9 March 2020

Office of Management and Budget
Request for Information on Improving and Reforming Regulatory Enforcement and Adjudication
OMB-2019-0006

Comments of Andrew N. Vollmer

These comments respond to the request for information from the Office of Management and Budget about reforms to provide due process in regulatory enforcement and adjudication, docket number OMB-2019-0006 (OMB Request). The questions posed in the request for information are exceedingly important. The way federal agencies investigate, charge, and resolve questions of potential misconduct too often is not fair to the many affected individuals and businesses.

Background

I have extensive experience with the enforcement and adjudication process at the Securities and Exchange Commission.

I was Deputy General Counsel of the SEC from mid-2006 to March 2009. While at the Commission, one of my main areas of responsibility was to advise the Commissioners and the Division of Enforcement on legal aspects of contemplated enforcement proceedings. I also had responsibility for the Adjudication Group, which assisted the Commission with published opinions to resolve contested appeals.

I was a partner in the securities litigation and enforcement practice of the law firm Wilmer Cutler Pickering Hale and Dorr LLP before and after my time at the SEC. While in private law practice, I represented many individuals and companies that were in SEC investigations and private securities litigation. Several of my clients entered into settlements with the SEC.

For over five years from 2014 to mid-2019, I was Professor of Law, General Faculty, and Director of the John W. Glynn, Jr. Law & Business Program at the University of Virginia School of Law. I taught Securities Regulation, Advanced Topics in Securities Regulation, and Securities Litigation and Enforcement.

I have written about the SEC enforcement process and testified about it before subcommittees of the Committee on Financial Services of the U.S. House of Representatives. You may reach me by email at andrew.vollmer@gmail.com.

Introduction

For the most part, my comments will address enforcement and adjudication procedures at the SEC. Some of my observations might also apply to other agencies, but I am less familiar with the procedures at other agencies. 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 to defendants. 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 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.

My comments address several of the questions and topics raised in the OMB Request: (1) partiality issues with the heads of certain agencies including the SEC and with initial administrative proceedings before administrative law judges; (2) ways to make SEC investigations fairer for defendants and more efficient, (3) the need for a reasonable limitations period for bringing SEC enforcement claims, (4) issues with SEC settlements, (5) the burden on a defendant to prove the absence of liability in a particular kind of SEC case, and (6) the need for the SEC and other agencies to apply prior judicial precedent faithfully in adjudications.

SEC Commissioner Hester Peirce expressed concern about a variety of the SEC's enforcement practices in a speech in 2018: The Why Behind the No: Remarks at the 50th Annual Rocky Mountain Securities Conference, https://www.sec.gov/news/speech/peirce-why-behind-no-051118.

Fairness of SEC adjudications

The OMB Request asked whether adjudicators sometimes lack independence from the enforcement arm of an agency and what reforms are needed. Practices at the SEC raise due process issues in administrative proceedings at the level of the Commissioners as heads of the agency and at the level of the initial adjudicators, administrative law judges.

One due process concern exists when the head of an agency combines enforcement and adjudication functions. In 2016, the Supreme Court held that a due process violation occurred when the same individual both played a significant adversarial role against a defendant and then participated in adjudicating that defendant's case. The Court "determined that an unconstitutional potential for bias exists when the same person serves as both accuser and adjudicator in a case." Williams v. Pennsylvania, 136 S. Ct. 1899, 1905 (2016).

At the SEC and other federal agencies, such as the FTC and the FCC, the standard practice is for the Commissioners both to charge a person with a violation of law and then to sit as judges to decide whether the defendant committed the violation. Often, one or more SEC Commissioners at the time of the initial charge are still Commissioners later when the Commission reviews an initial decision from an administrative law judge in the same case. According to the 2016 Supreme Court decision, due process prohibits SEC

Commissioners who voted to charge a person from later participating in the adjudication phase, but Commissioners do not recuse themselves. I discussed these issues at length in an article, gave examples, and recommended that Commissioners disqualify themselves from an adjudication when they participated in the vote that charged the defendant. See Accusers as Adjudicators in Agency Enforcement Proceedings, 52 U. Mich. J.L. Reform 103 (2018) (attached).

In addition, initial SEC administrative proceedings before ALJs raise questions about possible bias. My written testimony for a subcommittee of the House Financial Services Committee in 2018 gave a series of reasons why SEC administrative proceedings are either inherently unfair to defendants or appear to be unfair, including that the procedures used at the ALJ level hamper a defendant's ability to prepare and present a full defense and fall well short of the rights available in federal court (attached, see pages 7-12).

Various remedies to the problem exist, some of which are discussed in the testimony. One solution is to abolish administrative enforcement proceedings in regulatory agencies that impose fines, financial sanctions, and other severe remedies and assign those proceedings to federal district courts, possibly using an expanded group of magistrates. Another possibility is to give defendants in administrative proceedings the right to move the case to a federal district court. If the SEC and other enforcement agencies continue to use ALJs for initial decisions in enforcement cases, the ALJs must be independent of the agency heads and the enforcement operations. Agency heads should not appoint or remove the ALJs for their own agency.

Fairer and more efficient investigations

The OMB Request inquired about ways to make agency investigations fairer, more efficient, and shorter. In an article a few years ago, I suggested several ways to improve the SEC enforcement process. Four Ways To Improve SEC Enforcement, 43 Sec. Reg. L.J. 333 (2015) (attached). 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 SEC enforcement staff should make an effort to limit requests for information and the number of individuals called for testimony.

Many of these areas can be addressed internally at the Commission with better procedures, controls, and management and do not require action by Congress. The

Commissioners and staff at the SEC periodically pay attention to ways to improve the internal systems, but the problems addressed in the article largely remain relevant today.

An earlier article of mine discussed another problem area: the need to reduce the costs, burdens, and delays associated with overbroad subpoenas and requests for documents in the age of email and electronically stored information. Requests for large amounts of information prolong investigations. The SEC enforcement staff could ameliorate this problem reasonably easily by formulating more precise and careful document requests before they are sent. See Need for Narrower Subpoenas in SEC Investigations, N.Y.L.J. 4 (October 9, 2014) (attached).

Length of investigations

A major concern about SEC enforcement is the length of time investigations take. Investigations are often damaging to the individuals and businesses involved.

In my experience, the length of SEC investigations is strongly correlated to the five-year limitations period for fines, penalties, and forfeitures in 28 U.S.C. § 2462. The Commission and the staff have an incentive to complete investigations in time to commence enforcement proceedings before the five-year statute of limitations for monetary penalties and disgorgement expires. The Supreme Court decisions in Gabelli v. SEC, 568 U.S. 442 (2013), and Kokesh v. SEC, 137 S. Ct. 1635 (2017), addressed the application of section 2462 to SEC enforcement cases.

Congress is considering legislation that would give the SEC more time to commence an enforcement case for certain types of remedies. I discussed objections to extending the limitations period for SEC enforcement cases in testimony submitted to subcommittees of the House Financial Services Committee in 2018 (attached, pages 4-7) and 2019 (attached, pages 10-15). The inevitable result of any extension of the statute of limitations would be to prolong investigations and cause a variety of social harms described in my testimony.

Settlements

The OMB Request asked whether regulatory enforcement investigations and proceedings coerce settlements. Yes they do.

Many SEC cases lack merit, but the defendants settle. The routine response to this observation is that a defendant would not settle if the SEC case was faulty on the facts or the law. A defendant would not settle if it had a decent chance of winning. That is a myth believed by many, but the reality is that defendants settle for a variety of reasons and frequently settle even when they are confident they could defeat the SEC case in litigation. Defendants settle because their business, job, or personal relationships will not survive sustained adverse publicity repeating the SEC's allegations over and over during the long life of litigation, because they cannot be at odds with their main regulator, because they want the matter behind them, or because they do not have the financial resources to fight the government.[1]

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[1] See, e.g., United States v. Bailey, 696 F.3d 794, 800-02 (9th Cir. 2012) ("A defendant may settle a case for a variety of reasons. He may have committed the conduct alleged in the complaint or he may not have …."); In re Initial Public Offering Securities Litig., 2004 WL 60290, *4 (S.D.N.Y.) (just "because a party agrees to settle does

When a defendant has strong motivations to settle, which might exist without regard for the strength of the defendant's position, the defendant often puts up weakened resistance to the staff's proposed charges, relief, and language for the charging document. The staff is able to over-reach. Of course, that is not true for all settling defendants, but Commissioners must guard against the possibility of the staff taking advantage of a defendant. They should heighten rather than relax their review of proposed settlements and should evaluate whether the SEC would be more likely than not to be successful on the facts and the law if the case were litigated.

A further issue with SEC settlements is the agency's "policy not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings." 17 C.F.R. § 202.5(e). Standard language for a settlement includes this provision: "Consistent with this policy, Defendant agrees not to take any action or to make or permit to be made any public statement denying, directly or indirectly, any allegation in the Complaint filed in the Action or creating the impression that the allegations in the Complaint are without factual basis."

This is a government enforced gag order that raises First Amendment questions. The New Civil Liberties Alliance deserves credit for bringing attention to the issues. It petitioned the SEC to change its policy on the grounds that the "no-deny" restriction is unconstitutional, without legal authority, and ill-advised (available at https://www.sec.gov/rules/petitions/2018/petn4-733.pdf) and is representing a party who is challenging the SEC policy (see https://nclalegal.org/romeril-sec/).

Proof of the absence of legal liability

The OMB Request asked for examples in which a defendant must prove an absence of legal liability or prove innocence in a regulatory proceeding. In the federal securities law area, this occurs when the SEC brings an enforcement case against a person who relied on the private offering exemption in section 4(a)(2) of the Securities Act or another exemption to sell securities without complying with the section 5 obligation to have a registration statement in effect.

With one sentence and one citation to a 1907 decision, the Supreme Court created the rule that a defendant has the burden of proof to establish the private offering exemption in section 4(a)(2). In SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953), the Court said: "Keeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable." See also Zacharias v. SEC, 569 F.3d 458, 464 (D.C. Cir. 2009); In re Carley, 2008 WL 268598 (SEC) ("Exemptions from registration are affirmative defenses that must be established by the person claiming the exemption.").

Making the defendant prove the applicability of an exemption from registration is not consistent with section 556(d) of the Administrative Procedure Act, which states that,

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not mean that it is actually liable; similarly just because it agrees to settle for a certain amount does not mean that amount represents the actual value of the claims").

except as provided in a statute, "the proponent of a rule or order has the burden of proof," and is not based on the text of the Securities Act. The explicit words of section 4 take an exempt transaction out of the section 5 registration requirement. Section 4(a) says the "provisions of section 5 shall not apply to" a list of transactions. The Act does not give a registered offering a higher priority than an exempt transaction. They exist side by side. A person does not violate section 5 if the person complies with section 4. Nothing in the words of section 4 states that the defendant must shoulder the burdens of production and persuasion on compliance with the terms of section 4.

The justification for shifting the burdens to a defendant apparently is that use of an exemption is an affirmative defense to a claim that the defendant sold without an effective registration statement. The difference between the elements of a claim and an affirmative defense does not explain a defendant's obligation to prove the availability of an exemption. That difference is arbitrary and depends on a legislature's drafting decision (although, here, Congress did not make an exemption an affirmative defense). A claim and defense are substantively equivalent. "Whether a particular factor is part of one or the other cannot be derived from principle or logic." See John Calvin Jeffries, Jr. & Paul B. Stephan III, Defenses, Presumptions, and Burden of Proof in Criminal Law, 88 Yale L.J. 1325, 1331-32 (1979).

A hypothetical change to sections 4 and 5 of the Securities Act illustrates the point. At the moment, section 4 states that section 5 does not apply to exempt transactions, and section 5 prohibits a person from selling a security unless a registration statement is in effect. Assume that, instead, Congress had written section 5 to say that a person commits a violation by selling a security without a registration statement in effect and without an exemption. That wording would require the SEC to prove the absence of an effective registration statement and the absence of an exemption. The current structure of sections 4 and 5 is no different and should not operate differently.

The more fundamental response is that imposing the burden on the defendant to prove compliance with an exemption is different from typical affirmative defenses. Usually an affirmative defense excuses the commission of misconduct. The government or the plaintiff must first prove every element of a violation, and the defendant then must show an excuse for the misconduct, such as a statute of limitations or duress. See Dixon v. United States, 548 U.S. 1, 6, 8 (2006). A defendant using an exemption from registration is in a different position. It is seeking to comply with the federal securities laws and not to excuse a failure to comply. The failure to have an effective registration statement is not a violation of the Securities Act if the transaction complied with an alternative in a different part of the Act. The government should have the burden of proving that a defendant committed a violation by failing to have a registration statement in effect and failing to meet the terms of an exemption.

At a minimum, the burden of persuasion of the existence of a violation should remain with the government. The burdens on the defendant should be only to plead the use of an exemption and to sustain the initial burden to produce evidence of use of an exemption.

Law applied in an adjudication

A final question worth attention is the scope of an agency's discretion in interpreting the law to resolve an adjudication after courts have reached a reasonably consistent and settled construction of the applicable statute or regulation. Is the agency bound to follow the courts? Another way to think about this question is from a reviewing court's point of view. To what extent should a court defer to an agency conclusion of law in an adjudication if the agency conclusion differs meaningfully from the leading judicial position?

Justice Thomas discussed the legal authorities and issues in this area in response to an agency's use of an informal rule to disregard a prior judicial construction of a statute. Baldwin v. United States, No. 19-402 (February 24, 2020) (Thomas, J., dissenting from the denial of certiorari). He identified constitutional, APA, and statutory interpretation concerns that he believed the full Court should consider.

My view is that an agency must follow the leading judicial interpretations of statutes and rules when applying the law in an adjudication to determine whether a person committed a violation. The SEC and other agencies should apply prior judicial precedent faithfully in adjudications. If an agency extends or departs from judicial precedent, a reviewing court should not give Chevron deference to the agency and should take an agency's legal reasoning into account only to the extent it is persuasive. I discussed these issues in: SEC Revanchism and the Expansion of Primary Liability Under Section 17(a) and Rule 10b-5, 10 Va. L. & Bus. Rev. 273, 277-78, 321-40 (2016) (attached).

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