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TESTIMONY

Enforcement of Federal Securities Laws Should Be Vigorous but Fair

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SEC Enforcement: Balancing Deterrence with Due Process

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Chairman Wagner, Ranking Member Sherman, and Members of the Subcommittee:

I am pleased to have an opportunity to comment on several timely and important issues related to enforcement of the federal securities laws. I have extensive experience with those laws: I was Deputy General Counsel of the Securities and Exchange Commission from mid-2006 to March 2009 and taught courses on securities regulation at the University of Virginia School of Law from 2014 to 2019. For many years, I was a partner in the securities enforcement practice of Wilmer Cutler Pickering Hale and Dorr LLP and am currently a senior affiliated scholar with the Mercatus Center at George Mason University.

I will discuss (1) the SEC's unguided discretion to impose extremely high civil penalty amounts, (2) the need to clarify the 2021 disgorgement statute, which is already the subject of differing views of courts of appeals on an important issue, (3) the role of administrative proceedings in enforcement of the federal securities laws, and (4) general problems with SEC enforcement.

I have written about various aspects of the SEC enforcement process; a list of enforcement articles is at the end of these written remarks. The views I express in this written statement and in my oral testimony are solely my own and are not on behalf of and do not necessarily reflect the views of any other person. For convenience, I will refer to a person involved in an SEC investigation or charged with a violation of the securities laws as a defendant.

Enforcement of the federal securities laws should be vigorous but fair. Fair treatment of defendants increases accuracy of results, promotes the legitimacy and acceptability of the enforcement process, fosters respect for the law, and therefore advances the statutory goals of encouraging capital formation while protecting investors and markets. The SEC enforcement process should be based on the rule of law and not on administrative discretion and should provide each defendant with adequate advance notice of specific and identifiable standards of conduct, a meaningful opportunity to prepare and present a defense, and an ability to bring cases that lack merit to a rapid close. Fairness to defendants should be one of the highest values protected by the process used to enforce the federal securities laws.

1. Penalties in SEC Enforcement Cases

The federal securities statutes have an elaborate system for imposing civil monetary penalties in federal court cases and administrative proceedings (APs).[1] The penalties, along with disgorgement (discussed in section 2), have become a primary remedy in SEC enforcement cases. In the fiscal year ending September 30, 2023, the amount of penalties ordered in SEC court cases and through administrative proceedings was $1.58 billion. In fiscal year 2022, the amount was $4.19 billion and in fiscal 2021 $1.46 billion.[2]

The application of the civil monetary penalty regime suffers from two major defects, and Congress can and should fix them. The first is that the statutes do not set a workable standard for determining penalty amounts, and neither the courts nor the SEC interpreted the law to set consistent and predictable legal standards. The consequence is that the SEC, which as a practical matter means SEC enforcement staff rather than the Commissioners, has nearly total and unreviewable discretion to set penalty amounts, especially in settlements. The second defect is that penalty amounts are often excessive, unpredictable, inconsistent, and disproportionate to a reasonable assessment of the severity of a violation.

The penalty statutes in the federal securities laws establish three tiers of penalty amounts. The amounts increase for violations involving fraud or a deliberate disregard of a regulatory requirement, and then again for violations involving substantial losses or the risk of substantial losses to third parties. Each penalty tier has a specific dollar limit for natural persons and a higher dollar limit for any other person. A district court may impose a penalty up to the higher of the specific dollar limit or the gross amount of pecuniary gain to the defendant from the violation.

In district courts, the penalty amounts apply to "each violation" of a securities law or of a cease-and-desist order entered by the SEC. In an AP, the penalty amounts apply to certain specified acts or omissions, but the main basis for a penalty is a violation of the securities laws.

The SEC is required to increase the statutory maximum amounts each year based on inflation. For example, the range of maximum penalty amounts under the Securities Exchange Act in district courts is currently $11,524 (tier 1 for individuals) to $1,152,314 (tier 3 for legal entities).[3]

The courts and the SEC have not developed predictable, consistent, and textually based standards for defining a violation, act, or omission or applying the penalty statutes. The courts are divided on how to

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[1] See, e.g., 15 U.S.C. §§ 78u(d)(3), 78u-2. The other main securities acts have similar provisions. This statement does not address the penalty statute for insider trading. Id. § 78u-1.

[2] Press Release, SEC, SEC Announces Enforcement Results for Fiscal Year 2023 (Nov. 14, 2023), https://www.sec.gov/news/press-release/2022-206 [https://perma.cc/5UKW-3VZD]; Addendum to Division of Enforcement Press Release FY 2023, at 2, https://www.sec.gov/files/fy23-enforcement-statistics.pdf.

[3] Inflation Adjustments to the Civil Monetary Penalties Administered by the SEC (as of Jan. 15, 2024), https://www.sec.gov/enforce/civil-penalties-inflation-adjustments.

calculate penalty amounts.[4] The SEC and its administrative law judges have done no better in interpreting the statutes to establish a predictable method of counting violations.[5]

A commentator described the current situation: how SEC civil monetary penalties "are calculated and on what bases, and how the penalties relate to the underlying misconduct remains largely opaque." "Despite the statutory maximums, in some cases there is practically unlimited potential liability, which in turn gives rise to a penalty framework that is almost entirely discretionary."[6]

In a filing with the Supreme Court, the SEC confirmed this state of affairs. The SEC argued that, when setting a penalty amount, a district court may exercise broad discretion in light of the particular facts and circumstances of a case and approved the many differing approaches to calculating penalties that various courts have used. The SEC brief confirmed that the number of potential "violations" that count for a penalty can be vast. In that particular case, two defendants engaged in thousands of transactions as unregistered brokers. Each transaction was a violation, so the SEC said the district court could have imposed thousands of penalties on the defendants.[7]

The problems with the securities penalty statutes are particularly acute in settlements, and a high percentage of SEC enforcement cases settle. Many SEC enforcement cases settle simultaneously with initiation, and most settle before reaching a final litigated conclusion.[8] Only a few cases reach a final resolution on the merits by an ALJ, judge, or jury. Penalty amounts in settlements escape any effective review.[9]

The lack of reasonable, uniform standards for SEC penalty calculations delegates enormous discretion and bargaining power to the SEC staff during settlement negotiations, which results in extremely large penalty assessments and unfairness to defendants. In settlement discussions, the SEC staff may take whatever position they want on a possible penalty amount. Penalty demands can be arbitrary and unpredictable.[10]

Defendants are not able to hold the SEC staff to compulsory benchmarks for a penalty calculation to resolve a case. When defense lawyers attempt to inject rationality or principle into negotiations about a penalty amount, the discussion often rapidly descends into a staff claim that the amount turns

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[4] See SEC v. Murphy, 50 F.4th 832, 848 (9th Cir. 2022) ("District courts have discretion to determine what constitutes a 'violation' and have relied on various proxies."); Petition for a Writ of Certiorari, at 14-17 ("SEC and the courts have conjured up nearly limitless ways to slice up violations and then multiply SEC's statutory penalty caps"), Murphy v. SEC (U.S.) (No. 22-1241), cert. denied (Oct. 30, 2023).

[5] See In the Matter of Laurie Bebo, No. 3-16293, 2020 WL 4784633, at *107 (S.E.C. Aug. 13, 2020) (observing that Commission opinions have taken inconsistent approaches to penalties and that a review of federal court cases revealed "at least three other robust approaches—one for which penalties are based on the number of transactions or misstatements, another for which penalties are based on the number of victims, and a third for which penalties are based on the number of statutory provisions violated"); Brief of Securities Scholars and Former SEC Officials as Amici Curiae in Support of Petitioners, at 6-7, Murphy v. SEC (U.S.) (No. 22-1241), cert. denied (Oct. 30, 2023) (Amicus Brief).

[6] David Rosenfeld, Civil Penalties Against Public Companies in SEC Enforcement Actions: An Empirical Analysis, 22 U. Pa. J. Bus. L. 135, 179-80 (2019) (Rosenfeld).

[7] Brief for the Respondent in Opposition, at 13-15, 18-20, Murphy v. SEC (U.S.) (No. 22-1241), cert. denied (Oct. 30, 2023).

[8] See Amicus Brief at 8-9.

[9] See id. at 9-10.

[10] See Rosenfeld 182 ("The lack of a meaningful cap gives the agency the ability to extract settlements by threatening exorbitant penalties"; "the amount of the fine is entirely discretionary and subject to negotiation").

completely on the definition of "each violation," the lack of meaningful restrictions, and the ability to define an extremely large number of violations.

The absence of background legal standards on the meaning of the penalty statutes disadvantages defendants. Defendants are not able to compare the potential cost of a settled outcome with the risks of a litigated outcome. Defendants do not know what penalty position the SEC will take in litigation and do not know what an ALJ or court will decide if the case does not settle. Litigated penalty amounts are impossible to estimate and volatile, putting additional pressure on defendants to agree to SEC penalty demands in a settlement.

Penalty amounts in settlements often therefore are inexplicably large and are difficult to reconcile with the language of the penalty statutes or with the penalties in similar cases. For example, in 2010, the SEC extracted a $535 million penalty from Goldman Sachs for a single transaction. The complaint alleged two claims for relief and referred to three buyers of the securities.[11]

Another example is the SEC's campaign against registered persons for failing to retain instant messages, what the SEC calls the off-channel communications cases. Since December 2021, the Commission has charged nearly 60 firms—investment advisers, broker-dealers, and credit ratings agencies—with recordkeeping violations, resulting in combined penalties of just over $1.7 billion. The cases settled. Some defendants agreed to penalty amounts of $125 million—a staggering amount for a decision not to keep a certain category of records. The settled charging document for each of several defendants cited only four violations, no gain to defendants, and no loss to investors.[12]

In a speech, the deputy director of enforcement revealed some of the factors the SEC considered when determining penalty amounts in the off-channel communication cases.[13] One factor allowed the SEC to count an enormous number of violations, such as the number of off-channel communications, which were in the tens of thousands in some cases. Other factors had no connection to an effort to define a number of violations according to the statutes. The SEC considered size of the defendant, specifically the firm's revenues from the regulated parts of a business, the number of registered professional employees, and the number of individuals who used off-channel communications. In a 2022 statement, the SEC director of enforcement said he sought penalties that "are viewed as more than the cost of doing business,"[14] another factor not recognized by the statutes. The Amicus Brief in the Murphy case gave other examples of unpredictable or excessive penalties.[15]

The SEC and the courts should not have unfettered and unguided discretion when setting penalty amounts. The lack of meaningful legal standards denies ordinary people fair notice about the

[11] See SEC Press Release, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (Jul. 15, 2010), https://www.sec.gov/news/press/2010/2010-123.htm; SEC v. Goldman Sachs & Co., (S.D.N.Y. filed Apr. 16, 2010), https://www.sec.gov/files/litigation/complaints/2010/comp21489.pdf.

[12] See, e.g., Barclays Capital Inc., https://www.sec.gov/litigation/admin/2022/34-95919.pdf. The speech cited in the next note has references to other cases.

[13] Sanjay Wadhwa, Deputy Director, SEC Division of Enforcement, Remarks at SEC Speaks 2024 (Apr. 3, 2024), https://www.sec.gov/news/speech/sanjay-wadhwa-sec-speaks-2024-04032024.

[14] Press Release, SEC, SEC Announces Enforcement Results for FY22 (Nov. 15, 2022), https://www.sec.gov/news/press-release/2022-206.

[15] See Amicus Brief at 11-14.

consequences that will attach to conduct and permits arbitrary, inconsistent, and discriminatory enforcement. The solution is to amend the securities penalty statutes to provide guidance on the appropriate method of counting violations and limiting maximum penalty amounts. One of the draft bills contains language to do that.

Congress should also reconsider the alternative penalty amount of a defendant's gross pecuniary gain. Congress could decide that the alternative is not necessary because a court also may order disgorgement, even if gross pecuniary gain differs somewhat from net profits from a violation. In addition, in many cases, the concept of gross pecuniary gain would be difficult to allocate to "each violation" as opposed to the total amount the defendant profited from the entirety of its course of securities misconduct.

2. The 2021 Disgorgement Statute

In early 2021, Congress enacted a statute that explicitly permits a federal court to order disgorgement as a remedy in an SEC enforcement case and imposed a limitations period of five or ten years.[16] Disgorgement requires a defendant to repay profits it received from a violation of the securities laws and is a major part of the remedies in SEC enforcement cases. In the fiscal year ending September 30, 2023, the disgorgement amount ordered in SEC court cases and through administrative proceedings was $3.37 billion. In fiscal year 2022, the amount was $2.25 billion.[17]

The new statute resolved several contentious issues about the remedy of disgorgement in SEC enforcement cases, but, unfortunately, it created many new questions of interpretation. The statute passed within months of the Supreme Court decision in *Liu v. SEC*,[18] which found that disgorgement in an SEC enforcement case is an equitable remedy when it complies with three longstanding principles of equity: (1) a defendant's gains are returned to wronged investors for their benefit; (2) the disgorgement order does not extend to several wrongdoers under a joint-and-several liability theory; and (3) disgorgement does not exceed the net profits from wrongdoing after deducting legitimate expenses.[19] A key interpretive question the statute created is whether "disgorgement" as authorized by the new statute must abide by the equitable limitations the Liu Court described. Does the new statute incorporate the Liu decision and equitable principles?

Standard methods of statutory interpretation fail to produce a convincing resolution. They do not demonstrate that Congress wanted the terms "disgorgement" and "unjust enrichment" in the new statute to be treated as equitable remedies with the traditional equitable limitations the Court found in Liu, and they do not lead to the conclusion that Congress otherwise wanted to adopt the Supreme Court's Liu decision or its reasoning to incorporate equitable principles.

[16] William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, Pub. L. No. 116-283, § 6501, 134 Stat. 3388 (2021) (to be codified at 15 U.S.C. § 78u(d)(3), (7)–(9)).

[17] Press Release, SEC, SEC Announces Enforcement Results for Fiscal Year 2023 (Nov. 14, 2023), https://www.sec.gov/news/press-release/2022-206 [https://perma.cc/5UKW-3VZD]; Addendum to Division of Enforcement Press Release FY 2023, at 2, https://www.sec.gov/files/fy23-enforcement-statistics.pdf.

[18] 140 S. Ct. 1936 (2020).

[19] See id. at 1947–50.

I discussed this question about Liu and the new statute in and took parts of this testimony from Andrew N. Vollmer, "Liu and the New SEC Disgorgement Statute," 15 Wm. & Mary Bus. L. Rev. 307 (2024). I listed other questions created by the new disgorgement statute in Andrew N. Vollmer, "Statutes of Limitations and Unanswered Questions in the New SEC Disgorgement Statute," Sept 7, 2022), http://ssrn.com/abstract=4211723.

The courts of appeals have already reached different conclusions about Liu and the new disgorgement statute. The Fifth Circuit in *SEC v. Hallam* concluded that the new statute did not incorporate Liu: "Congress used the term 'disgorgement' to authorize the sorts of disgorgement awards courts were ordering before Liu."[20] The Second Circuit reached the opposite conclusion in *SEC v. Ahmed*: "disgorgement under [the new statute] must comport with traditional equitable limitations as recognized in Liu."[21] The SEC has not been entirely consistent but generally has taken the position that the new disgorgement statute codified Liu.[22]

Courts also disagree about the statute's use of the Liu factor that disgorgement should be paid to victims of the misconduct. *SEC v. Govil* said that the new statute, incorporating the Liu limitations, required disgorgement to be awarded for victims and that disgorgement was not available unless the SEC proved that investors suffered pecuniary harm.[23] A district court in Florida reasoned that the new disgorgement statute does not require that disgorgement be "for the benefit of investors," as required by the statute construed in Liu (section 21(d)(5)), and held that it may direct that disgorged funds be sent to the Treasury under the new disgorgement statute.[24]

Congress can and should amend the new disgorgement statute to fix these problems. The uncertainties should not be left to the courts to resolve because the courts will reach conclusions that are not consistent and not necessarily in line with the desires of Congress.

A draft bill proposes to resolve the key issues. To begin, it would clear up an ambiguity and make disgorgement under the new statute, section 21(d)(7), the exclusive method of obtaining disgorgement and would not permit the alternative of equitable disgorgement of the type Liu approved under a different statute, section 21(d)(5).

On the first Liu issue, the bill would permit disgorgement even if the return of disgorged funds to injured investors is not feasible. That is the better outcome because a defendant should not retain wrongful profits if reimbursement to victims is not practical and because current law already has a

[20] SEC v, Hallam, 42 F.4th 316, 341 (5th Cir. 2022). Id. at 339.

[21] SEC v. Ahmed, 72 F.4th 379, 396 (2d Cir. 2023). See also SEC v. Camarco, 2021 WL 5985058, at *25 (10th Cir.) (Bacharach, J., dissenting) (following the SEC argument "that the new [statute] expressly authorizes 'disgorgement' as a form of 'equitable relief'").

[22] See SEC v. Ahmed, 72 F.4th 379, 395 (2d Cir. 2023) (SEC assumed that Liu's equitable limitations on disgorgement survived the new statute); SEC v. Hallam, 42 F.4th 316, 337 (5th Cir. 2022) (SEC's position was that the new disgorgement statute codified Liu); SEC v. Blackburn, 15 F.4th 676, 681 n.4 (5th Cir. 2021) (SEC told the court that the new statute gave district courts broader authority to order disgorgement than Liu did); SEC v. Camarco, 2021 WL 5985058, at *2 n.3 (10th Cir.) (SEC did not argue that the disgorgement statute effected any change from Liu and continued to claim equitable disgorgement in the case).

[23] SEC v. Govil, 86 F.4th 89, 98 (2d Cir. 2023).

[24] SEC v. Spartan Sec. Grp., Ltd., 620 F. Supp. 3d 1207, 1223, 1224, 1225 (M.D. Fla. 2022), on appeal, No. 22-13129 (11th Cir.).

provision allowing disgorgement to be imposed when distribution to victims does not occur,[25] although the provision is not being followed. As a result, a statutory amendment should clarify that a federal court should prefer the use of a disgorgement or distribution fund to repay investors when cost effective but, if a fund would not be cost effective, deposit disgorged amounts in the Investor Protection Fund established by the Dodd-Frank Act.

A second Liu issue concerns ordering a defendant to pay disgorgement of profits it did not receive. Holding one person liable for the amount gained by another under theories of concerted wrongdoing, joint responsibility, or joint-and-several liability for actions by several wrongdoers is not consistent with the concept of disgorgement of ill-gotten gains and converts disgorgement into a penalty. The securities laws have separate provisions on civil penalties. The new disgorgement statute seems to address and prevent this kind of disgorgement order, but again a confirming amendment would be desirable.

An amendment also could provide that a defendant could be liable if he, she, or it directed a transfer of wrongful profits to the defendant from the person initially receiving them. This provision would deal with a legal entity formed and dominated by a defendant when the entity receives proceeds from a securities violation and the defendant instructs the entity to pass them through to the defendant. The provision should not apply a control concept because control is widely and loosely defined in the securities laws.[26] For that same reason, the statutes on liability of a control person should be amended to exclude joint-and-several liability for disgorgement.[27]

The final Liu issue is that a disgorgement and unjust enrichment should be net profits after deducting legitimate expenses. An amendment should add this provision but also specify that expenses incurred directly in the commission of a violation may not be deducted. In accompanying materials, Congress should explain that courts should be guided by established precedent on the calculation of disgorgement as discussed in the Restatement of Restitution and Unjust Enrichment. The Restatement has detailed rules, comments, and illustrations on determining the value that a defendant received and the expenses that should be excluded from the disgorgement amount.[28]

3. The Role of SEC Administrative Proceedings in Enforcement of the Federal Securities Laws

SEC administrative enforcement proceedings have been the subject of serious criticism and complaint for decades and now face a serious constitutional attack. In *Jarkesy v. SEC* the Fifth Circuit found three features of SEC administrative proceedings (APs) to be unconstitutional.[29] The Supreme Court is reviewing all three issues and is expected to announce a decision soon.

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[25] Congress created an Investor Protection Fund for the SEC to pay awards to whistle-blowers and to fund the SEC Inspector General. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 922(a), 124 Stat. 1841, 1844 (2010) (codified at 15 U.S.C. § 78u-6(g)(2)). The Fund was to receive any disgorgement collected by the SEC "that is not added to a disgorgement fund . . . or otherwise distributed to victims of a violation of the securities laws." 15 U.S.C. § 78u-6(g)(3)(A)(i).

[26] See 17 C.F.R. §§ 230.405, 240.12b-2.

[27] See, e.g., 15 U.S.C. § 77*o*(a), 78t(a).

[28] 1 Restatement (Third) of Restitution and Unjust Enrichment § 51(4)–(5), at 203–04; id. cmt. h, at 216–20 (2011).

[29] Jarkesy v. SEC, 34 F.4th 446 (5th Cir. 2022).

If the Supreme Court leaves SEC APs alive in any way, Congress should take action to address remaining concerns. Aside from the questions in *Jarkesy*, the basic problem with SEC APs is that they are either inherently unfair to defendants or appear to be unfair. Defendants caught up in the process emerge with a sense that they did not receive the same even-handed and impartial consideration from an AP that they would have received in district court.

The first level of adjudication is before an administrative law judge (ALJ) who has or appears to have reasons to favor the SEC. The Commission appoints the ALJs and may start a process to remove them. The second level of adjudication is before the Commission itself, which is the same body that voted to charge the defendant. A defendant could be forgiven for questioning whether the body—sometimes the very same Commissioners—that sued him is entirely open-minded on the ultimate question of whether he committed the violation.

In addition, the procedures used at the ALJ level hamper a defendant's ability to prepare and present a full defense. The SEC staff spends years investigating potential violations. They have subpoena power and often amass an enormous investigative record. After the SEC sues, APs are on a short time schedule. That short schedule can have advantages over district court litigation but generally favors the SEC because the staff is already more familiar with the facts and evidence than the defendant. The SEC must disclose most (but not all) of the record to the defendant, but the shortness of time seriously impairs considered review of the record, especially in large or complicated matters.

A defendant's ability to obtain information during an AP is severely restricted. A defendant must request a subpoena for depositions or documents and is not assured of obtaining it. When several persons are defendants in a single case, they may notice no more than five depositions and must move for additional depositions. SEC rules do not offer all forms of discovery available pursuant to the Federal Rules of Civil Procedure.

Restrictions on a defendant's ability to obtain information is consequential because the investigative record reflects the efforts of the SEC staff to obtain information to charge and support a violation. The staff has little incentive to develop facts that could support exoneration or a defense. The result is that the investigative record in many cases is incomplete from the defendant's point of view, and a defendant is not provided the time or tools to prepare an adequate defense.

A jury is not available in an SEC AP. Many assert that protection of the right to trial by jury in civil cases is fundamental to the US legal system and a critical check on government power.[30]

Empirical research has only a limited ability to sort through a comparison of the fairness of APs and district court cases. The results in district court cases cannot just be compared to the results of APs because the allocation of enforcement cases between court and APs is not random. The SEC staff and the Commissioners decide on the allocation. They are human and make decisions for many different reasons. They could be sending easier or more difficult cases to APs, or the likelihood of success in the two categories of cases could be the same.

[30] See Jarkesy v. SEC, 34 F.4th 446, 451-52 (5th Cir. 2022).

If Congress concludes that reasonable questions about the impartiality and legitimacy of APs exist, it could take one of several different actions. First, Congress could give serious consideration to abolishing SEC APs and could collect more information on whether the benefits of retaining APs outweigh their costs, particularly the cost of the actual or perceived unfairness. The general assumption is that APs are faster and more expert than district court proceedings, but those assumptions could be tested. Are ALJs and Commissioners actually more expert and more accurate than district courts on the issues raised by standard enforcement cases involving a fraud, misstatement, or the mistreatment of a customer by a broker-dealer or investment adviser? Do the short periods of time for proceedings before ALJs actually serve the interests of justice and fairness to defendants in a case of factual complexity?

A further question is whether elimination of APs would impose an unacceptable burden on district courts. That does not appear to be a problem because most litigated SEC enforcement cases have been directed to the district courts for the past few years without apparent difficulty. The SEC reduced the use of APs for contested enforcement cases in recent years while the courts considered constitutional questions about ALJs and APs. It initiated only 15 cases before ALJs in the period from April 2020 through September 30, 2023.[31] In any event, the cost of more district court judges should be preferred over continued use of suspect SEC APs.

A second approach would be to make APs as fair to defendants as district court cases. Whether that could be accomplished is not clear. The SEC Rules of Practice would need to be overhauled to give defendants an adequate opportunity to obtain information and to prepare and present a complete defense. Congress could require SEC APs to use the Federal Rules of Civil Procedure and the Federal Rules of Evidence after having a group of experts modify the Rules specifically for use before ALJs. The Federal Rules are highly regarded, treat all parties equally, and have held up well over time. ALJs would need to be independent from the Commission, but constitutional problems with appointment and removal would need to be resolved. More thought should be given to the triple role of SEC Commissioners: They adopt substantive rules of conduct, initiate enforcement cases, and then make final determinations of violations when reviewing ALJ decisions. Concentrating that much power and discretion in the same small group of individuals cannot be healthy or appropriate in our system of government.[32]

A third approach would be to give defendants in APs the right to move the case to district court. This is the removal concept. The idea has several variations, some of which create complicated removal procedures that rely on vague and subjective standards to be applied by the district court. The more complicated versions could add cost, delay, and uncertainty to the enforcement process.

My preference is to let the SEC make the initial forum selection, as it does now, but then give a defendant in any type of AP a right to transfer the case to district court. The right would be unqualified and unreviewable. The approval of the district court would not be needed. This approach would be simple and fast and would allow each defendant to consider the specifics of the particular case and decide whether an AP or a district court would produce a more accurate and fairer result. Under this

[31] See, e.g., Report on Administrative Proceedings for the Period April 1, 2023, through September 30, 2023, (report filed by the SEC Secretary twice a year), https://www.sec.gov/files/34-98830.pdf.

[32] I discuss the due process issues from the combination of charging and adjudicating functions in Accusers as Adjudicators in Agency Enforcement Proceedings, 52 U. Mich. J.L. Reform 103 (2018).

approach, the number of cases each year that would be entitled to use a removal right would not be too large and should not burden the federal courts. The right would matter only when a defendant intended to contest the SEC charges and would not be used when a defendant settled at the time of initiation or very soon after initiation. As mentioned, most contested SEC enforcement cases go to federal court at the moment.

Some have proposed requiring the use of APs for certain types of cases. In these proposals, a defendant could not remove certain cases, or the SEC could have a district court remand certain cases back to the SEC for continuation as an AP. My concern with these proposals is that APs do not necessarily offer a clear comparative advantage for any particular category of case. ALJs are not necessarily more expert than federal court judges in all areas of the federal securities laws, and the time limit for APs is not necessarily a benefit for a defendant who needs time to prepare a defense. Statutory language attempting to define a category of cases more suitable to be litigated as APs is likely to be over and under inclusive and inflexible.

H.R. 6695 would create a simple and straightforward removal right. It could be broadened to all APs rather than just those cases for a cease-and-desist order and a penalty.

4. Persistent Problems with SEC Enforcement

In an article several years ago, I suggested ways to improve the SEC enforcement process.[33] The article said that the SEC could extend more fairness and consideration to defendants without any damage to tough enforcement by

- using established and accepted legal theories and not basing claims on new, untested liability theories;
- creating an objective and balanced investigative record that considers both potential wrongdoing and innocent explanations;
- applying rigorous, neutral standards before opening investigations and initiating cases: the Commissioners should not authorize a proceeding unless they believe a reasonable person would conclude that the SEC is more likely than not to prevail on the facts and the law and believe that a proceeding would serve broad and legitimate enforcement goals; and
- substantially shortening investigations: each member of the staff should make an effort to limit the number of documents requested and the number of individuals called for testimony.

The problems addressed in the article remain largely relevant today.

For Further Reading: Articles on Enforcement

I have written on various aspects of the SEC enforcement process and private securities cases:

Liu and the New SEC Disgorgement Statute, 15 Wm. & Mary Bus. L. Rev. 307 (2024).

Accusers as Adjudicators in Agency Enforcement Proceedings, 52 U. Mich. J.L. Reform.

[33] Andrew N. Vollmer, Four Ways To Improve SEC Enforcement, 43 Sec. Reg. L.J. 333 (2015).

A Rule of Construction for the Personal Benefit Requirement in Tipping Cases, 11 N.Y.U. J.L. & Lib. 331 (2017).

SEC Revanchism and the Expansion of Primary Liability Under Section 17(a) and Rule 10b-5, 10 Va. L. & Bus. Rev. 273 (2016).

Computer Hacking and Securities Fraud, 47 Sec. Reg. & L. Rep. (Bloomberg BNA) 1985 (October 19, 2015).

Four Ways To Improve SEC Enforcement, 43 Sec. Reg. L.J. 333 (2015).

Need for Narrower Subpoenas in SEC Investigations, New York Law Journal 4 (October 9, 2014).

A Chance to Rein in Securities Class Actions, Wall Street Journal A17 (March 4, 2014).

Should Class Actions To Enforce Rule 10b-5 Be Expanded or Curtailed?, 44 Sec. Reg. & L. Rep. (Bloomberg BNA) 325 (2012).

How hedge fund advisers can reduce insider trading risk, 3 Journal of Securities Law, Regulation & Compliance 106 (2010).