

**I. *The SEC's Increased Use of Administrative Proceedings: Increased Efficiency or Unconstitutional Expansion of Agency Power?***

**A. Introduction**

The 2010 passage of section 929P of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)<sup>1</sup> greatly expanded the Security Exchange Commission’s (“SEC”) enforcement powers through the use of “in house” Administrative Law Courts (“ALCs”).<sup>2</sup> Currently, five Administrative Law Judges (“ALJs”)—subject matter experts in securities and financial law that are appointed by the SEC—oversee these ALCs.<sup>3</sup> Under this new legislation the SEC can pursue administrative proceedings for violations like insider trading not just against investment industry insiders, but against nearly anyone.<sup>4</sup> The SEC has taken advantage of this expanded authority by increasingly preferring to pursue enforcement actions in front of ALCs rather than the district courts.<sup>5</sup> However, while the SEC argues that these ALCs offer significant benefits over traditional district courts, the SEC’s administrative courts provide significantly fewer protections than the federal courts for defendants, including limited discovery, no

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(a), 15 U.S.C. § 77h–1 (2012).

<sup>2</sup> Sonia A. Steinway, Comment, *SEC “Monetary Penalties Speak Very Loudly,” But What Do They Say? A Critical Analysis of the SEC’s New Enforcement Approach*, 124 YALE L.J. 209, 227 (2014); Stewart Bishop, *SEC Again Sued Over ‘Unconstitutional’ Administrative Cases*, LAW360 (Oct. 20, 2014, 8:20 PM), <http://www.law360.com/articles/588683/sec-again-sued-over-unconstitutional-administrative-cases>.

<sup>3</sup> Jed S. Rakoff, District Judge, S.D.N.Y., Keynote Address at PLI Sec. Reg. Inst., *Is the S.E.C. Becoming a Law Unto Itself?* 7 (Nov. 5, 2014), *available at* <http://assets.law360news.com/0593000/593644/Sec.Reg.Inst.final.pdf>, *archived at* <http://perma.cc/5N8A-TNYN>; *see also* Andrew Ceresney, Director, SEC Division of Enforcement, Remarks to the American Bar Association’s Business Law Section Fall Meeting (Nov. 21, 2014), *available at* [http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#.VN Bim0fF\\_iM](http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#.VN Bim0fF_iM), *archived at* <http://perma.cc/3532-8KPP>.

<sup>4</sup> 15 U.S.C. § 77h–1(a).

<sup>5</sup> Gretchen Morgenson, *At the S.E.C., a Question of Home-Court Edge*, N.Y. TIMES, Oct. 6, 2013, at BU1.

prohibitions against hearsay, and no access to a jury.<sup>6</sup> Though the SEC looks posed to increasingly rely on its ALCs for enforcement actions, several lawsuits recently filed in federal court threaten to stem this new SEC tactic.<sup>7</sup>

This Article provides a brief overview of the SEC's increased use of administrative proceedings and outlines some of the challenges and criticism the SEC has faced for this strategy. Part B provides a brief history of the SEC's administrative law courts. Part C discusses the recent rise of the SEC's use of its administrative law courts and its implications. Finally, Part D looks at a few recent challenges to the SEC's authority to use its administrative law courts, but concludes that the trend toward more administrative actions is likely to continue.

## **B. Brief History**

### **1. Dodd-Frank and Expanded SEC Administrative Powers**

Before Dodd-Frank the SEC could only launch administrative enforcement actions against persons registered with the SEC and affiliated with SEC-regulated industries.<sup>8</sup> During this period the SEC had to bring many enforcement actions in the federal district courts.<sup>9</sup> However, the SEC's administrative enforcement powers through the use of ALCs were significantly increased under Dodd-Frank.<sup>10</sup> The

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<sup>6</sup> Steinway, *supra* note 2, at 226; Michelle van Oppen & Danielle Van Wert, *There's No Place Like Home: The Constitutionality of the SEC's In-House Courts*, ORRICK, HERRINGTON & SUTCLIFFE LLP SEC. LITIG. INVESTIGATIONS AND ENFORCEMENT (Oct. 28, 2014), <http://blogs.orrick.com/securities-litigation/2014/10/28/theres-no-place-like-home-the-constitutionality-of-the-secs-in-house-courts/>, archived at <http://perma.cc/KUY6-AG9A>.

<sup>7</sup> Bishop, *supra* note 2; *see, e.g.*, Peixoto v. SEC, No. 14-CV-8364 (S.D.N.Y. dismissed Jan. 30, 2015) (bringing action against the SEC alleging that its use of administrative proceedings are unconstitutional); Stilwell v. SEC, No. 14-CV-7931 (S.D.N.Y. filed Oct. 1, 2014) (arguing that the SEC's administrative proceedings were unfair and unconstitutional).

<sup>8</sup> Steinway, *supra* note 2, at 227.

<sup>9</sup> Kenneth B. Winer & Laura S. Kwaterski, *Assessing SEC Power in Administrative Proceedings*, LAW360 (Mar. 24, 2011, 1:47 PM), <http://www.law360.com/articles/233299/assessing-sec-power-in-administrative-proceedings>.

<sup>10</sup> Steinway, *supra* note 2, at 227.

SEC is no longer reliant on the district courts, and potentially fickle juries, to enforce its regulations.<sup>11</sup> Instead, the SEC is able to quickly and, arguably, more accurately adjudicate its enforcement actions.<sup>12</sup> However, these potential benefits come with a cost.<sup>13</sup>

## 2. Difference Between Federal Court and an SEC Administrative Proceeding

While the SEC argues that there are considerable benefits to utilizing ALCs, administrative proceedings lack a number of protections that the district courts traditionally provide.<sup>14</sup> Perhaps most significant, SEC administrative proceedings lack juries.<sup>15</sup> This difference from the district court is key—while this policy keeps complicated securities cases out of the hands of non-expert juries, it opens the SEC to claims of bias.<sup>16</sup> Rather than having a neutral panel return a verdict, ALJs housed and paid for by the SEC rule on the enforcement actions.<sup>17</sup> While these ALJs are purportedly and theoretically independent, and thus allegedly have no reason to favor the SEC over the defendants, the fact that their jobs are created, maintained, and funded by the SEC raises some suspicion as to how impartial the ALJs may actually be.<sup>18</sup>

Beyond just the lack of an independent jury, SEC administrative proceedings are not subject to Federal Rules of Evidence,<sup>19</sup> most of the typical disclosures and fact finding periods of discovery, and, arguably, any meaningful appeals process.<sup>20</sup> By severely

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<sup>11</sup> *Id.*

<sup>12</sup> Winer & Kwaterski, *supra* note 9.

<sup>13</sup> Rakoff, *supra* note 3, at 7.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> Morgenson, *supra* note 5, at BU17.

<sup>17</sup> *Id.*

<sup>18</sup> Thomas C. Frongillo, Ariel Raphael, & Caroline Simons, *SEC Looks to Tackle Insider Trading on Its Home Field – Defense Bar Claims Unnecessary Roughness*, LEXOLOGY LITIG. BLOG (Dec. 8, 2014), <http://www.lexology.com/library/detail.aspx?g=a17c0d1e-6dc9-4ac7-b956-c52fefe3793f>, archived at <http://perma.cc/C3TP-MFTN>.

<sup>19</sup> Rakoff, *supra* note 3, at 7.

<sup>20</sup> *Peixoto Charges SEC Insider Trading Administrative Action Is Unconstitutional*, SEC. DIARY (Oct. 21, 2014), <http://securitiesdiary.com/2014/10/21/>

restricting discovery, the SEC's ALCs prevent the defendant from compiling all the facts they would usually have in a federal district court case.<sup>21</sup> This essentially leaves the defendant with no more than the record the SEC itself developed in the course of its investigation.<sup>22</sup> Further, restricting discovery also significantly expedites the trial process, with some defendants complaining of a "rocket docket" that leaves them inadequate time to prepare.<sup>23</sup> Because SEC administrative proceedings do not follow the Federal Rules of Evidence, the SEC can consequently admit hearsay.<sup>24</sup>

Finally, commentators have argued that the SEC's increased use of ALCs prevents most meaningful judicial review.<sup>25</sup> The first level of appeal from an SEC administrative decision is not to a court, but to the SEC itself.<sup>26</sup> If the appeal to the SEC fails—which seems likely given that its own administrative courts made the ruling—the party may only then appeal to a federal court.<sup>27</sup> However, far from the *de novo* review on questions of law possible on appeal from the district court, appellate courts apply the *Chevron* deference doctrine to

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peixoto-charges-sec-insider-trading-administrative-action-is-unconstitutional/, archived at <http://perma.cc/L7Y2-SDY8>.

<sup>21</sup> Rakoff, *supra* note 3, at 7.

<sup>22</sup> 2014 Year-End Securities Enforcement Update, GIBSON, DUNN & CRUTCHER LLP (Jan. 12, 2015), available at <http://www.gibsondunn.com/publications/Documents/2014-Year-End-Securities-Enforcement-Update.pdf>, archived at <http://perma.cc/PL65-UHU6>.

<sup>23</sup> Jim Meyers, *SEC Gives Itself the Home Court Advantage in an Accounting Fraud / Internal Controls Action Against a Corporate CEO*, ORRICK, HERRINGTON & SUTCLIFFE LLP SEC. LITIG., INVESTIGATIONS AND ENFORCEMENT (July 31, 2014), <http://blogs.orrick.com/securities-litigation/2014/07/31/sec-gives-itself-the-home-court-advantage-in-an-accounting-fraud-internal-controls-action-against-a-corporate-ceo/>, archived at <http://perma.cc/BXS5-GKMG>.

<sup>24</sup> Van Oppen & Van Wert, *supra* note 6; see FED. R. EVID. 801-02 (defining hearsay and prohibiting its admissibility except under certain enumerated circumstances).

<sup>25</sup> SEC. DIARY, *supra* note 20.

<sup>26</sup> Sarah N. Lynch, *SEC to File Some Insider-Trading Cases in its In-House Court*, REUTERS (June 11, 2014, 4:12 PM), <http://www.reuters.com/article/2014/06/11/us-sec-insidertrading-idUSKBN0EM2DI20140611?irpc=932>, archived at <http://perma.cc/LX5Q-UDU9>.

<sup>27</sup> *Id.*

administrative decisions on law.<sup>28</sup> Regardless, despite these potential problems, the SEC has increasingly turned to administrative proceedings to bring its enforcement actions.<sup>29</sup>

### C. Recent Developments

While the SEC argues that its increased reliance on administrative proceedings is based on the fact that its in-house ALCs provide better expediency and expertise than the district courts, there are other explanations for this trend.<sup>30</sup> Particularly, some commentators have concluded that both the SEC's increased bargaining power when bringing an administrative proceedings and its higher rate of success in its own ALCs play a significant role in the SEC's new tactics.<sup>31</sup>

#### 1. The SEC's Increased Use of Administrative Proceedings

The SEC's use of administrative proceedings has rapidly increased in the years since Dodd-Frank's passage.<sup>32</sup> While the SEC insists that this increase can be explained by the positive benefits that proceedings in ALCs provide for the complicated and highly technical cases it typically brings, some commentators have theorized that the SEC's intentions are less than pure.<sup>33</sup>

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<sup>28</sup> *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-44 (1984) ("If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."); Rakoff, *supra* note 3, at 10.

<sup>29</sup> Steinway, *supra* note 2, at 227.

<sup>30</sup> Brian Mahoney, *SEC Could Bring More Insider Trading Cases In-House*, LAW360 (June 11, 2014, 6:53 PM), <http://www.law360.com/articles/547183/sec-could-bring-more-insider-trading-cases-in-house>.

<sup>31</sup> *Id.*; Jean Eaglesham, *SEC Steers More Trials to Judges It Appoints*, WALL ST. J., Oct. 21, 2014, at A1.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

**i. The SEC's Take: Expediency and Expertise**

The SEC argues that by relying on its in house ALCs, it is simply leaning on the experts to fairly resolve disputes.<sup>34</sup> Using ALCs, the SEC reasons, allows the subject matter expert ALJs immersed in the complicated area of securities and financial law to hear cases that the district courts are often ill-prepared to handle.<sup>35</sup> This increased use of administrative proceedings also lessens the load on the overburdened district courts, potentially providing benefits for the entire legal system.<sup>36</sup> In fact, the SEC asserts that by utilizing ALCs it is better able to resolve disputes, since ALCs' dockets move much faster than the typical federal district court.<sup>37</sup> However, while the SEC touts the benefits of this system as its reason for ramping up ALC use, there are alternative explanations that may more accurately reflect the SEC's motivations.<sup>38</sup>

**ii. SEC's Increased Bargaining Power**

Andrew Ceresney, the director of the SEC Division of Enforcement, has publicly recognized the advantage that the SEC has when bringing an enforcement action in an ALC rather than in district court.<sup>39</sup> Simply by threatening an agency administrative enforcement action the SEC has increased bargaining power in settlement talks.<sup>40</sup> This increased leverage is key when considering the fact that the vast majority of SEC enforcement actions settle before trial.<sup>41</sup> By utilizing the pressure of a perceived biased system to its advantage, the SEC may be able to force defendants into more favorable settlement terms.<sup>42</sup>

However, this increased pressure to settle may end up resulting in at least some positives for the defendant as well.<sup>43</sup> Since historically

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<sup>34</sup> *Id.*

<sup>35</sup> Morgenson, *supra* note 5, at BU17; Mahoney, *supra* note 30.

<sup>36</sup> Ceresney, *supra* note 3.

<sup>37</sup> Eaglesham, *supra* note 31, at A4.

<sup>38</sup> Rakoff, *supra* note 3, at 7.

<sup>39</sup> Mahoney, *supra* note 30.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> See Frongillo, Raphael, & Simons, *supra* note 18.

most SEC enforcement settlements involved a finding of “neither admit nor deny,” the result may simply have been that persons who violated the law were effectively fined by the SEC, but allowed to escape the consequences of their actions.<sup>44</sup> Many defendants targeted by the SEC may prefer this arrangement.<sup>45</sup> However, the SEC has recently moved away from this tactic, removing some of the benefits for defendants under the ALC system.<sup>46</sup> Beyond just its increased leverage in settlement negotiations, the SEC’s exceptional success rate with its in house ALCs may also explain the SEC’s increased reliance on administrative proceedings.<sup>47</sup>

## 2. The SEC’s Success Rate in Federal Court Versus Administrative Proceedings

While the SEC has had a recent string of bad luck in federal court, including the loss of at least one very high profile case,<sup>48</sup> its success rate in its in house ALCs has been phenomenal.<sup>49</sup> Indeed, in fiscal year 2011 the SEC prevailed in 88% of its ALC proceedings, versus a win ratio of only 63% in district court proceedings.<sup>50</sup> This represents a 25% difference in successful verdicts.<sup>51</sup> The year of September 2013 to September 2014 produced even more disparate results.<sup>52</sup> During this time span the SEC won 100% of its contested administrative hearings, but only 61% of trials held in federal court.<sup>53</sup> Indeed, since 2011 the SEC’s overall win percentage in its administrative proceedings has hovered well north of 90%.<sup>54</sup>

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<sup>44</sup> 2013 *Mid-Year Securities Enforcement Update*, GIBSON, DUNN & CRUTCHER LLP, 2-3 (July 15, 2013), available at <http://www.gibsondunn.com/publications/Documents/2013-Mid-Year-Securities-Enforcement-Update.pdf>, archived at <http://perma.cc/Y8ZP-8SZ5>.

<sup>45</sup> Frongillo, Raphael, & Simons, *supra* note 18.

<sup>46</sup> GIBSON, DUNN, & CRUTCHER LLP, *supra* note 44 (discussing the SEC’s move towards “requir[ing] party admissions as a condition of settlement.”).

<sup>47</sup> Rakoff, *supra* note 3, at 7.

<sup>48</sup> *Sec. & Exch. Comm’n. v. Obus*, No. 06 Civ. 03150 (S.D.N.Y. June 2, 2014); Mahoney, *supra* note 30.

<sup>49</sup> Eaglesham, *supra* note 31, at A4.

<sup>50</sup> Morgenson, *supra* note 5, at BU17.

<sup>51</sup> *Id.*

<sup>52</sup> Eaglesham, *supra* note 31, at A4.

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

This disparity indicates both why the SEC would favor resolving matters in front of its ALCs and raises concerns about the actual level of independence of the ALJs.<sup>55</sup> Though the SEC's ALJs are theoretically independent, ALJs' close ties with the agency, combined with the ALC outcome record, suggests that there may exist some bias within the SEC's ALCs.<sup>56</sup> Indeed, Judge Rakoff of the Southern District of New York recently warned that increased SEC administrative proceedings would "hinder[] the balanced development of the securities laws."<sup>57</sup> Judge Rakoff went on to warn about the loss of the securities laws' neutral character, and that the SEC would instead essentially directly make, enforce, and adjudicate these laws.<sup>58</sup> Despite these warnings, however, the SEC looks to continue its reliance on administrative proceedings unless prevented from doing so by the courts.<sup>59</sup>

#### D. General Trends and Pending Developments

The SEC's success, combined with its increased bargaining power, suggest that its tendency to rely on administrative proceedings is likely to continue.<sup>60</sup> "Indeed, in late 2014 the SEC took steps to prepare for the increased administrative caseload, adding two new administrative law judges, bringing the total to five."<sup>61</sup> This increased capacity will allow the SEC to continue moving more and more of its enforcement actions away from the district courts.<sup>62</sup> However, this trend has not gone uncontested.<sup>63</sup> In the past year two court cases have been filed, challenging the constitutionality of the SEC's use of administrative proceedings for enforcement actions.<sup>64</sup>

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<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> Rakoff, *supra* note 3, at 7.

<sup>58</sup> *Id.* at 10.

<sup>59</sup> Steinway, *supra* note 2, at 227.

<sup>60</sup> *Id.*; Mahoney, *supra* note 30.

<sup>61</sup> GIBSON, DUNN, & CRUTCHER LLP, *supra* note 22, at 2.

<sup>62</sup> *Id.*

<sup>63</sup> SEC. DIARY, *supra* note 20.

<sup>64</sup> *Id.*



**1. *Peixoto v. SEC, Stilwell v. SEC, and the Future of SEC Administrative Proceedings***

In *Peixoto v. SEC*<sup>65</sup> and *Stilwell v. SEC*<sup>66</sup> the plaintiffs claimed that the SEC's use of administrative proceedings is unconstitutional by violating Article II of the Constitution, equal protection, and due process.<sup>67</sup> Article II, the plaintiffs claimed, forbids the structure of the SEC's ALCs since the ALJs are officers of the United States but are not directly removable "by the President."<sup>68</sup> The plaintiffs further claimed that the SEC's use of administrative proceedings deprived them of due process, as the SEC lacked all the protections and procedures offered by the courts.<sup>69</sup> Finally, the plaintiffs claimed that the SEC is targeting specific types of offenders for administrative proceedings, violating equal protection.<sup>70</sup> If successful these arguments could have forced the SEC to defend itself in various district courts around the country until it could secure rulings in important circuit courts or a Supreme Court decision.<sup>71</sup> However, the SEC dropped the *Peixoto* case in January 2015,<sup>72</sup> and settled the *Stilwell* case in March

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<sup>65</sup> No. 14-CV-8364 (S.D.N.Y. dismissed Jan. 30, 2015) (bringing action against the SEC alleging that its use of administrative proceedings are unconstitutional).

<sup>66</sup> No. 14-CV-7931 (S.D.N.Y. filed Oct. 1, 2014) (bringing a similar action against the SEC).

<sup>67</sup> See Complaint at 1, *Peixoto v. SEC*, No. 14-CV-8364 (S.D.N.Y. Oct. 20, 2014) [hereinafter *Peixoto* Complaint]; Complaint at 1-2, *Stilwell v. SEC*, No. 14-CV-7931 (S.D.N.Y. Oct. 1, 2014) [hereinafter *Stilwell* Complaint]; see also SEC. DIARY, *supra* note 20.

<sup>68</sup> SEC. DIARY, *supra* note 20.

<sup>69</sup> *Peixoto* Complaint, *supra* note 67, at 4.

<sup>70</sup> *Id.*

<sup>71</sup> Van Oppen & Van Wert, *supra* note 6.

<sup>72</sup> *Peixoto*, Exchange Act Release No. 74176, 2015 WL 366001 (Jan. 29, 2015) (dismissing the SEC's proceedings against Jordan Peixoto); Notice of Voluntary Dismissal Pursuant to Fed. R. Civ. P. 41(A)(1)(A)(I), *Peixoto v. SEC*, No. 14-cv-08364-WHP (S.D.N.Y. Jan. 30, 2015) (dismissing Jordan Peixoto's action against the SEC since the SEC had dropped its case against Mr. Peixoto).

2015.<sup>73</sup> Without a ruling limiting its use of ALCs, the SEC's trend toward more administrative proceedings looks likely to continue.<sup>74</sup>

### E. Conclusion

Ultimately, the SEC's increased reliance on administrative proceedings in front of its own ALCs is a mixed bag. While the increased expediency and expertise of the SEC's ALJs are likely helpful in the often slow and technically complex world of financial regulation, commentators argue that the lack of significant protections offered by the district court is troubling.<sup>75</sup> Further, experts contend that the skewed win ratio the SEC enjoys in its own proceedings, and the resulting significant gain in bargaining power in settlement discussions, raise concerns about the impartiality of the SEC's ALJs and the potential for the SEC's abuse of power.<sup>76</sup> While the SEC faces criticism and challenges to its trend of bringing increasingly large number of enforcement actions in its own ALCs rather than the district courts,<sup>77</sup> this trend looks likely to continue unless the SEC suffers a series of major losses in court.<sup>78</sup>

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<sup>73</sup> Stilwell, Investment Advisers Act Release No. 4049, Investment Company Act Release No. 31504, 2015 WL 1142990 (Mar. 16, 2015) (detailing the SEC's factual findings as part of Mr. Stilwell's settlement offer).

<sup>74</sup> Morgenson, *supra* note 5, at BU17.

<sup>75</sup> See *supra* notes 30, 31, and accompanying text (summarizing arguments for and against SEC administrative proceedings).

<sup>76</sup> See *supra* notes 50, 52, 53 and accompanying text (compiling various sources of the SEC's win ratios in administrative proceedings versus district courts).

<sup>77</sup> See Peixoto Complaint, *supra* note 67, at 1; Stilwell Complaint, *supra* note 67, at 1-2; see also SEC. DIARY, *supra* note 20.

<sup>78</sup> Steinway, *supra* note 2, at 227.

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