondent's pre-OIP "Wells submission"[138] contesting the theory—is unlikely to reverse its prior determination.

Thus, to raise a legal challenge, a respondent ordinarily must be prepared to submit to trial before an ALJ. Trial can be a risky proposition for white-collar

136. Rakoff, Law Unto Itself, *supra* note 53; *Is the SEC Stretching Itself Too Thin?*, SEC Enforcement Q. (Sidley Austin, LLP, Chicago, IL), Q3 2012, at 2, 2, *available at* http://www.sidley.com/~/media/files/news/2012/10/sec-enforcement-quarterly-newsletter/files/click-here-to-view-the-newsletter/fileattachment/secenforcementnewsletter_103112.pdf ("[T]he SEC has increasingly relied on charges based on novel or relatively untested legal theories, particularly in complex cases."); Resley et al., *supra* note 48; Complaint at para. 25, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Oct. 20, 2014).

137. *See* Platt, *supra* note 28.

138. The SEC's Rules on Informal and Other Procedures provide that "[p]ersons who become involved in . . . investigations may . . . submit a written statement to the Commission setting forth their interests and position in regard to the subject matter of the investigation." The Enforcement Manual explains that this practice "evolved from recommendations made by an advisory committee chaired by John Wells." U.S. Sec. & Exch. Comm'n Div. of Enforcement, Enforcement Manual § 2.4 (June 4, 2015).

defendants. New facts might emerge which spur further investigation or, even worse, a referral to DOJ for consideration of criminal charges. Principals and other witnesses might be called to testify, which could generate additional unwanted media attention. The uncertainty may lead shareholders, investors, financial counterparties, or other stakeholders to take business elsewhere or charge a risk premium. In addition, the legal costs of trial can be very substantial.

Even if he chooses to endure a trial, a respondent will not get a chance to present his claims in an Article III forum until he receives the ALJ's opinion (as long as 300 days after the OIP), appeals that to the Commission, and then appeals that to a circuit court. That means not only more delay, and extended uncertainty, but also (potentially) multiple rounds of negative publicity.

Thus, faced with a choice between attacking a faulty legal theory after a trial and reaching a settlement, many (or even most) respondents will choose the latter. More importantly, respondents in APs are more likely to make this choice than are defendants in district court actions, who have relatively easy access to legal challenges via a motion to dismiss or for summary judgment prior to trial. The SEC understands this settlement-forcing power of APs and takes advantage. The director of enforcement recently admitted: "there have been a number of cases in recent months where we have threatened administrative proceedings[;] it was something we told the other side we were going to do, and they settled."[139]

The result is that APs present an appealing mechanism for the agency to advance and establish novel theories of liability, relatively immune from timely judicial challenge. Over time, settlements add up into a body of agency "precedent." One chairman of the Commission explained:

> [W]hen the SEC staff comes upon a novel activity that it believes violates the law, it will often attempt to settle the first several cases of that nature, so that it can establish its own set of precedents. . . . The advantage to the Commission . . . is that [it] can issue a lengthy description of the conduct it finds objectionable, and its rationale for finding that conduct violative of the law. . . . After one or two of these relatively lenient settlements, the SEC will then increase the "penalty" for similar violations . . . .[140]

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139. Bryan Mahoney, *SEC Could Bring More Insider Trading Cases In-House*, LAW360 (June 11, 2014, 6:53 PM EST), http://www.law360.com/articles/547183/sec-could-bring-more-insider-trading-cases-in-house (quoting Andrew Ceresney); *see also* Appellant's Brief at 11–12 n.8, Jarkesy v. SEC, No. 14-5196 (D.C. Cir. Dec. 24, 2014).

140. Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look at the Next Decade*, 7 YALE J. ON REG. 149, 181–82 n.126 (1990) (collecting cases); *see also* Zachary W. Carter, *The SEC's "Settlement Prudence": "Law" Creation Through a Coercive Settlement Process*, LAW SEMINARS (June 30, 2004, 2:32 PM), http://www.lawseminars.com/materials/07SDAMNY/carter.pdf; Roberta S. Karmel, *Creating Law at the Securities and Exchange Commission: The Lawyer as Prosecutor*, 61 LAW & CONTEMP. PROBS. 33 (1998); ROBERTA KARMEL, REGULATION BY PROSECUTION 219–22 (1982).

Critics have also emphasized another problem: that, even if a respondent refuses to settle and pursues a legal challenge to an appellate court, that court will review the agency's legal determinations with deference accorded by administrative law. *E.g.*, Rakoff, Law Unto Itself, *supra* note 53. I think this criticism is secondary, and I discuss it further in Part IV.

Though this tendency toward regulation by settlement is, to some extent, hardwired into APs, recent developments have intensified the effect. Dodd-Frank's enhancement of the penalties available in APs strengthened the SEC's ability to coerce settlement, by making it even costlier for respondents to refuse to deal. The SEC will threaten a respondent with draconian penalties (lifetime bars from working in the securities industry, very large fines, etc.), unless the respondent accepts the SEC's offer to settle the case.[141] As discussed above, the SEC used to have an incentive to prefer district court actions in some cases—if the agency wanted a severe penalty, it had to go to that forum, even if it meant sacrificing some procedural advantages. Dodd-Frank equalized the penalties across fora and removed the built-in incentive.

In addition, APs may function as a substitute for rulemaking, which has recently become more costly for the agency. As former Commissioner Roberta Karmel put it: "constraints . . . on the regulatory process . . . increase the incentives on agencies like the SEC to develop new standards through enforcement cases rather than through rulemaking proceedings."[142] In 1996, Congress amended the rulemaking provisions of the securities laws to require the agency to "consider . . . whether the action will promote efficiency, competition, and capital formation."[143] Beginning with *Chamber of Commerce v. SEC*,[144] then *American Equity Investment Life Insurance Co. v. SEC*,[145] and most recently *Business Roundtable v. SEC*,[146] the D.C. Circuit has struck down major SEC rules, finding the agency's "consideration" of the 1996 factors was inadequate.[147] Many commentators observed that these cases seemed to abandon the deference to SEC judgment in favor of a much more stringent review.[148] These cases made rulemaking

141. *Cf.* Appellant's Brief at 11, Jarkesy v. SEC, No. 14-5196 (D.C. Cir. Dec. 24, 2014); Complaint at para. 29, Stilwell v. SEC, No. 14-cv-7931 (S.D.N.Y. Oct. 1, 2014); Complaint at para. 26, Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Feb. 19, 2015).

142. Karmel, *supra* note 140, at 288 ("Because of the prominence of enforcement programs in a deregulatory environment, there remains a possibility that enforcement proceedings will become a substitute for formal regulation.").

143. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 106, 110 Stat. 3416, 3424–25 (1996) (codified as amended at 15 U.S.C. § 77b(b) (2012) (Securities Act), 15 U.S.C. § 78c(f) (2012) (Exchange Act), 15 U.S.C. § 80a-2(c) (2012) (Investment Company Act), 15 U.S.C. § 80b-2(c) (2012) (Investment Advisers Act)). For a review of the history of this provision, see James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 Tex. L. Rev. 1811, 1818–24 (2012). The agency had been performing some version of cost-benefit analysis even before this statute. *See* Bruce Kraus & Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 Yale J. on Reg. 289, 296–300 (2013).

144. 412 F.3d 133 (D.C. Cir. 2005).

145. 613 F.3d 166 (D.C. Cir. 2010).

146. 647 F.3d 1144 (D.C. Cir. 2011).

147. For critical commentary on this trio, see Kraus & Raso, *supra* note 143; Cox & Baucom, *supra* note 143; Jill E. Fisch, *The Long Road Back:* Business Roundtable *and the Future of SEC Rulemaking*, 36 Seattle U. L. Rev. 695 (2013).

148. For instance, Raso and Kraus suggest:

> The *Business Roundtable* court appears to have applied a new burden of proof—the opposite of deference—to the SEC's rule. The proxy access rule was vacated on "admittedly (and at best) 'mixed' empirical evidence," evidence that evidently failed to convince the court. If unclear, unconvincing evidence fails the test, perhaps the court meant to require that the SEC present "clear and convincing" evidence—a heavy and unprecedented burden of proof.

more costly for the agency, which subsequently hired many economists and established a new Division of Economic and Risk Analysis to bring stronger economic analysis to rulemaking.[149] Some have also suggested that the SEC's rulemaking machinery has been "clogged" by mandatory rulemaking imposed by recent legislation.[150]

In sum, recent developments have made APs a relatively appealing method for the SEC to establish new theories of liability as compared to both district court actions and rulemaking.

2. Is the SEC Advancing Novel Theories in APs?

Commentators have suggested that the agency is using its new AP authority to advance novel theories of liability.[151]

There is some support for this claim. Indeed, the agency has acknowledged as much. Chairwoman Mary Jo White recently announced that the agency had brought a large number of "first-of-their-kind cases that expanded our enforcement footprint," and she cited several APs as evidence.[152] The director of enforcement has made similar statements.[153] The Division of Enforcement's recently released guidelines on forum selection states that an AP may be preferable to a district court action where a matter "is likely to raise unsettled and complex legal issues under the federal securities laws" because of the Commission's "expertise concerning those matters."[154] Some of the plaintiffs

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Raso & Kraus, *supra* note 143, at 316. Similarly, Cox and Baucom suggest:

> Through its single-minded focus on cost-benefit analysis, the ultimate effect of the *Chamber of Commerce* and *Business Roundtable* decisions appears to be nothing less than establishing a new review standard.

Cox & Baucom, *supra* note 143, at 1828. And, "the D.C. Circuit has assumed for itself a role opposed to the one Congress prescribed for courts reviewing SEC rules." *Id.* at 1813.

149. *See, e.g., Current Guidance on Economic Analysis in SEC Rulemakings*, U.S. SEC. & EXCH. COMM'N (Mar. 16, 2012), https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf (implementing the demanding standard of economic analysis articulated by the D.C. Circuit in *Business Roundtable*); *see generally* Raso & Kraus, *supra* note 143, at 325–32.

150. Raso & Kraus, *supra* note 143, at 319; *see also* DAVIS POLK, SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, ENACTED INTO LAW ON JULY 21, 2010 ii (2010), *available at* http://www.davispolk.com/sites/default/files/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Preview/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf (counting 243 rulemakings required by the Act); *see also* Fisch, *supra* note 147, at 696 (Dodd-Frank "tasked the SEC with an unprecedented number of required rulemakings").

151. *See* sources cited at *supra* note 136 and *infra* notes 176–77.

152. Mary Jo White, Chairman's Address at SEC Speaks 2015 (Feb. 20, 2015).

153. Ceresney, ABA Speech, *supra* note 20 (describing several APs filed in 2014 as "first-of-their-kind actions").

154. Division of Enforcement Approach, *supra* note 4; *see also* Nicholas Bourtin et al., *Sullivan & Cromwell Discusses SEC Guidance on Approach to Forum Selection in Contested Actions*, CLS BLUE SKY BLOG (June 15, 2015), http://clsbluesky.law.columbia.edu/2015/06/15/sullivan-cromwell-discusses-sec-guidance-on-approach-to-forum-selection-in-contested-actions ("[T]he guidance may exacerbate the criticism voiced by Judge Rakoff and others that the SEC should expose novel applications of the securities laws to de novo judicial review rather than handle them through administrative proceedings.").

in the constitutional challenges to SEC AP authority have also raised this allegation.[155]

Consider the agency's string of APs defining the scope of fiduciary duties borne by private equity and hedge fund managers—investment advisers formerly exempt from regulation with the Commission but obligated to register by Dodd-Frank.[156] Last year, the agency brought charges against Lincolnshire Management, a private equity firm, based on actions related to the integration of companies controlled by two separate funds under its management.[157] The firm had properly disclosed the merger but, according to the SEC, breached its fiduciary duties by allowing "one portfolio company (and, indirectly, the fund that owned it) [to]pay[] *more than its share* of certain expenses that benefitted both companies."[158]

Long ago, the U.S. Supreme Court found that the antifraud provision of the Investment Advisers Act "establishe[d] 'federal fiduciary standards' to govern the conduct of investment advisers,"[159] including those exempt from registration with the Commission. But, apart from a general obligation to disclose conflicts, which is now separately required by rule,[160] the precise contours of these federal fiduciary duties for hedge fund and private equity advisers have remained obscure.[161]

Per the Supreme Court, advisers bear a fiduciary duty to "*eliminate, or at least to expose*, all conflicts of interest which might incline an investment adviser—

155. *See* Complaint at para. 25, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Oct. 20, 2014) ("This case represents the SEC's attempts to expand the boundaries of insider trading law.").

156. Private equity advisers and hedge fund advisers had been exempt from registration with the Commission and also from general reporting requirements, until Dodd-Frank. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. IV, 124 Stat. 1376, 1570–80 (2010); *see also* Lyman P.Q. Johnson, *Why Register Hedge Fund Advisers—A Comment*, 70 WASH. & LEE L. REV. 713 (2013) (defending the investor protection rationale for registration and reporting requirements on hedge funds).

157. *In re* Lincolnshire Mgmt., Inc., SEC Admin. Proceeding No. 3-16139 (Sept. 22, 2014) (order instituting cease-and-desist proceedings).

158. *Id.* at paras. 10, 37 (emphasis added). These expenses "related to administrative fees associated with payroll and 401(k) benefits; information technology; sales and marketing; and corporate management." *Id.* at para. 26.

159. Transamerica Mortg. Advisors, Inc. (TAMA) v. Lewis, 444 U.S. 11, 17 (1979) (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191–92 (1963)). *But see* Arthur B. Laby, SEC v. Capital Gains Research Bureau *and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051 (2011) (arguing that the *Capital Gains* Court correctly found only that § 206 recognized the preexisting fiduciary duties of advisers, while the *Transamerica Mortgage* Court misread it as finding that § 206 established new federal duties).

160. 17 C.F.R. § 275.206(4)-8 (2015).

161. One treatise explains:

> The precise scope of Section 206 is subject to debate. Some practitioners believe that Section 206 essentially imposes a disclosure requirement on advisers. . . . A second school of thought views Section 206 as imposing substantive regulatory requirements on advisers in addition to disclosure obligations. Under this view, making full disclosure or obtaining client consent may not, by itself, be sufficient to insulate an adviser from liability if the adviser is not acting in the best interests of clients consistent with its fiduciary obligation. There is no definite answer as to which view of Section 206 is correct . . . .

THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF INVESTMENT ADVISERS § 2:30 (2015); *see also* Laby, *supra* note 159, at 1054 (the fiduciary standard is "notoriously imprecise"); *id.* at 1088–98 (documenting sources of ambiguity).

consciously or unconsciously—to render advice which was not disinterested."[162] This formulation leaves open the possibility of duties beyond mere disclosure. Some have suggested that conflicts of interest in hedge funds and private equity funds are "completely pervasive" and "far more common than in ordinary companies."[163] Such ubiquity only exacerbates the vagueness of the duty to avoid them.

The *Lincolnshire* case appears to represent a step toward the elaboration of substantive fiduciary duties for these formerly exempt advisers. An SEC official explained that the case stood for the principle that "[a]dvisers that commingle assets across funds must do so in a manner that satisfies their fiduciary duties to each fund and prevents one fund from benefiting to the detriment of the other."[164] Commentators have read this case as imposing a new substantive obligation on firms regarding the treatment of cross-fund investments and transactions.[165]

The SEC also brought several other significant APs articulating fiduciary obligations under section 206.[166] SEC leaders have indicated that more enforcement

162. *Capital Gains*, 375 U.S. at 191–92 (emphasis added); *see also* Julie M. Riewe, Co-Chief, Asset Mgmt. Unit, Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Conflicts, Conflicts Everywhere—Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View (Feb. 26, 2015).

163. John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 Yale L.J. 1228, 1262 (2014). Morley lists some of the conflicts that arise where (as is common) multiple funds are under the same management:

> Because managers owe fiduciary duties to each of their funds and because resources are scarce, the allocation of virtually any resource to one fund places the manager in a conflict of interest with its other funds. These conflicts arise in innumerable aspects of management companies' operations, such as the allocation of investment opportunities; the allocation of workers' time; the allocation of administrative resources; the order in which trades are executed; the way shares are voted in portfolio companies when different funds hold conflicting interests in the companies; and the speed and order in which redemptions are processed, as well as myriad other matters.

Id. at 1261. Morley also cites a "boom in academic articles that catalog new sources of inter-fund conflicts for fund managers." *Id.* at 1261 & n.76 (collecting sources).

164. Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges New York-Based Private Equity Fund Adviser with Misallocation of Portfolio Company Expenses (Sept. 22, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543006673#.VQni9OHlx5Y.

165. *E.g.*, Veronica E. Rendon et al., *New Developments in the SEC Focus on Private Funds*, Arnold & Porter (Dec. 2014), https://goo.gl/fjgh6t ("The basic lesson from Lincolnshire is that allocations among multiple entities must be equitable."); *cf.* Jason Brown et al., *SEC Brings First Action Against a Private Equity Fund Adviser for Misallocation of Portfolio Company Expenses*, Ropes Gray (Sept. 23, 2014), https://www.ropesgray.com/newsroom/alerts/2014/September/SEC-Brings-First-Action-Against-a-Private-Equity-Fund-Adviser.aspx (explaining that Lincolnshire "confirms that the SEC is pursuing the industry aggressively, providing added support to the conclusion that firms are well advised to ensure that they are reviewing their practices"). The firm's general counsel, for his part, explained the decision not to litigate because the litigation was "very expensive" and "a distraction to our business, and so we are happy to get it behind us and resolve it." Sarah N. Lynch, *Private Equity Adviser Settles SEC Charges over Expense Allocations*, Reuters (Sept. 22, 2014, 12:36 PM EST), www.reuters.com/article/2014/09/22/sec-privateequity-fees-idUSL2N0RN0ZO20140922 (quoting James McLaughlin, managing director and general counsel at Lincolnshire); Eva C. Carman et al., *Takeaways from SEC Action Against Lincolnshire*, Law360 (Sept. 26, 2014, 10:24 AM EST), http://www.law360.com/articles/581223/takeaways-from-sec-action-against-lincolnshire.

166. In February 2014, the SEC brought an AP charging Clean Energy Capital, a private equity firm, with, *inter alia*, violating its fiduciary duties by engaging in a conflict of interest related to

against private equity and hedge funds for violating fiduciary duties under section 206 is likely.[167]

From the standpoint of "efficiency, competition, and capital formation,"[168] the optimal scope of these firms' substantive fiduciary duties—as defaults or otherwise—is debatable.[169] By elaborating the fiduciary obligations of hedge fund advisers and private equity advisers through APs and settlements, the SEC avoids a more transparent debate over these questions. Because each incremental advance in the scope of the fiduciary duties creates a risk of liability, the firms must respond by reviewing and possibly changing their practices and/or by taking on additional compliance and legal costs.

* * *

There are other examples of the SEC's recent use of APs to advance novel understandings of the law.

For instance, in *Peixoto*, the agency seems to have attempted to use an AP to broaden the definition of "material nonpublic information" in insider trading cases. Traditionally, these cases revolve around secret information that belongs to a public company—e.g., an announcement about a new business plan,

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fees and withdrawal of funds without adequate disclosure. *See In re* Clean Energy Capital, LLC, SEC Admin. Proceeding No. 3-15766 (Feb. 25, 2014) (order instituting proceedings). The respondents initially refused to settle, apparently believing to have been within their legal rights having relied on advice from counsel, but reached a settlement on the eve of trial before an ALJ. *In re* Clean Energy Capital, LLC, SEC Admin. Proceeding No. 3-15766 (Oct. 17, 2014) (order making findings and imposing remedial sanctions). Commentators noted that the case was the first of its kind. Rendon et al., *supra* note 165 ("[T]he lesson from Clean Energy is that the SEC is taking the allocation of fees and expenses seriously and is prepared to take action if it discovers infractions in this area."); Sarah N. Lynch, *Private Equity Adviser, CEO Settle with SEC over Fee Allocations*, REUTERS (Oct. 17, 2014, 6:49 PM EST), http://www.reuters.com/article/2014/10/17/us-sec-privateequity-fees-idUSKCN0I62GF20141017 (case was "the first one the SEC filed as part of a broader crackdown into private equity fund fees").

And, in June 2014, the SEC filed and settled an AP against Paradigm Capital, a hedge fund, accusing it of proprietary trading without adequate disclosures. *In re* Paradigm Capital Mgmt., Inc., SEC Admin. Proceeding No. 3-15930 (June 16, 2014). As the SEC later explained, while this was not a breach of fiduciary duty case, it "nonetheless involved a conflict we see frequently: principal transactions without the required written disclosure and consent." Riewe, *supra* note 162.

167. A February 2015 speech announced that advisers' conflicts of interest would be a priority for the agency in 2015. Riewe, *supra* note 162 ("[O]n the hedge fund side, we anticipate cases involving undisclosed fees; all types of undisclosed conflicts, including related-party transactions . . . . On the private equity side . . . we expect to see more undisclosed and misallocated fee and expense cases like the Clean Energy Capital and Lincolnshire Management, Inc. cases we brought in 2014.").

168. *See supra* note 143 (discussing National Securities Market Improvement Act of 1996).

169. The traditional argument was that because investors in these funds were more sophisticated than average securities investors, they were less in need of regulatory protection. But, according to some, the financial crisis revealed that unsophisticated investors were exposed to these funds, e.g., through pension funds. But there may be other reasons to question the application of the full retinue of fiduciary duties to hedge fund and private equity advisers. Prohibiting fund managers from all conflicted transactions, managing multiple funds, engaging in proprietary trading, or charging exorbitant fees would deprive investors of ways they might compensate those who manage their money. *See* Houman B. Shadab, *Hedge Fund Governance*, 19 STAN. J.L. BUS. & FIN. 141 (2013). John Morley argues that investors in these funds have strong exit rights, as compared to investors in publicly traded companies, and thus may have less need for the protections offered strong fiduciary duties. *See generally* Morley, *supra* note 163.

lower than expected earnings, a new hire, etc. In *Peixoto,* by contrast, the respondent had secret information belonging to a hedge fund about its plans regarding investments in a public company.[170] The respondent claimed that the case represented an attempt "to expand the boundaries of existing insider trading law" and that the agency had never before "charged an individual with trading in advance of a private hedge fund's disclosure of its investment plan."[171]

And, in *Gray Financial Group*, the SEC threatened an investment adviser with an AP for violations of his fiduciary duties as articulated by a 2012 Georgia state law governing pension investments.[172] The accused has argued that the issue was a "matter of first impression on the unique state statute that is at best unclear,"[173] and a Westlaw search confirms that there have been no reported cases construing this statute.[174]

Using APs to explore new areas of law is not unique to the post Dodd-Frank era. However, the phenomenon may be accelerating. (A closer comparison of APs before and after Dodd-Frank would be necessary to precisely evaluate the claim.)

3. Challenges to the SEC's Legitimacy

Judge Jed Rakoff laments that the SEC's use of APs to advance novel theories of liability "hinders the balanced development of the securities laws."[175] Another commentator worried that SEC enforcement settlements "impose[] hidden costs interrupting the development of the law."[176] Earlier, former Commissioner Roberta Karmel explained that she had "always been troubled by the utilization of

170. *In re* Peixoto, SEC Admin. Proceeding File No. 3-16184 (Sept. 30, 2014) (order instituting cease-and-desist proceedings at paras. 1–4).

171. Complaint at para. 25, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Oct. 20, 2014). The agency subsequently dropped this case after the Second Circuit issued a decision paring back insider trading liability. *See generally* United States v. Newman, 773 F.3d 438 (2d Cir. 2014); *see also* Michelle Celarier, *SEC Drops Herbalife Insider-Trading Case Amid New Standards*, N.Y. Post (Dec. 16, 2014, 4:30 AM EST), http://nypost.com/2014/12/16/sec-drops-herbalife-insider-trading-case-amid-new-standards/; James Sterngold, *Charges Dropped After Insider-Trading Ruling*, Wall St. J. (Dec. 15, 2014, 7:19 PM EST), http://www.wsj.com/articles/charges-dropped-after-insider-trading-ruling-1418689195.

172. *In re* Gray Fin. Grp., Inc., SEC Admin. Proceeding No. 3-16554, Securities Act Release No. 9789 (May 21, 2015) (order instituting administrative and cease-and-desist proceedings at para. 12).

173. Complaint at para. 24, Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Feb. 19, 2015).

174. *See also id.* at para. 17 ("There has not been any publicly available formal statutory interpretation of the unique language of the New Georgia Pension Law, either through reported legislative history or reported appellate case law."). *But see* Division of Enforcement Approach, *supra* note 4 ("[W]here application of state law or other specialized areas of federal law is integral to the matter, district court may be appropriate.").

175. Rakoff, Law Unto Itself, *supra* note 53.

176. Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 Vill. L. Rev. 701, 709 (2010); *see also, e.g.*, U.S. Chamber of Commerce, Report on the Current Enforcement Program of the Securities and Exchange Commission 7 (Mar. 2006) ("The Commission should endeavor to avoid interpretation or expansion of regulations through enforcement actions and should seek to clarify its views on standards of conduct and legal standards before initiating enforcement actions for violation of those standards.").

novel theories in . . . SEC civil enforcement cases where the consequences are serious to the individual defendants."[177]

To the extent critics attack the very concept of regulation through case-by-case adjudication as a general matter,[178] such criticism seems overstated. Scholars of law and economics and administrative law have long recognized that regulation through the ex post interpretation of general standards in individual cases possesses efficiency advantages over regulation through ex ante promulgation of rules.[179] For instance, the relative flexibility of the ex post method may allow for a greater ability to incorporate changes on the ground in the industry, a feature that can be especially valuable in the regulation of a fast-developing industry. Of course, what this method gains in flexibility it may lose in predictability, which might generate costly uncertainty in the regulated industry.

The strongest criticism of the current regime of APs is not the sheer fact that it allows for the development of the law through adjudication, but that it does so without adequately providing for input from the regulated industry. In theory, case-by-case adjudication is an effective method of legal development because each party has the incentive to present the strongest possible argument, allowing the adjudicator to make an informed decision. As the previous discussion suggests, APs appear to have evolved away from that ideal. Rather than a forum for an ALJ to develop the securities laws on the crucible of adversarial litigation, APs now serve as a platform for the SEC to unilaterally assert its interpretation of the laws; respondents are under such terrific pressure to settle, and the SEC uses settlements as if they were meaningful precedents. In a sense APs now represent the worst of both worlds: they impose the uncertainty costs on the regulated industry associated with ex post regulation, without the benefit of flexibility and accommodation usually thought to be offered by that method of regulation.

One way to understand Judge Rakoff's concern that APs may disrupt the "*balanced* development of the law" is that APs lack adequate input from the regulated industry and so may tend to skew toward overregulation, unnecessarily chilling desirable market conduct without any commensurate gains in investor protection. For instance, defining substantive fiduciary duties of hedge fund and private equity managers may over-deter beneficial conduct—if it becomes too costly to manage multiple funds, or to take compensation by proprietary

177. Karmel, *supra* note 140, at 35. Karmel was a persistent critic on this topic. *See id.* at 45 ("The case-by-case development of regulatory law and policy produces many problems, especially when the policy involves law enforcement actions . . . that have serious adverse consequences."); KARMEL, *supra* note 140, at 219–22.

178. *See* Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 FORDHAM J. CORP. & FIN. L. 367, 411 (2008) ("There should not be institutional encouragement for using discretion to formulate theories of liability that overstep the boundaries of existing law. Law making is reserved for legislative process in Congress and the SEC rulemaking process under the strict requirements of the Administrative Procedure Act; it is not a function of the Enforcement Division.").

179. *See, e.g.*, Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); *id.* at 557 n.1 (collecting literature).

trading, or to have certain fee arrangements, these practices may be pushed out or limited to those firms that can afford compliance costs.

It might be objected that this *in terrorem* effect does more good than harm at least in some parts of the financial sector, where (some suggest) inadequate caution helped produce the crisis of 2008. It is far from obvious that promoting general caution with regard to possible enforcement would also promote market stability. But ultimately, while the claim that APs are hampering the securities industry and harming investors is speculative, its endorsement by Judge Rakoff and others undermines the agency's legitimacy and indirectly strengthens the hand of plaintiffs who have filed constitutional attacks.

4. Operationalizing the Criticism

While the pending lawsuits have not generally attacked the SEC's use of APs to advance novel interpretations,[180] a future plaintiff might do so by arguing that a novel interpretation advanced in an AP bears the characteristics of a legislative rule, and thus must be promulgated via notice and comment under the Administrative Procedure Act. Though the U.S. Supreme Court has given agencies broad discretion to establish rules by case-by-case adjudication,[181] a plaintiff could argue that the specifics of the penalties now available in APs, the procedures governing the regime, and the SEC's enforcement strategy extend this discretion too far.

Of course, there are serious obstacles for such a challenge. Line drawing between legislative and interpretive rules is famously difficult.[182] And, though the broad discretion accorded to agencies to develop rules via case-by-case adjudication has been criticized,[183] it remains essentially unlimited.[184]

But, as with the constitutional challenges discussed above, even if this criticism does not produce a particular legal claim, it still signals serious doubts of legitimacy for the agency's enforcement program.

180. *But cf.* Complaint at para. 25, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Oct. 20, 2014) ("The case represents the SEC's attempt to expand the boundaries of existing insider trading law.").

181. *See* SEC v. Chenery Corp., 332 U.S. 194 (1947).

182. *See, e.g.*, David L. Franklin, *Legislative Rules, Nonlegislative Rules, and the Perils of the Short Cut*, 120 YALE L.J. 276, 278 (2010) ("There is perhaps no more vexing conundrum in the field of administrative law than the problem of defining a workable distinction between legislative and nonlegislative rules.").

183. Perhaps none more eloquent than the dissenting justices in that case, including Justice Frankfurter who was one of the architects of the SEC.

> [T]he administrative process deserves fostering in our system as an expeditious and nontechnical method of applying law in specialized fields. I cannot agree that it be used, and I think its continued effectiveness is endangered when it is used, as a method of dispensing with law in those fields.

Chenery Corp., 332 U.S. at 217–18 (Jackson, J., dissenting).

184. *E.g.*, Franklin, *supra* note 182 (reviewing the literature).

III. History of SEC Procedural Reform as Justification and Explanation for Present Backlash

Even as they have begun persuading some courts that the SEC's contemporary enforcement architecture is unconstitutional, opponents (litigants as well as commentators and other key stakeholders) have struggled to articulate a core limiting principle for their criticisms of the SEC's use of APs. If APs are unfair now, why have they not always been unfair? If the SEC's use of APs to develop the law is wrong, then why was it not wrong before Dodd-Frank? Why the new scrutiny of long-established features of administrative adjudication? In short: what explains and what justifies the present backlash?

This Part finds an answer suggested by the SEC's own recent history: the SEC's contemporary enforcement architecture turns its back on a core principle of procedural fairness—that, holding all else equal, procedures be commensurate with penalties—which it demonstrated respect for in the past.

A. The Remedies Act of 1990 and Procedural Reform

In the late 1980s, an SEC task force on fraudulent financial reporting issued a report finding that the agency's existing remedial authority was not adequate to combat fraud in the securities industry.[185] The report urged Congress to give the SEC the authority to "tailor enforcement actions more precisely to particular facts . . . [in order to] maximize its enforcement effectiveness."[186] The SEC ultimately submitted a legislative proposal based on the report's recommendations. With a few modifications, the proposal was enacted as the Securities Enforcement Remedies Act of 1990.[187]

This legislation dramatically expanded the SEC's remedial authority in APs. It empowered the agency to impose financial penalties in APs against regulated firms and individuals associated with those firms,[188] to impose cease-and-desist orders,[189] and to order respondents to account for and disgorge ill-gotten gains.[190] Naturally, SEC leaders at that time praised these new powers as "usher[ing] in a new era of Commission enforcement,"[191] by enhancing "flexibility" and increasing "both the efficiency and deterrent effect of the Enforcement program."[192]

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185. Report of the National Commission on Fraudulent Financial Reporting (Oct. 1987), *available at* http://www.coso.org/publications/NCFFR.pdf.

186. *Id.* at 64.

187. Securities Enforcement Remedies and Penny Stock Reform Act (Remedies Act), Pub. L. No. 101-429, 104 Stat. 931 (1990).

188. *See* Remedies Act § 202, 15 U.S.C. § 78u-1 (2012).

189. *See* Remedies Act § 102, 15 U.S.C. § 78u-3 (2012).

190. *See* Remedies Act § 102, 15 U.S.C. § 77 (2012).

191. William R. McLucas et al., *SEC Enforcement: A Look at the Current Program and Some Thoughts About the 1990s*, 46 Bus. Law. 797, 798 (1991). Notably, McLucas has been highly critical of the agency's recent use of APs. *See* McLucas & Martens, *supra* note 52.

192. McLucas et al., *supra* note 191, at 832.

But these broad new administrative powers also generated substantial criticisms and attacks on the agency's legitimacy. Some predicted that the new penalty authority would cause the Commission to shift away from district court proceedings toward APs;[193] that "the Commission may utilize the administrative forum to extend the reach of the federal securities laws or to advance novel or unique theories";[194] and that the cease-and-desist authority was "so broad that it may be used to circumvent certain requirements of other provisions."[195] Critics also identified constitutional defects, including some of the same theories being advanced in the litigation pending today i.e., violations of due process,[196] nondelegation,[197] and the Seventh Amendment.[198]

Unlike the present backlash, however, the criticisms and anxieties provoked by the 1990 remedies act never escalated into an existential threat to the AP system. No collateral attacks were filed attacking the constitutionality of APs. While some expressed anxieties about the new powers granted by the legislation, there was not the same level of backlash or legitimacy crisis as has been recently directed at the agency's actual implementation of its new powers. One reason: the Commission's expansion of remedial administrative authority was quickly followed by a rulemaking process to undertake a substantial procedural overhaul.[199]

193. Ralph C. Ferrara et al., *Hardball!: The SEC's New Arsenal of Enforcement Weapons*, 47 Bus. Law. 33, 97–98 (1991); Pitt & Shapiro, *supra* note 140, at 246 (discussing the 1990 proposal) ("[I]t would in almost every case allow the Commission, at its own discretion, to bypass the federal courts altogether, thereby bypassing many of the safeguards currently protective of respondents' rights in the judicial system."). In fact, a 1994 study found that the SEC had brought "far fewer administrative cases than injunctive actions seeking penalties under the Remedies Act." Arthur Laby & W. Hardy Callcott, *Patterns of SEC Enforcement Under the 1990 Remedies Act: Civil Monetary Penalties*, 58 Alb. L. Rev. 5, 46 (1994).

194. Ferrara et al., *supra* note 193, at 97–98; *see also* Harvey Pitt & Dixie Johnson, *The Securities Law Enforcement Remedies Act of 1990: A New Era in Enforcement*, N.Y. L.J., July 26, 1990, at 5.

195. Ferrara et al., *supra* note 193, at 97–98; *see also* Pitt & Johnson, *supra* note 194, at 5.

196. ABA Comm. on Fed. Regulation of Sec., *Report of Task Force on the SEC Administrative Law Judge Process*, 47 Bus. Law. 1731, 1732 n.2 (1992) [hereinafter *ALJ Task Force Report*] ("The Task Force expresses no opinion as to the constitutionality of such proceedings where there exists a viable alternative which is less restrictive of respondents' fundamental due process rights."); Ferrara et al., *supra* note 193, at 64 ("If the ex parte determination [in a temporary cease-and-desist proceeding] is held to constitute prejudgment, it may be possible to challenge the subsequent decision" since "[a] de facto determination on the merits, and the issuance of an ex parte cease-and-desist order by the same individual or individuals who will conduct the subsequent hearing may not comport with the appearance of justice and, therefore, might result in a judge invalidating the order."); *cf.* Pitt & Shapiro, *supra* note 140, at 249 (worrying that the 1990 proposed remedies framework would "permit the imposition of extraordinarily harsh punishment for seemingly trivial misconduct").

197. *ALJ Task Force Report*, *supra* note 196, at 1732 n.2 (expressing "no opinion" on "the constitutionality of either the [Remedies Act] or current SEC practice whereby the SEC, at its complete discretion and with no articulated standards, can proceed either before an ALJ or in federal court"); *cf.* McLucas et al., *supra* note 191, at 834 ("the Commission is presently confronting new issues concerning when to seek relief in the judicial or administrative forum"); *cf.* Pitt & Shapiro, *supra* note 140, at 249 (questions of "fairness" arise because "the Commission has the choice, at its complete discretion and without any express or implied standards, to proceed in an administrative forum").

198. Ferrara et al., *supra* note 193, at 54–55; Pitt & Shapiro, *supra* note 140, at 249 (the 1990 proposal).

199. In fact, the impetus for the 1995 procedural revision discussed below seems to have come from Congress. *See* McLucas et al., *supra* note 191, at 834–35 (suggesting the expanded administra-

The Commission convened a special task force to consider reforms of the procedures governing its implementation of the new powers granted in this legislation.[200] The task force, led by Commissioner (and future Chairwoman) Mary Schapiro, eventually issued a report that recommended "revis[ing] completely the entire Rules of Practice."[201]

After the task force report was issued, the Commission quickly proposed significant changes to the Rules of Practice, including many of the task force's recommendations.[202] After receiving input from stakeholders and outside groups like the Administrative Conference of the United States,[203] the American Bar Association, and commentators from the regulated industry, the SEC promulgated final revised rules in 1995.[204]

The final rules included substantial new protections for individuals charged in APs (and subject to the agency's enhanced penalty authority in that forum). For instance, new Rule 230 imposed broad automatic disclosure requirements for the agency upon commencement of an action.[205] Similarly, new Rule 232 gave respondents authority to request that the ALJ subpoena documents to be delivered "at any designated time or place." This replaced the former subpoena rule, which made these documents deliverable only at the hearing itself.[206]

And new Rule 250 gave respondents the right to file a motion for summary disposition before trial with leave of the hearing officer. This replaced the former rule, which categorically prohibited such motions before the hearing.[207]

However, the Commission declined to adopt a rule authorizing depositions, finding them to be a "source of delay, extensive collateral disputes, and high lit-

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tive powers were conditioned on an informal "[c]ongressional mandate to modify the Commission's Rules of Practice . . . within a year").

200. *See* Fair and Efficient Administrative Proceedings, Report of the Task Force on Administrative Proceedings of the United States Securities and Exchange Commission (Feb. 1993); Press Release, U.S. Sec. & Exch. Comm'n, SEC Releases Schapiro Task Force Report on Fair and Efficient Administrative Proceedings (Mar. 15, 1993).

201. *See* Rules of Practice, 60 Fed. Reg. 32738, 32738–39 (June 9, 1995). The report also concluded that the "fundamental structure of the Commission's administrative process [wa]s sound." *Id.* at 32739.

202. Proposed Rules, Securities Act Release No. 33163 (Nov. 5, 1993).

203. The entire numbering and organization system for the 1995 Rules of Practice is adapted from the ACUS's model rules. *See* 60 Fed. Reg. at 32738, 32739; *see generally* Michael P. Cox, *The Model Adjudication Rules (MARS)*, 11 T.M. Cooley L. Rev. 75 (1994).

204. 60 Fed. Reg. 32738.

205. The proposed rule had conditioned disclosure upon a finding of "relevance" by the agency, but the final rule eliminated that condition and made the disclosure automatic "based in part upon comments received that contended that a relevancy determination by the staff was problematic." 60 Fed. Reg. at 32738, 32741; *see also id.* at 32763 ("One commenter suggested that the scope of required production was too narrow and ill defined, thereby providing too much discretion to the Division of Enforcement staff to determine whether a document was relevant. . . . The rule no longer calls upon the Division of Enforcement staff to make relevancy determinations.").

206. *Id.* at 32741, 32763–65.

207. *Id.* at 32741; *see also id.* at 32767 ("The possibility that such motions may simplify the proceeding should not be allowed to delay the planned start of the hearing."). The Commission rejected a proposal to make these motions more widely available, reasoning that APs "[t]ypically . . . involve basic disagreement as to material facts" such that "the circumstances when summary disposition prior to hearing could be appropriately sought or granted will be comparatively rare." *Id.* at 32768.

igation costs" in civil litigation. Moreover, the Commission reasoned, there was less need for depositions in the context of an AP, where "there is ordinarily a detailed pre-institution fact finding investigation and a rigorous pre-institution review process," as compared to in civil litigation "where neither party can compel testimony prior to the filing of the complaint."[208]

The Commission also adopted the task force's recommendation of adopting "guidelines for the timely completion of adjudicatory proceedings," but expressly declined to impose such timelines as rules[209]:

> The guidelines do not create a requirement that each portion of a proceeding or the entire proceeding be completed within the periods described. Proceedings at either the hearing stage or on review by the Commission may require additional time because they are unusually complex or because the record is exceptionally long or for other reasons. In addition, fairness to all parties requires that the Commission's deliberative process not be constrained by an inflexible schedule.[210]

Strikingly, the SEC would later reverse course, imposing mandatory timelines.[211]

Thus, after the 1990 legislation dramatically enhanced the SEC's penalty authority, the agency engaged the regulated industry and outside experts in a rulemaking process that culminated in substantial reforms to the procedures that govern in that forum.

This engagement with stakeholders and the procedural reforms that resulted might have helped defuse the potential backlash or challenge to agency legitimacy that seems to be plaguing the agency's enforcement program now. No collateral attacks were filed challenging the constitutionality of APs. The constitutional criticisms faded away and the industry adjusted to the new regime without any major disruption.

B. Sarbanes-Oxley Act of 2002 and Procedural Reform

The pattern repeated itself on a much smaller (and more ambiguous) scale after the Sarbanes-Oxley Act of 2002. Among many other things, that statute gave the SEC authority to seek to bar individuals from serving as directors and officers of public companies in an AP,[212] a sanction that it had formerly had to go to district court to obtain. This penalty enhancement was a very minor portion of the Sarbanes-Oxley Act. And, as Figure 1 above indicates, Sarbanes-Oxley seems to have triggered a burst of activity of APs over district court actions—though this burst likely had much more to do with other provisions of the Act than the director and officer bar provision. This provision prompted some moderate criticism,[213] including speculation that such lifetime bars might be unconstitutional

208. *Id.* at 32764.
209. *Id.* at 32742–43.
210. *Id.*; *see also id.* at 32821.
211. Rules of Practice, 68 Fed. Reg. 35787 (June 17, 2003).
212. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1105, 116 Stat. 745, 809.
213. *E.g.*, Jayne W. Barnard, *SEC Debarment of Officers and Directors After Sarbanes-Oxley*, 59 Bus. Law. 391, 410–18 (2004).

as applied in an administrative forum.[214] However, the constitutional and legitimacy-based attacks on the agency were contained. Once again, shortly after enactment, the agency enacted a package of amendments and refinements to its rules of practice,[215] including a limited right to take depositions to preserve testimony that would otherwise be unavailable.[216] Though Sarbanes-Oxley generated substantial criticisms, it did not give rise to the constitutional and legitimacy doubts now plaguing the agency's enforcement program.

C. Procedural Reform, Fairness, and Legitimacy

This history provides a useful lens to interpret the current backlash.

1. Justifying the Backlash

Holding all else equal, fairness requires that procedures be commensurate with the stakes of the adjudication. When greater penalties or deprivations are on the line, procedural protections ought to be relatively more robust (again holding all else equal). Thus, the U.S. Supreme Court, in *Mathews v. Eldridge*, held that "the specific dictates of due process generally require[] consideration of . . . the private interest that will be affected by the official action."[217] And criminal defendants (who face incarceration) are generally accorded greater protections than civil litigants (who do not)—and capital defendants accorded greater protections than others.

Before Dodd-Frank, the SEC's enforcement architecture embodied a commitment to this principle in two ways.

First, the SEC adjusted its procedural regime to accommodate new penalty powers created by Congress. As documented above, when the agency received new penalty powers inside its administrative forum, it expanded the procedural protections available to respondents in that forum accordingly. Thus, procedures remained commensurate with penalties *over time*.

Second, before Dodd-Frank, the penalties available in each of the three fora available for securities law violations (criminal, civil, and administrative) were commensurate with the level of procedural guarantees available. That is, criminal trials offered both the greatest procedural protections (e.g., reasonable doubt) *and* penalties (prison), APs offered the weakest procedures (see above) and penalties (e.g., formal censures or orders to "obey the law"), and civil actions were in the middle. In this equilibrium, the Enforcement Division therefore had an incentive to bring more significant cases in district court rather than in APs.[218] In-

214. *Id.* at 415 ("It is . . . fair to stop and contemplate whether a lifetime bar order is appropriate in a civil proceeding when a comparable order is not available in a criminal proceeding!"); *but see id.* at 417 (noting that the problems are "probably not of constitutional proportions").

215. Adoption of Amendments to the Rules of Practice and Delegations of Authority of the Commission, 69 Fed. Reg. 13166 (Mar. 19, 2004).

216. *See id.* at 13170.

217. 424 U.S. 319, 325 (1976).

218. Geoffrey F. Aronow, *Back to the Future: The Use of Administrative Proceedings for Enforcement at the CFTC and SEC*, Futures & Derivatives L. Rep., Jan./Feb. 2015, at 1, 3 ("Given the history of limited authority to proceed via administrative procedure in enforcement actions, the SEC Enforcement Di-

deed, in its 1990 expansion of the SEC's remedial authority in APs, Congress seems to have expressly avoided "equalization" of penalties across APs and district court actions because of concerns about such incentive effects.[219] Thus, penalties were commensurate with procedures *across fora*.

After Dodd-Frank, the SEC's enforcement architecture plainly no longer respects this principle—either *over time* or *across fora*. When Congress raised the penalties available inside APs, the agency failed to update procedures to keep pace as it had done in the past. Instead, the agency actually pressed forward with an aggressive new enforcement strategy designed to maximize its new substantive powers to take advantage of its preexisting procedural advantages. This includes the practice of testing out novel theories of liability in APs and forcing respondents into settlements with the threat of harsh penalties.

And after Dodd-Frank the penalties available inside district court and APs are now equal.[220] A House report states the goal as enhancing the flexibility and efficiency of SEC enforcement by making the "SEC's authority in administrative penalty proceedings *coextensive* with its authority to seek penalties in Federal Court."[221] But there is a significant gap between the procedures available in these fora. The agency's choice of forum calculus is no longer set up to preserve the principle; because of the incentive effect on the agency to proceed with difficult cases in a more procedurally advantageous forum, the forum selection calculus is now set up to *subvert* the principle.

This story casts the current backlash into sharper relief. The problem is not (or not *only*) that the SEC has been bringing more (and more important) cases in its home forum, that the procedures in that forum are deficient per se, or that the penalties available in that forum are draconian. Rather, the problem it is that, unlike in the past, under the SEC's current enforcement architecture, procedural protections are not commensurate with penalties.

None of this is to suggest that the agency cannot justly expand its penalty authority without also increasing procedural protections. To the contrary, other factors may well justify such a move. (Thus, the principle is that "*holding all else equal*," fairness requires that procedures be commensurate with the stakes

vision brought most of its cases, and virtually all of its important cases, in federal court. As a result, even as the authority to use the alternative, administrative route expanded over the years, the Division appeared to continue to believe that important cases should have the imprimatur of federal court.").

219. As one former commissioner explains: "The concern among members of Congress and internally at the SEC was that if the same remedies were available to the SEC under both judicial and administrative proceedings, then the SEC might be perceived to have an incentive to conduct more enforcement actions through its own administrative proceedings, rather than before a federal district court judge." Atkins & Bondi, *supra* note 178, at 393–94.

220. *See* Rakoff, Law Unto Itself, *supra* note 53 ("The net result of all of this is that the S.E.C. can today obtain through internal administrative proceedings nearly everything it might obtain by going to court."); Plaintiff's Motion for Preliminary Injunction at 2, Bebo v. SEC, No. 15-cv-3 (E.D. Wis. Jan. 23, 2015), ECF No. 14 ("Providing an agency with the ability to obtain the same remedy in federal court or in an AP is a unique (and unconstitutional) enforcement regime previously unheard of in the large and ever-growing administrative state."); *see also id.* at 13–15.

221. H. Rep. No. 111-687, at 78 (2010) (emphasis added) (Investor Protection Act of 2009); *see also* Plaintiff's Motion for Preliminary Injunction at 15–16, Bebo v. SEC, No. 15-cv-3 (E.D. Wis. Jan. 23, 2015), ECF No. 14; Appellant's Brief at 7, Jarkesy v. SEC, No. 14-5196 (D.C. Cir. Dec. 24, 2014).

of the litigation.) For instance, in addition to the "private interest that will be affected," the *Mathews v. Eldridge* test also takes account of "the probable value, if any, of additional procedural safeguards," and "the Government's interest, including the fiscal and administrative burdens that the additional or substitute procedures would entail."[222]

Neither Congress, nor the SEC, offered any such justification. They did not adequately explain why the increase in penalties inside of APs did not mandate any sort of re-evaluation of the procedures in that forum—to the contrary, senior SEC officials seemed to acknowledge that some procedural reform was necessary.[223] Nor did they adequately explain why the SEC could pursue the same violation with the same penalty under two vastly different procedural regimes. The closest thing to a justification is a recently released set of factors governing the Division of Enforcement's forum selection decisions.[224] But, as discussed above, these factors are malleable, and they fail to resolve the questions of fairness.[225] The SEC's own recent history provides support for the contention that its current enforcement architecture is unfair.

2. Explaining the Backlash

More formal procedures increase the costs of enforcement.[226] Why would the SEC ever voluntarily adopt such procedures?[227]

One possibility is that SEC officials have a genuine commitment to due process of law and other values promoted by more robust procedures. But SEC officials are also committed to effectively enforcing the securities laws. Facing a tradeoff between these two commitments, why choose to sacrifice effective enforcement on the altar of due process?

Another possibility is that the voluntary adoption of more robust procedures reflects agency capture by the regulated industry. That is, the SEC voluntarily undertakes measures that will slow down enforcement as a favor to their friends in the securities industry. Or, perhaps they do so to create more (and more specialized) work for the private securities bar which they plan to reenter.

The story presented above points toward an alternative explanation: the SEC adopts more formal procedures strategically to secure the legitimation of its en-

222. Matthews v. Eldridge, 424 U.S. 319, 335 (1976).

223. Daniel Wilson, *SEC Administrative Case Rules Likely Out of Date*, *GC Says*, LAW360 (June 17, 2014, 5:55 PM EST), http://www.law360.com/articles/548907/sec-administrative-case-rules-likely-out-of-date-gc-says.

224. Division of Enforcement Approach, *supra* note 4.

225. *See supra* text accompanying notes 127–29.

226. *See* MASHAW ET AL., *supra* note 40, at 311 ("Individualized adjudicatory justice, particularly if it entails all the trappings of formal adversary procedure, is wonderfully anti-bureaucratic. . . . The stage is thus set for continuous trench warfare between ideas of managerial competence and individual fairness. . . . These battles are a ubiquitous feature of administrative legal life and are waged on a host of procedural fronts.").

227. By "voluntarily," I mean to distinguish the question of why Congress or the courts would impose such requirements on agencies. *Cf.* Mathew D. McCubbins, Roger G. Noll & Barry R. Weingast, *Administrative Procedures as Instruments of Political Control*, 3 J.L. ECON. & ORG. 243 (1987); Lisa S. Bressman, *Procedures as Politics in Administrative Law*, 107 COLUM. L. REV. 1749 (2000).

forcement program and prevent a full-scale defection by the regulated industry. The need to secure legitimation (and reduce the risk of backlash) tends to be particularly acute after significant expansions of the SEC's administrative enforcement powers because these expansions disrupt the equilibrium between procedures and penalties. Adopting new, defendant-favorable procedures helps restore the balance, and thereby avoid a rebellion. In these circumstances, procedural *reform* avoids full-blown *revolution*.

After Dodd-Frank, the agency did not engage the regulated industry regarding the procedures that would govern its exercise of the new penalty powers as it had done in the past. Dodd-Frank's equalization of penalties across fora put the agency in a vulnerable position, but the agency's own failure to consider procedural reform left the industry with no alternative but to launch a full-scale assault, bringing along leading commentators and stakeholders.

IV. Procedural Reform

After blazing forward with aggressive implementation of its new administrative powers and ignoring attacks on the legitimacy of its enforcement program for several years, the agency has finally signaled an understanding that it has overreached. In September 2015, the agency proposed several amendments to its rules of practice[228]—seemingly designed to quell the mounting criticism.[229]

These reforms are too little, too late. That is, they come too late to derail the backlash, and they are too minimal to resolve the procedural imbalance or remedy the damage to the agency's reputation.

After briefly reviewing these proposals, this Part advances a bolder package of procedural reforms that would go farther to mitigate some of the concerns that provoked the current wave of backlash.

A. The SEC's Proposed Procedural Reforms

In September 2015, the SEC proposed several amendments to the Rules of Practice, including changes to the rules governing experts, hearsay evidence, appellate rights, and filings. Two of the most significant changes are to timing and deposition rights.

Timing: As discussed above, APs are currently subject to rigid timelines. Even the most complex matters proceed from service of the OIP to trial in four months. The proposed rules retain the rigidity of the current regime, but would double the timeline for the most complex cases from four to eight months

228. Amendments to the Commission's Rules of Practice, 80 Fed. Reg. 60082 (proposed Oct. 5, 2015); Amendments to the Commission's Rules of Practice, 80 Fed. Reg. 60091 (proposed Oct. 5, 2015).

229. *E.g.*, Elizabeth P. Gray et al., *SEC Proposes Amended Rules to Govern Administrative Proceedings*, Willkie Farr & Gallagher LLP (Sept. 28, 2015), http://www.willkie.com/~/media/Files/Publications/2015/09/SEC_Proposes_Amended_Rules_to_Govern_Administrative_Proceedings.pdf (suggesting the rules were proposed "in order to insulate the Commission from recent constitutional challenges to the forum and format of the proceeding").

from when the OIP is served to the hearing.[230] This change would give respondents valuable additional time to review massive investigatory files and develop their case for trial. However, it would not erase the substantial gap between respondents and the Enforcement Division, which often has a great deal more time to prepare its case—enough to be "measured in years rather than months."[231] Critics may not be appeased by anything less than abandoning the rigid structure of mandatory timelines.

Depositions: As also discussed above, under current rules, respondents may only take depositions in order to preserve testimony that would not be available at the hearing. The proposed rules would give both the respondent and the Enforcement Division the right to take up to three depositions in a matter involving a single respondent, and up to five in a matter involving multiple respondents, without any "preservation" requirement.[232] Again, this is a significant reform, but one that may not go far enough. A complex case is likely to involve more than three (or five) critical witnesses. And, again, the Enforcement Division has had the opportunity to interview many more than five individuals in the course of its investigation, such that giving the same number of depositions to both respondent and Division will, in the words of one group of commentators, "leave the playing field tilted in favor of the Division."[233]

* * *

The SEC's proposals suggest that the agency has, at long last, come to the recognition that it has overreached. But, though these reforms constitute substantial advances in the fairness of APs, they are too little, too late. Perhaps if the agency had acted sooner, announcing these reforms *in conjunction with* the newly expanded emphasis on APs after Dodd-Frank, they might have forestalled any backlash. But as it is, the constitutional challenges are unlikely to be affected much by these proposals, nor will the weakened legitimacy of the agency's enforcement program be remedied by them. For that, a bolder set of procedural reform is required.

B. An Alternate Package of Reforms: Conditional Stipulation and Interlocutory Review[234]

1. Conditional Stipulation

The SEC should amend its rules of practice to provide respondents a right to enter a conditional stipulation, similar to the "conditional pleas" that criminal de-

230. 80 Fed. Reg. at 60092.

231. Barry R. Goldsmith et al., *SEC Proposed Amendments to Rules for Administrative Proceedings*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Oct. 15, 2015), http://corpgov.law.harvard.edu/2015/10/15/sec-proposes-amendments-to-rules-for-administrative-proceedings/.

232. 80 Fed. Reg. at 60092.

233. Peter K.M. Chan et al., *Tweaking the "Home Court" Rules for SEC Administrative Proceedings*, Morgan Lewis (Sept. 28, 2015), www.morganlewis.com/pubs/tweaking-the-home-court-rules-for-sec-administrative-proceedings.

234. Proposals are written out in Appendix A.

fendants are entitled to enter under Federal Rule of Criminal Procedure 11(a)(2).[235] That rule provides defendants with the right to accept a plea bargain, and thereby waive the right to a jury trial, while retaining the right to challenge some legal basis for the government's prosecution—often a Fourth Amendment suppression argument. If the defendant prevails on his legal challenge—either in the district court or on appeal—he may withdraw the plea.[236] According to a leading treatise, "[m]ost commentators have looked with favor upon [conditional pleas] because they serve to avoid the necessity for trials undertaken for the sole purpose of preserving pretrial objections."[237]

Respondents charged APs should be entitled to enter, with or without the consent of the Enforcement Division, a conditional stipulation, accepting as true all or substantially all[238] of the facts alleged in the OIP, but reserving the right to challenge the SEC's legal theory of liability—before an ALJ, the SEC, and ultimately, the U.S. Court of Appeals. Such a stipulation would entail a unilateral waiver of the right to a trial before an ALJ, in exchange for the right to attack the SEC's legal theory pursuant to existing (or slightly modified) rules governing motions for summary disposition and interlocutory review.

Such a conditional stipulation could be withdrawn if and when the respondent substantially prevails on his legal challenge—whether before an ALJ, on appeal to the Commission, or on appeal to the U.S. Court of Appeals. And, once withdrawn, it would not have any legal effect. For instance, it could not be used as evidence in a private civil suit.

Making the right exercisable unilaterally, without requiring any negotiation with the Enforcement Division, would make this a powerful tool for respondents to wield. Merely creating the right to effective, low-cost review of the SEC's legal theories would likely deter the agency from pursuing borderline cases in APs.

One difficulty of this proposal is determining what proportion of the factual allegations raised in the OIP would have to be included in the stipulation in order to trigger the trial waiver and the right to appeal. Requiring all of the facts seems unnecessary, given that some of the allegations may be irrelevant to the liability determination, and merely there for the penalty phase. The formulation "substantially all" is meant to accommodate this scenario.

If a respondent loses on his legal challenge, the stipulation would become irrevocable, and he would either have to undergo trial for the penalty phase, or reach some settlement with the Commission on that issue.

Taking an appeal from the Commission to a circuit court should not pose any difficulty. Such review is limited to "final" orders of the Commission, and the

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235. "With the consent of the court and the government, a defendant may enter a conditional plea of guilty or nolo contendere, reserving in writing the right to have an appellate court review an adverse determination of a specified pretrial motion. A defendant who prevails on appeal may then withdraw the plea." FED. R. CRIM. P. 11(e).

236. *Id.*

237. 5 WAYNE R. LAFAVE ET AL., CRIMINAL PROCEDURE § 21.6(b) (3d ed. 2014) (collecting sources).

238. A respondent should take advantage of the conditional plea without admitting to facts included in the OIP that are unnecessary to establish his liability.

U.S. Supreme Court has expressly ruled that "interlocutory" orders do not qualify. However, in this case, the order is "interlocutory" in name only: because of the conditional plea, the Commission's decision upholding the legal theory would be tantamount to a final order. Thus, judicial review would be available. (If necessary, the rules could also provide for a nominal penalty to be imposed on respondents who enter conditional pleas.)

2. Interlocutory Judicial Review

Alternatively, or in addition to the conditional stipulation, the SEC could adopt a package of reforms that would allow a respondent to challenge the SEC's legal theory of prosecution *without* reaching any plea agreement.

The rule governing motion for summary disposition could be changed to allow for such motions to be filed as of right before trial. Currently, the rule authorizes such motions, but only with "leave" of the ALJ—the determination to grant or deny this leave is unreviewable.[239]

Respondents' track record with dispositive motions is laughable: only five have been granted between 1996 and 2014.[240] Moreover, it is not enough to provide a prompt method to challenge the legal theory before the ALJ. The rule governing interlocutory appeals should be amended to allow for immediate appeals of denials of motions for summary disposition contesting the government's underlying legal theory. Currently, the rule makes interlocutory appeals "disfavored" and granted in only "extraordinary circumstances."[241] The rule should be changed to encourage the Commission to hear interlocutory appeals from denials of motions for summary disposition that squarely confront the Commission's legal theory.

The rules governing "stays" or extensions of trial should be amended to allow for delays of trials pending resolution of the plaintiff's challenge to the government's legal theories, including all appeals. Currently the rules establish rigid timelines and strongly discourage departures from these.[242]

As discussed above, the securities statutes authorize judicial review only of "final" orders. A Commission rejection (on the merits) of an interlocutory appeal attacking the Commission's legal theories is "final" in the sense that it adopts a view of the meaning of the securities laws that is binding on the respondent. But it is not "final" in the sense that it still leaves open the possibility that the respondent will escape any agency action by disproving the charges at trial. The agency might try to solve this problem by adopting a rule construing the word "final," as

239. The current rule on summary disposition itself was amended in 1995—prior to that date, the rule flatly prohibited such motions. *See* 17 C.F.R. § 201.11(e) (1994); *see* 2 BLOOMENTHAL & WOLF, *supra* note 6, § 36.69.

240. *See* Platt, *supra* note 28.

241. 17 C.F.R. § 201.400 (2015).

242. *See id.* § 201.360; *see also supra* text accompanying notes 19–21.

used in the judicial review statutes, as encompassing Commission decisions upholding legal theories. This rule could require the Commission to "certify" such rulings for judicial review, declaring them "final" for purposes of the securities statutes. The weakness in this solution is that courts, which bear the responsibility for construing the judicial review statutes, could look past the Commission's "certification" of an issue as "final."

* * *

These reforms would help re-establish the equilibrium between procedures and penalties inside APs. Both reforms aspire to overcome the practical obstacles that respondents face in attacking the Commission's legal theories. As such, they would also combat the SEC's incentive to assert novel untested legal theories in APs. When Dodd-Frank increased the SEC's penalty powers in APs, the procedural protections afforded to respondents in these proceedings should have similarly expanded. It is now too late to prevent backlash, but these reforms would go a long way toward restoring the agency's respect for the principle that procedures should be commensurate with penalties, and restore some of the enforcement regime's lost legitimacy.

From the agency's perspective, the reforms might also have an additional benefit: they may somewhat reduce some of the risks under the constitutional claims. For instance, they may reduce the risk of an Article II violation by transforming ALJs into merely recommendatory agents, rather than policy-making "officers." The government has argued that ALJs do not qualify as "officers" because, unlike the PCOAB members, "ALJs do not draft regulations" but merely "adjudicate cases."[243] And "[a]djudications by SEC ALJs . . . do not involve the same kind of important policy choices [as decisions by the PCOAB]; they involve the application of the law to a discrete set of facts in individual cases."[244] But, as discussed above, the SEC's use of APs increasingly blurs that distinction. By relying on APs to develop novel theories of the law, the agency makes ALJs into quasi-rulemaking entities. Allowing for expedited appellate review of legal issues would weaken plaintiffs' claims that ALJs effectively wield final rulemaking authority, and thus demonstrate that, unlike PCOAB members, ALJs do not constitute "officers" of the United States.

Adoption of this proposal might also diminish the prospect that the nondelegation argument would prevail. Plaintiffs must convince a court to find the choice of forum amounted to a legislative (or quasi-legislative) act. The only way for a plaintiff to do so would be to convince a court that APs functioned as quasi-legislative proceedings, producing new rules for the regulated industry relatively immune from judicial review. The proposal diminishes the ALJs' control over this "rulemaking" function, by entitling respondents to prompt and rel-

243. Government's Opposition at 37, Bebo v. SEC, No. 15-cv-3 (E.D. Wis. Feb. 3, 2015), ECF No. 15.
244. *Id.*

atively low-cost access to judicial review, and thereby mitigates the potential liability for a nondelegation challenge.

3. Counterarguments

Some might object that this solution targets only one facet of the problem with APs—their impact on the development of the law—and leaves other flaws, constitutional and otherwise, unaddressed. For instance, the proposal does not purport to resolve the possible Seventh Amendment and procedural due process problems: unregistered persons would remain subject to APs, where they would be denied various procedural protections (including a jury trial) and potentially subjected to severe penalties.

It is true that by failing to promptly engage in procedural reform following Dodd-Frank, the SEC may have lost its best opportunity to avoid backlash. Now that the litany of constitutional defects with APs have been aired, and the legitimacy of the agency's expanded use of APs called into doubt, it will take a very significant effort to change the momentum. Still, though it is surely not guaranteed to stop the backlash in its tracks, the proposal is worth consideration insofar as it: (1) does possibly mitigate some of the constitutional arguments (Article II and nondelegation); (2) directly mitigates the criticism, articulated by Judge Rakoff, among others, that the agency is unfairly using APs to develop new doctrines; and, therefore, as a result, (3) may restore some lost legitimacy to APs, which could have an effect on these remaining constitutional challenges.

Some might also object that solution does not go far enough in resolving the concerns about the development of the securities laws. Judge Rakoff criticized APs in part because if and when a legal challenge does reach an Article III court, that court will review legal determinations of the agency with the deference required under *Chevron* and related doctrines.[245]

But the SEC's legal theories advanced in APs have always been subject to judicial review under *Chevron*. And even those who are deeply skeptical of deference regimes seem to have accepted that *Chevron* is here to stay.[246] A better view of the problem (as articulated above) is that APs hinder balanced development of the securities laws not because of *Chevron* deference, but because they too often keep respondents out of the process, thereby depriving adjudicators of input from the regulated industry. Case-by-case adjudication is a legitimate method of law development—only where there is adequate input from both sides of the case. The proposal would remedy the current imbalance in APs by ensur-

245. Rakoff, Law Unto Itself, *supra* note 53 ("[W]hile the decisions of federal district courts on matters of law are subject to de novo review by the appellate courts, the law as determined by an administrative law judge in a formal administrative decision must be given deference by federal courts unless the decision is not within the range of reasonable interpretation.").

246. *E.g.*, Perez v. Mortg. Bankers Ass'n, 135 S. Ct. 1199, 1212–13 (2015) (Scalia, J., concurring in the judgment) (admitting with apparent reluctance that the "problem" of deference to agency statutory interpretation is "perhaps insoluble if *Chevron* is not to be uprooted," while actively urging the abandonment of deference to agency regulatory interpretation).

ing that litigants have a low-cost opportunity to contest legal theories articulated by the agency.

Moreover, *Chevron* deference may be overrated. An empirical study of every U.S. Supreme Court opinion from 1986 to 2010 involving an agency interpretation concluded that *Chevron* deference has been applied unevenly at best.[247] Courts have not shied away from closely scrutinizing the SEC's constructions of the securities statutes on review of APs even under the *Chevron* standard.[248] Nor have they been unwilling to take a close look at the agency's decisionmaking in the rulemaking context, despite the standards of deference that apply there.[249]

Most important, several recent opinions cast doubt on certain forms of deference.[250] For instance, in *Whitman v. United States*, Justice Scalia (joined by Justice Thomas) suggested that the deference courts accord to agency interpretations cannot properly, under the rule of lenity, apply to statutes that contemplate both civil and criminal enforcement.[251] This would apply to many of the securities laws that form the basis of APs.[252] And, in *Perez v. Mortgage Bankers Ass'n*, Justices Thomas, Scalia, and Alito suggested (with varying degrees of certainty) overturning precedents requiring deference to agency interpretations of their own regulations.[253]

Some might also object that this proposal goes too far—that respondents will overuse this right to seek appeal as a delaying tactic. The effect would be to diminish the timeliness advantage of APs.

This criticism points to the fact that, as a practical and political matter, any procedural reform solution to the present constitutional backlash must preserve the fundamental advantages of APs for the agency, or else it will not be worth the agency's time in taking it up. There may be methods to effectively deter overuse or frivolous uses of this new right. But if none of these prove effective, the SEC

247. Connor N. Raso & William N. Eskridge, Jr., Chevron *as a Canon, Not a Precedent: An Empirical Study of What Motivates Justices in Agency Deference Cases*, 110 COLUM. L. REV. 1727 (2010).

248. *E.g.*, Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

249. *See supra* text accompanying notes 143–50 (discussing *Business Roundtable*, etc.).

250. *See Perez*, 135 S. Ct. at 1210–25 (opinions of Scalia, J., Thomas, J., and Alito, J.).

251. 135 S. Ct. 352 (2014) (Scalia, J., respecting the denial of certiorari); *see also* Carter v. Welles-Bowen Realty, Inc., 736 F.3d 722, 729 (6th Cir. 2013) (Sutton, J., concurring).

252. *See* Securities Act § 20(b); Exchange Act § 21(d)(1); Investment Advisers Act § 209(d); Investment Company Act § 42(d).

253. 135 S. Ct. 1199, 1210–25 (2015). Again, the opinions expressed this view with varying degrees of confidence. *Compare id.* at 1213 (Thomas, J., concurring in the judgment) (rejecting deference to agency interpretations of their own regulations which "effects a transfer of the judicial power to an executive agency," "undermines our obligation to provide a judicial check on the other branches," and "subjects regulated parties to precisely the abuses that the Framers sought to prevent"), *and id.* at 1212–13 (Scalia, J., concurring in the judgment) ("I would therefore restore the balance originally struck by the APA with respect to an agency's interpretation of its own regulations, not by rewriting the Act in order to make up for *Auer*, but by abandoning *Auer* and applying the Act as written. The agency is free to interpret its own regulations with or without notice and comment; but courts will decide—with no deference to the agency—whether that interpretation is correct."), *with id.* at 1210 (Alito, J., concurring in part and concurring in the judgment) ("I await a case in which the validity of *Seminole Rock* may be explored through full briefing and argument.").

should adopt the conditional stipulation method, which does not raise similar concerns.[254]

C. Rival Proposals

Scholars have only just begun to examine the current backlash.[255] But commentators have advanced a number of proposals to modify the system to mitigate some of the concerns about SEC enforcement.

1. Forum Selection Guidelines

Early in 2015, Commissioner Michael Piowar suggested the agency adopt guidelines governing the choice of forum, in order to "avoid the perception that the Commission is taking its tougher cases to its in-house judges, and to ensure that all are treated fairly and equally."[256] In June 2015, the Division of Enforcement released a four-page document outlining the factors it weighs in making forum selection determinations.[257]

This document does not resolve the legitimacy or constitutional concerns raised about APs. It explicitly states that APs are particularly useful for cases involving "unsettled and complex legal issues under the federal securities laws" because of the Commission's "expertise concerning those matters."[258] It does nothing to restore the pre-Dodd-Frank procedural balance. And because the factors listed are so malleable, it does little to assuage the fear that the SEC is using the choice of forum unfairly to obtain a procedural advantage.[259]

254. Another criticism: The proposal gives respondents the right to challenge new legal theories, but it is not always easy to distinguish between new legal theories and old legal theories applied to new facts. Insofar as my proposal subjects the former, but not the latter, to greater scrutiny, it might simply encourage the agency to disguise some of its legal innovations as factual.

255. The only full-length scholarly treatment of these issues that I am aware of is a student note. Ryan Jones, Note, *The Fight Over Home Court: An Analysis of the SEC's Increased Use of Administrative Proceedings*, 68 SMU L. Rev. 507 (2015).

256. Michael S. Piowar, Comm'r, U.S. Sec. & Exch. Comm'n, A Fair, Orderly, and Efficient SEC, Remarks at 2015 SEC Speaks Conference (Feb. 20, 2015).

257. *See Division of Enforcement Approach*, *supra* note 4; *see also supra* text accompanying notes 126–128.

258. *Id.*; *see also* Bourtin et al., *supra* note 154 ("[T]he guidance may exacerbate the criticism voiced by Judge Rakoff and others that the SEC should expose novel applications of the securities laws to de novo judicial review rather than handle them through administrative proceedings."); McLucas & Martens, *supra* note 52 (asserting that the guidance on forum selection "did not address the significant objections that critics have raised").

259. *See* McLucas & Martens, *supra* note 52 (criticizing the four-page memo and urging the SEC to develop truly "objective criteria" to guide the choice of forum). The Chamber of Commerce's 2015 policy report urges the Commission to adopt more rigid forum selection guidelines, which would limit APs to cases "based upon well-established legal principles that have been adopted by Article III courts." U.S. Chamber of Commerce, Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices 3 (July 2015).

2. Right of Removal

In the last round of anti-AP backlash in the early 1990s (after the Remedies Act, discussed above), the American Bar Association suggested that the SEC should grant all respondents charged in APs a right of "removal," akin to that provided by 28 U.S.C. § 1441, such that any respondent charged in an AP could unilaterally force the SEC to proceed in federal court.[260] The U.S. Chamber of Commerce recently revived the proposal,[261] and it has been taken up by a member of Congress, who introduced legislation in October 2015.[262]

This is strong medicine. Respondents would likely opt out of the AP system very widely, if only for the added delays provided in federal court litigation. APs are a valuable mechanism to enforce the securities laws which have been available since the beginning of the Commission itself. If this were the only available solution, the SEC would have no incentive to take action—it may as well let the constitutional challenges proceed and take its chances.

3. Allocate Choice of Forum

The ABA advanced a second proposal in the early 1990s: to allocate the choice of forum outside of the prosecutorial Enforcement Division to the advisory general counsel.[263] The general counsel provides a variety of services to the Commission, including the preparation of Commission opinions, representing the Commission in federal appellate courts, and providing legal advice. Reallocating the choice of forum from the Enforcement Division to the general counsel, the ABA argued, would eliminate the sense that the agency was forum shopping.

This solution is weak. Much of the mistrust of APs arises from the comingling of prosecutorial and adjudicative functions. Assigning the forum selection role to another actor in the same agency hardly mitigates such concerns. And, in any event, it leaves open the possibility that the choice of forum would simply continue on the current trajectory.

Moreover, the proposal is also likely to be resisted by the Enforcement Division that may feel that the attorneys who know the case best should be the ones who determine which forum best suits the case.

4. ALJ Reform

In *Hill*, Judge May suggested that the appointments violation she found "could easily be cured by having the SEC commissioners issue an appointment."[264] This

260. *ALJ Task Force Report*, *supra* note 196, at 1736.

261. U.S. Chamber of Commerce, *supra* note 259, at 4 ("The Commission should adopt a policy that any party named in an administrative proceeding that desires a jury trial may file a notice to remove the proceeding to federal district court.").

262. Jean Eaglesham, *SEC Faces New Attack on In-House Judges*, Wall St. J. (Oct. 21, 2015), http://blogs.wsj.com/moneybeat/2015/10/21/sec-faces-new-attack-on-in-house-judges/.

263. *ALJ Task Force Report*, *supra* note 196, at 1737.

264. Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088, at *20 (N.D. Ga. June 8, 2015). Judge May's proposal is parallel to another recent proposal targeting ALJs more generally, which would re-

would resolve the appointment challenge, but would leave unaddressed the remaining constitutional challenges as well as the concern about the proper development of the law. Moreover, the solution would raise a host of issues regarding cases already decided by (illegally appointed) ALJs.[265]

V. Conclusion

The wave of backlash facing the SEC poses risks potentially reaching well beyond the agency. The agency might have been able to preempt this backlash by promptly recalibrating the procedural protections available in APs, just as it did after receiving new AP penalty authority in the past. It is too late to prevent backlash, but it may not be too late for the agency to mitigate the harm that follows. By substantially reforming its rules of practice to afford respondents an effective opportunity to test the SEC's legal theories, the SEC might shore up legitimacy of its AP system.

The agency's recent proposals are a step in the right direction, but are too little, too late. It has been twenty years since the last comprehensive review of the Rules of Practice in 1995. In the interim, Congress has enacted several major overhauls to the securities laws, the financial industry has been transformed by countless innovations, advances in technology have reshaped litigation, and key legal doctrines governing agency action have changed substantially. The Rules of Practice are due for a comprehensive review. Bold reforms are required.

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solve the constitutional questions raised by Article II by changing the appointment and removal structure of ALJs. Instead of being appointed by the Commission, Professor Kent Barnett proposes having ALJs appointed (and removed) by the D.C. Circuit. Kent Barnett, *Resolving the ALJ Quandary*, 66 Vand. L. Rev. 797 (2013). Notably, Judge May cites Prof. Barnett's article elsewhere in her opinion. *See Hill*, 2015 WL 4307088, at *16. And Professor Barnett endorsed Judge May's suggestion. *See* Kent Barnett, *The SEC's Inferiority Complex*, Yale J. on Reg. Notice & Comment (June 11, 2015), http://www.yalejreg.com/blog/the-secs-inferiority-complex-by-kent-barnett).

Barnett's D.C. Circuit proposal seems extremely unlikely to move forward. Judges seem likely to resist any such imposition of administrative duties. True, my proposal also requires additional work from the D.C. Circuit by making it more likely that more cases will come up through the system for a legal appeal. But, at least it is the same genre of work that judges are used to performing—i.e., interpreting the law and reviewing the work of administrative agencies—not reviewing resumes.

265. *E.g.*, Peter J. Henning, *S.E.C. Finds Itself in a Constitutional Conundrum*, N.Y. Times DealB%k (June 15, 2015), http://www.nytimes.com/2015/06/16/business/dealbook/sec-finds-itself-in-a-constitutional-conundrum.html?_r=0; Frankel, *supra* note 14 (quoting SEC critics as suggesting that, if the SEC reappointed its ALJs as Judge May suggests, "Any defendant with a pending case before an SEC in-house judge—and even defendants previously tried in administrative proceedings—will be able to challenge the constitutionality of the regime in which they were tried.").

Appendix A

AGENCY: Securities and Exchange Commission

ACTION: Proposed rules and request for comment.

SUMMARY: The Securities and Exchange Commission is proposing to adopt revisions to the Rules of Practice.

DATES: Comments must be submitted on or before [Insert date 90 days after date of publication in the FEDERAL REGISTER].

Proposed Amendments:

Rule 161. Extensions of time, postponements and adjournments

. . . .

(b) Considerations in determining whether to extend time limits or grant postponements, adjournments and extensions.

(1) In considering all motions or requests pursuant to paragraph (a) or (b) of this section, the Commission or the hearing officer should adhere to a policy of strongly disfavoring such requests, except in circumstances where the requesting party makes a strong showing that the denial of the request or motion would substantially prejudice their case, ***or where the requesting party is pursuing a motion for summary disposition which primarily attacks the legal theory underlying the enforcement action or an interlocutory appeal of such a motion***. In determining whether to grant any requests, the Commission or hearing officer shall consider, in addition to any other relevant factors:

(i) The length of the proceeding to date;

(ii) The number of postponements, adjournments or extensions already granted;

(iii) The stage of the proceedings at the time of the request;

(iv) The impact of the request on the hearing officer's ability to complete the proceeding in the time specified by the Commission; and

(v) Any other such matters as justice may require.

Rule 203. Conditional Stipulation

(a) In lieu of filing an Answer, a respondent may enter a conditional stipulation, with or without the consent of the Enforcement Division, accepting all or substantially all of the factual allegations asserted in the OIP as true, while reserving the right to challenge the enforcement action on legal grounds.

(b) Upon the entry of such a conditional stipulation, the hearing officer shall set a schedule for briefing of a Motion for Summary Disposition.

(c) A respondent who prevails on these legal claims before the hearing officer, the Commission, or on Judicial Review, may withdraw the stipulation.

Rule 250. Motion for Summary Disposition

(a) After a respondent's answer has been filed and, in an enforcement or a disciplinary proceeding, documents have been made available to that respondent for inspection and copying pursuant to § 201.230, the respondent or the interested division may make a motion for summary disposition of any or all allegations of the order instituting proceedings with respect to that respondent. If the interested division has not completed presentation of its case in chief, a motion for summary disposition shall be made only with leave of the hearing officer~~.~~, ***unless the motion is directed primarily to attacking the legal theory underlying the prosecution, in which case a respondent may file such motion before the hearing as of right.*** The facts of the pleadings of the party against whom the motion is made shall be taken as true, except as modified by stipulations or admissions made by that party, by uncontested affidavits, or by facts officially noted pursuant to § 201.323.

Rule 400. Interlocutory Review

(a) Availability. The Commission may, at any time, on its own motion, direct that any matter be submitted to it for review. Petitions by parties for interlocutory review are disfavored, and the Commission ordinarily will grant a petition to review a hearing officer ruling prior to its consideration of an initial decision only in extraordinary circumstances. ***However, petitions for interlocutory review of motions for summary disposition primarily attacking the legal theory underlying the prosecution should be granted.*** The Commission may decline to consider a ruling certified by a hearing officer pursuant to paragraph (c) of this section or the petition of a party who has been denied certification if it determines that interlocutory review is not warranted or appropriate under the circumstances. This section is the exclusive remedy for review of a hearing officer's ruling prior to Commission consideration of the entire proceeding and is the sole mechanism for appeal of actions delegated pursuant to §§ 200.30–.9 and 200.30–.10 of this chapter.

. . . .

(d) Proceedings not stayed. The filing of an application for review or the grant of review shall not stay proceedings before the hearing officer unless he or she, or the Commission, shall so order. ***However, a petition for interlocutory review of a motion for summary disposition attacking***

> ***the underlying legal theory shall stay proceedings.*** The Commission will not consider the motion for a stay unless the motion shall have first been made to the hearing officer.

Rule ____. Certification for Judicial Review

Whenever the Commission denies (on the merits) an interlocutory appeal from a denial of a motion for summary disposition which primarily attacks the legal theory of the OIP, the Commission shall certify this order as "final" for purposes of judicial review, reflecting the fact that it is the Commission's final statement of the law, creating binding obligations on respondent and others similarly situated.