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# The SEC's Shift to Administrative Proceedings: An Empirical Assessment

Stephen J. Choi  
*New York University*

Adam C. Prichard  
*University of Michigan Law School, [acplaw@umich.edu](mailto:acplaw@umich.edu)*

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# The SEC's Shift to Administrative Proceedings: An Empirical Assessment

Stephen J. Choi and A.C. Pritchard<sup>†</sup>

*Congress has repeatedly expanded the authority of the SEC to pursue violations of securities laws in proceedings adjudicated by the SEC's own administrative law judges, most recently through the Dodd-Frank Act. We report the results from an empirical study of SEC enforcement actions against non-financial public companies to assess the impact of the Dodd-Frank Act on the balance between civil court and administrative enforcement actions. We show a general decline in the number of court actions and an increase in the number of administrative proceedings post-Dodd-Frank. At the same time, we show an increase in average civil penalties post-Dodd-Frank for both court actions and administrative proceedings involving non-financial public companies. Companies were also more willing to cooperate with the SEC, consistent with an increase in the SEC's leverage in administrative proceedings.*

*We also provide evidence that the mix of cases the SEC brings in administrative proceedings has changed post-Dodd-Frank. We show an increase in the disgorgement amount and the number of years during which the violation allegedly took place, which are two proxies for the complexity and cost of prosecution of the alleged underlying securities law violation. At the same time, administrative proceedings following Dodd-Frank tended to be weaker (i.e., less likely to prevail) and less salient (i.e., less likely to garner media attention). These findings are consistent with the SEC attempting to maximize the monetary penalties it imposes as well as positive media attention from its enforcement actions, while allocating its limited resources between administrative proceedings and civil court actions in a cost-effective way. Although we cannot measure the deterrent impact of the additional cases that the shift to administrative proceedings has allowed the SEC to bring, it does appear that the SEC is using administrative proceedings to expand its enforcement efforts against public companies.*

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<sup>†</sup> Choi is the Murray and Kathleen Bring Professor of Law, New York University. Pritchard is the Frances and George Skestos Professor of Law, University of Michigan. Thanks to Un Kyung Park for helpful comments.

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## Introduction

Who should decide whether the law has been violated? Under the Constitution’s traditional separation of powers, Article I authorizes Congress to make the laws, and Article II charges the executive with prosecuting their violation. Article III places the decision of whether the law has been violated in the hands of an independent judiciary with life tenure (sometimes with the help of a jury).<sup>1</sup> This tripartite model was championed by the Framers of the Constitution as a bulwark of freedom. As James Madison put it in *The Federalist Papers* 47, “Where the whole power of one department is exercised by the same hands which possess the whole power of another department, the fundamental principles of a free constitution are subverted.”<sup>2</sup>

The advent of the New Deal swept into power Franklin Delano Roosevelt’s cadre of progressives who chafed at the restraints imposed by the Framers’ separation of powers model.<sup>3</sup> The progressives’ new science of public administration was premised on modern society’s need for expertise in developing and implementing policy.<sup>4</sup> Experts would run agencies, which would promulgate regulations to rein in the abuses of a modern, complex economy.<sup>5</sup> Expert administrative tribunals would be better qualified than

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1. See U.S. CONST. art. I, II, III.

2. THE FEDERALIST NO. 47 (James Madison) (emphasis omitted).

3. See A.C. Pritchard & Robert B. Thompson, *Securities Law and the New Deal Justices*, 95 VA. L. REV. 841, 842 (2009).

4. See *id.* at 893; Reuel E. Schiller, *The Era of Deference: Courts, Expertise, and the Emergence of New Deal Administrative Law*, 106 MICH. L. REV. 399, 417-21 (2007).

5. See Pritchard & Thompson, *supra* note 3, at 907.

generalist judges to oversee the enforcement of rules that independent agencies devised.<sup>6</sup>

Combining the functions of the legislature, executive, and judiciary in one body seemed to directly challenge the structure of government laid down by Articles I, II, and III of the Constitution. Nevertheless, the Supreme Court has upheld the legitimacy of independent agencies that combine the three critical powers of government, and these agencies have become an established feature of the administrative state.<sup>7</sup> The passage of time has gradually established the independent agencies as an accepted, if not beloved, feature of modern government.

Among the independent agencies, the Securities and Exchange Commission ("SEC") has enjoyed a relatively favorable reputation for competence and efficiency, marred occasionally by the agency's failure to uncover the corporate scandal du jour with sufficient alacrity.<sup>8</sup> Even the SEC's failures, however, have ultimately redounded to its benefit. Over its history, the SEC has shown a remarkable facility to translate its failures into broader authority.<sup>9</sup> After scandals, Congress has repeatedly obliged the SEC with additional enforcement tools. Granting the regulator greater authority is a tried-and-true means of showing that the legislators were "doing something" to respond to a perceived crisis.

Nowhere has the SEC's ability to convert its failures into a wider jurisdiction been more conspicuous than the realm of administrative proceedings. From their modest beginnings as a means to oversee regulated entities, administrative proceedings have gradually taken over the field of securities law.<sup>10</sup> Indeed, critics now worry that the SEC may entirely abandon enforcement actions in federal court in favor of administrative proceedings, where it allegedly enjoys a "home court" advantage.<sup>11</sup> Administrative proceedings are decided, in the first instance, by administrative law judges ("ALJs") employed by the SEC. Congress recently expanded the SEC's authority in administrative proceedings through the Dodd-Frank Act of 2010, allowing the SEC to impose civil penalties through its own administrative proceedings on essentially anyone it finds to have violated the federal securities laws. In the wake of this most recent expansion of its authority, these

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6. *See id.* at 893.

7. *See, e.g., Humphrey's Ex'r v. United States*, 295 U.S. 602 (1935).

8. *See* Jean Eaglesham, *SEC Tries To Rebuild Its Reputation*, WALL ST. J. (Sept. 11, 2013), <http://www.wsj.com/articles/SB10001424127887323864604579064961041032146>.

9. *See infra* Section II.B.

10. *See* Arthur F. Mathews, *Litigation and Settlement of SEC Administrative Enforcement Proceedings*, 29 CATH. U. L. REV. 215, 217-18 (1980); Blake Edwards, *The SEC Is Doubling Down on Its Home Field Advantage, Report Says*, BLOOMBERG BNA (Jan. 14, 2016), <https://bol.bna.com/the-sec-is-doubling-down-on-its-home-field-advantage-report-says>.

11. *See* Ryan Jones, *The Fight Over Home Court: An Analysis of the SEC's Increased Use of Administrative Proceedings*, 68 S.M.U. L. REV. 507 (2015); Tyler L. Spunaugle, *The SEC's Increased Use of Administrative Proceedings: Increased Efficiency or Unconstitutional Expansion of Agency Power?*, 34 BANKING & FIN. L. REV. 406 (2015).

proceedings have been subjected to heightened scrutiny by the media and to constitutional challenges.<sup>12</sup>

This Article evaluates the consequences of the expanded use of administrative proceedings by the SEC. First, it explains the gradual erosion of limits on the SEC's authority to proceed before administrative tribunals, including recent failures of constitutional challenges to that authority. As the law stands today, the SEC can pursue most sanctions for violations of the securities laws in either federal court or in an administrative proceeding.<sup>13</sup> After laying out this background, we then turn to the main focus of the Article, an empirical examination of the SEC's shift to administrative proceedings. In particular, we address these questions: (1) Has the SEC used its increased leverage in administrative proceedings to increase civil penalties against public companies, and have public companies responded with a greater willingness to cooperate? (2) Have the expanded penalties, coupled with reduced prosecution costs and quicker resolution times in administrative proceedings, encouraged the SEC to pursue cases against public companies that it would not have pursued prior to Dodd-Frank? (3) Are such cases more complex to prosecute, such that the SEC would not find prosecution cost efficient in another forum? (4) Do they include weaker cases in which the SEC, all other things being equal, has a lower chance of prevailing against the defendants, such that prosecution would not be worthwhile without the advantages of the administrative forum? (5) Do they include less salient cases in which the SEC, all other things being equal, has a lower chance of getting media attention?

Our empirical results show a decline in the number of court actions and an increase in the number of administrative proceedings post-Dodd-Frank. We also show an increase in average civil penalties post-Dodd-Frank for both court actions and administrative proceedings. We also show greater cooperation by companies with the SEC in connection with its enforcement actions.

Cases brought in administrative proceedings have become more complex post-Dodd-Frank. We show an increase in the disgorgement amount and the number of years during which the violation allegedly took place. At the same time, administrative proceedings following Dodd-Frank tended to be weaker (i.e., less likely to prevail) and less salient (i.e., less likely to garner media attention). These findings are consistent with the SEC attempting to maximize the monetary penalties it imposes as well as positive media attention from its enforcement actions, while allocating its limited resources between administrative proceedings and civil court actions in a cost-effective way.

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12. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P(a), 124 Stat. 1376, 1862 (2012) (codified at 15 U.S.C. § 77h-1); sources cited *supra* note 10; *infra* Section II.B.

13. See Securities Exchange Act of 1934 § 21(b), 15 U.S.C. § 78u (2012).

## The SEC's Shift to Administrative Proceedings

### I. SEC Administrative Proceedings

#### A. Beginnings

Established in 1934, the SEC was charged with bringing Wall Street to heel.<sup>14</sup> The agency earned its stripes early by confronting regulated entities such as exchanges and utilities, often in administrative proceedings.<sup>15</sup> The agency's first two decades were occupied with dismantling the octopus-like public utility conglomerates, cutting them down to a more-readily regulated size.<sup>16</sup> Along the way, the Supreme Court endorsed the SEC's discretion to use administrative proceedings to develop the law. The SEC was not required to proceed through the cumbersome process of rulemaking; it could announce new rules in the course of administrative adjudication.<sup>17</sup>

After a fallow period in the 1950s, the SEC re-established itself in the 1960s as an activist agency, with a new emphasis on enforcement.<sup>18</sup> The new era began when President John F. Kennedy appointed law professor William Cary as Chairman of the SEC.<sup>19</sup> One of Cary's opening shots in revitalizing the agency was an enforcement case brought as an administrative proceeding, *Cady, Roberts*.<sup>20</sup> In *Cady, Roberts*, the SEC announced a novel interpretation of Rule 10b-5 of the Securities Exchange Act of 1934.<sup>21</sup> Rule 10b-5 is the catch-all anti-fraud provision of the Exchange Act, adopted by the SEC two decades earlier under its § 10(b) authority.<sup>22</sup> The rule (and its § 10(b) statutory authority) makes no mention of insider trading. Cary interpreted the rule, however, to prohibit not only garden-variety deception relating to the purchase or sale of securities, but also insider trading, the exploitation of confidential information by corporate insiders.<sup>23</sup> *Cady, Roberts* gave notice that in interpreting "[the] elements [of § 10(b)] under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications."<sup>24</sup> *Cady, Roberts* further signaled that the SEC would push the limits of its authority to pursue highly salient enforcement matters. Nearly fifty

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14. See generally JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 213-64 (3d ed. 2003).

15. See *id.* at 218.

16. See *id.* at 218-22.

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

18. See A.C. Pritchard, *Launching the Insider Trading Revolution: SEC v. Capital Gains Research Bureau*, in *RESEARCH HANDBOOK ON INSIDER TRADING* 33 (Stephen M. Bainbridge ed., 2013).

19. See SELIGMAN, *supra* note 14, at 290.

20. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

21. See *id.*; Securities Exchange Act of 1934 § 10(b)(5), 15 U.S.C. § 78j (2012).

22. See Securities Exchange Act § 10(b).

23. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907.

24. See *id.* at 912.

years of subsequent enforcement efforts have confirmed that few securities law violations attract headlines like insider trading.<sup>25</sup>

The SEC was able to adopt its interpretation of Rule 10b-5 in an administrative proceeding because the respondent was a broker-dealer. The brokerage firm had received inside information from one of its partners, who happened to also serve as a director of a public company.<sup>26</sup> Broker-dealers, like investment advisers and other regulated entities, were subject to SEC administrative proceedings from the agency's beginning.<sup>27</sup> The fiction was that the regulated entity had consented to oversight by the agency, including administrative enforcement actions, when it registered to do business in that regulated industry. Of course, that "choice" was illusory since Congress made it illegal to act as a broker-dealer without registering.<sup>28</sup>

Decisions in administrative proceedings are subject to judicial oversight. Initial decisions by ALJs can be appealed to the five SEC Commissioners,<sup>29</sup> and the Commission's decisions can be appealed to a federal court of appeals.<sup>30</sup> That appellate review, however, is limited. The SEC's decisions are given substantial deference by the appellate courts. Findings of fact cannot be overturned if they are supported by "substantial evidence."<sup>31</sup> Moreover, the SEC's legal interpretations of the securities laws may also be entitled to the deference given to administrative agencies under the *Chevron* doctrine if the statute is ambiguous.<sup>32</sup> These procedural advantages for the SEC are a key factor underlying criticism that the SEC enjoys a "home court" advantage.<sup>33</sup>

Although the SEC had authority to bring administrative proceedings against regulated entities at the time of the *Cady, Roberts* decision, the agency could only seek remedial sanctions. In *Cady, Roberts*, for example, the partner of the broker-dealer was suspended from trading for twenty days, and the firm itself was not sanctioned at all.<sup>34</sup> More serious misbehavior, such as pump-and-

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25. See Pritchard, *supra* note 18, at 51.

26. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907.

27. Securities Exchange Act § 15(b).

28. Securities Exchange Act § 15(a).

29. SEC Rule of Practice 410, 17 C.F.R. § 201.410 (2016).

30. See 15 U.S.C. § 78y(a)(1) (2012).

31. 5 U.S.C. § 706 (2012); *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 478-79 (1951) (applying substantial evidence standard).

32. See *Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

33. For a more detailed explanation of these critiques, along with suggestions for reform, see *Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices*, U.S. CHAMBER COM. (July 15, 2015) [hereinafter U.S. Chamber Com.], [http://www.centerforcapitalmarkets.com/wp-content/uploads/2015/07/021882\\_SEC\\_Reform\\_FIN1.pdf](http://www.centerforcapitalmarkets.com/wp-content/uploads/2015/07/021882_SEC_Reform_FIN1.pdf). See also Robert Anello, *Addressing the SEC's Administrative "Home Court" Advantage in Enforcement Proceedings*, FORBES (Sept. 7, 2015), <http://www.forbes.com/sites/insider/2015/09/07/addressing-the-secs-administrative-home-court-advantage-in-enforcement-proceedings/>.

34. *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

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dump schemes, was referred to the Department of Justice for criminal prosecution.<sup>35</sup>

### *B. Expansion of SEC Authority*

The SEC's authority was expanded to include punitive sanctions in the 1980s.<sup>36</sup> The impetus was Congress's desire to demonstrate how tough it could be on insider trading. The first step was the Insider Trading Sanctions Act of 1984, which gave the SEC authority to seek treble damages in insider trading cases.<sup>37</sup> For the first time, the agency could seek civil penalties. It could only seek those penalties, however, in federal court. Insider trading scandals continued to dominate the news in the mid-1980s.<sup>38</sup> In response, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988.<sup>39</sup> That law authorized the SEC to seek penalties against control persons of insider traders, again only in federal court.

The big expansion in the SEC's penalty authority came two years later, with the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("Penny Stock Act"), which for the first time authorized the SEC to impose money penalties in its administrative proceedings.<sup>40</sup> That authority was limited, however, to entities directly regulated by the SEC, such as broker-dealers, who had been subject to administrative proceedings from the beginning. The SEC was also given more limited "cease-and-desist" authority over non-regulated entities in its administrative proceedings, along with the power to order disgorgement of illegally obtained gains.<sup>41</sup> The other expansions of power were limited to actions in federal court, such as the authority to seek penalties against non-regulated entities<sup>42</sup> and to pursue orders barring persons from serving as officers and directors of public companies.<sup>43</sup> Thus, in federal court, the SEC had authority to seek civil penalties against anyone violating the securities laws, but in its own administrative proceedings, the agency could only impose remedial sanctions on non-regulated entities. Congress was concerned that if the SEC had the same authority in judicial and administrative

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35. 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, 384 (2008).

36. See Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified as amended in scattered sections of 15 U.S.C.); Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended in scattered sections of 15 U.S.C.).

37. See Insider Trading Sanctions Act of 1984.

38. See Thomas W. Joo, *Legislation and Legitimation: Congress and Insider Trading in the 1980s*, 82 *IND. L.J.* 575, 576 (2007).

39. See Insider Trading and Securities Fraud Enforcement Act of 1988.

40. See Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990) (codified as amended in scattered sections of 15 U.S.C.).

41. Securities Exchange Act of 1934 § 21(d), 15 U.S.C. § 78u-(d) (2012).

42. 15 U.S.C. § 78u-(d)(3).

43. *Id.* § 78u-(d)(2).



proceedings, the agency would have an incentive to shift to administrative proceedings to avoid scrutiny from Article III judges.<sup>44</sup> The penalty authority that Congress gave the SEC was sparingly used; between 1990 and 2002, the SEC brought only four actions seeking money penalties against non-regulated entities.<sup>45</sup> Moreover, the penalties sought were de minimis, totaling less than \$5 million.<sup>46</sup> The SEC did not appear to have much interest in using its limited penalty authority.

The SEC's thirst for penalties increased exponentially after the collapse of Enron and WorldCom in the early 2000s.<sup>47</sup> Beginning with a \$10 million penalty assessed against Xerox in 2002,<sup>48</sup> SEC penalties against public corporations have skyrocketed. Since 2000, penalties have increased by at least 30% annually.<sup>49</sup> Partially fueling the SEC's newfound enthusiasm for corporate penalties may be the "Fair Funds" provision adopted by Congress as part of the Sarbanes-Oxley Act.<sup>50</sup> The Fair Funds provision allows the SEC to distribute penalties obtained from wrongdoers to compensate harmed shareholders, a politically popular initiative.<sup>51</sup> Maximizing monetary recovery appears to have now become an SEC enforcement priority. At the end of fiscal year 2014, the director of the SEC's Division of Enforcement, Andrew Ceresney, was trumpeting that his unit had "obtained orders for over \$4 billion in monetary sanctions—nearly 20% larger than our previous high."<sup>52</sup>

### C. The Dodd-Frank Act and Subsequent Constitutional Challenges

Congress has enthusiastically endorsed the SEC's increased use of penalties. This is not surprising, perhaps, given that most of the amounts collected by the SEC go to the U.S. Treasury, despite the Fair Funds provision

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44. Atkins & Bondi, *supra* note 35, at 393-94.

45. *Id.* at 394.

46. *Id.*

47. See Jonathan Weil & John Wilke, *Systemic Failure by SEC Is Seen in Enron Debacle*, WALL ST. J. (Oct. 7, 2002), <http://www.wsj.com/articles/SB1033944629262271233>.

48. See SEC v. Xerox Corp., Litigation Release No. 17,465, 77 SEC Docket 971 (Apr. 11, 2002).

49. 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, 209-10 (2014).

50. See Sarbanes-Oxley Act of 2002 § 308, 15 U.S.C. § 7246 (2012).

51. See Sarbanes-Oxley Act § 308(a). This provision only allowed the SEC to distribute penalties to shareholders when a court had ordered disgorgement. The SEC circumvented this restriction by negotiating settlements including nominal disgorgement amounts in order to allow for penalties to be distributed. See Bruce Carton, *When a Dollar (of Disgorgement) Is Worth Millions*, SEC. CLASS ACTION SERV. (Dec. 3, 2004), <http://scas.issproxy.com/Newsletter/isscasDecember2004.html>. The Dodd-Frank Act eliminated the need for this pretense by deleting the requirement of disgorgement for penalties to be included in an SEC Fair Fund.

52. Andrew Ceresney, Dir., SEC Div. of Enf't, Remarks to the American Bar Association's Business Law Section Fall Meeting (Nov. 21, 2014), <http://www.sec.gov/News/Speech/Detail/Speech/1370543515297>.

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added by Sarbanes-Oxley.<sup>53</sup> The SEC's role in the events leading to the financial crisis of 2008-2009 was widely criticized, particularly its failure to detect excessive risk-taking by large investment banks. The authority to supervise investment banks was taken away from the SEC by the Dodd-Frank Act of 2010,<sup>54</sup> but what the SEC lost in supervisory power, it gained in enforcement authority. Most notably, the SEC gained the authority to impose civil penalties on non-regulated entities and individuals in its administrative proceedings.<sup>55</sup> The caution that Congress showed in 1990 in expanding the SEC's penalty authority was cast aside in 2010.<sup>56</sup> After Dodd-Frank, the SEC no longer needs to proceed in federal court in order to assess civil penalties. The SEC must go to federal court only in a narrow range of circumstances, such as when it needs emergency relief like an asset freeze or a temporary restraining order.<sup>57</sup> Money penalties can be pursued either in court or in an administrative proceeding.

The SEC did not immediately shift its enforcement efforts to administrative proceedings in response to the authority granted to it by the Dodd-Frank Act. Administrative proceedings showed only a modest uptick between 2011 and 2013, before a sharp increase in 2014.<sup>58</sup> The SEC's recent shift to administrative proceedings has not gone unchallenged, and the initial challenges met with some success.

The first post-Dodd-Frank constitutional challenge arose in an insider trading case. Rajat Gupta was alleged to be a co-conspirator, along with twenty-seven others, in the Galleon Hedge Fund insider trading scandal. The twenty-seven others were sued in federal court by the SEC; the last case, Gupta's, was filed as an administrative proceeding.<sup>59</sup> Gupta filed suit in federal court challenging the SEC's administrative proceeding against him on equal protection grounds, arguing that he was being targeted as a class of one.<sup>60</sup> The district court temporarily enjoined the administrative proceeding, holding that it

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53. See *Statement of the Securities and Exchange Commission Concerning Financial Penalties*, SEC. & EXCHANGE COMMISSION (Jan. 4, 2006), <https://www.sec.gov/news/press/2006-4.htm>.

54. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(a), 15 U.S.C. § 77h-1 (2012) (amending § 8A of the Securities Act, § 21B(a) of the Securities Exchange Act of 1934, § 9(d)(1) of the Investment Company Act, and § 203(i)(1) of the Investment Advisers Act). See also Dodd-Frank Wall Street Reform and Consumer Protection Act § 618 (b), 12 U.S.C. § 1850a (granting supervisory power to the Federal Reserve).

55. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(a).

56. See *id.*

57. A narrow category of actions can only be brought in an administrative proceeding. This category includes proceedings to terminate the registration of public companies for failure to file periodic reports, see Securities Exchange Act of 1934 § 12(j), 15 U.S.C. 77l (2012), and "follow-on" administrative proceeding to bar persons or entities from the securities industry, based on a prior entry of a civil injunction or a criminal proceeding. See, e.g., Securities Exchange Act § 15(b)(4). These proceedings tend to be open-and-shut and are rarely contested.

58. See 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>; *infra* Figure 1.

59. See *In re Rajat K. Gupta*, Exchange Act Release No. 63,995, 2011 WL 722394 (Mar. 11, 2011).

60. *Gupta v. SEC*, 796 F. Supp. 2d 503 (S.D.N.Y. 2011).

had jurisdiction to hear Gupta's equal protection claim.<sup>61</sup> Rather than having the district court resolve the constitutional issue, the SEC backed down, refiling its case against Gupta in federal court.<sup>62</sup>

The SEC has stuck to its guns in subsequent cases, however, arguing that district courts do not have jurisdiction to entertain constitutional challenges to the agency's administrative proceedings.<sup>63</sup> As the SEC has filed more administrative proceedings—the “new normal”<sup>64</sup>—the “class of one” argument has faded away, and defendants are now relying on Article II challenges under the Appointments Clause.<sup>65</sup> Article II stipulates:

[The President] shall nominate, and by and with the Advice and Consent of the Senate, shall appoint . . . all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law: but the 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.<sup>66</sup>

These Article II challenges take two forms: (1) the SEC's ALJs are “inferior officers” who must be appointed by the head of an executive department (i.e., the SEC); and (2) the SEC's ALJs are unconstitutional because they are insulated from oversight by the President by more than one layer of “for-cause” removal.

The inferior officers argument is a straightforward textual argument; the only question that needs to be answered is whether ALJs are “inferior officers” or employees. The key Supreme Court precedent here is *Freytag v. Commissioner*,<sup>67</sup> in which the Supreme Court held that a special trial judge of the tax court was an “inferior officer.”<sup>68</sup> The SEC has taken the position that its ALJs, who presently are hired in a process administered by the U.S. Office of Personnel Management, are employees rather than officers because their

61. *See id.* at 513-514.

62. *See* SEC v. Gupta, Litigation Release No. 22,140, Civil Action No. 11-CV-7566 (Oct. 26, 2011).

63. *See, e.g.*, Tilton v. SEC, 824 F.3d 276, 281 (2d Cir. 2016); Peter J. Henning, *SEC Finds Itself in a Constitutional Conundrum*, N.Y. TIMES (June 15, 2015), <http://www.nytimes.com/2015/06/16/business/dealbook/sec-finds-itself-in-a-constitutional-conundrum.html>.

64. Jean Eaglesham, *SEC Is Steering More Trials to Judges It Appoints*, WALL ST. J. (Oct. 21, 2014) (quoting Kara Brockmeyer, head of the SEC's Foreign Corrupt Practice unit), <http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it-appoints-1413849590>.

65. Some cases have also asserted due process challenges based on the perceived unfairness of administrative proceedings. *See, e.g.*, SEC v. Bebo, 799 F.3d 765 (7th Cir. 2015) (dismissing due process challenges for lack of jurisdiction).

66. U.S. CONST. art. II, § 2.

67. 501 U.S. 868 (1991).

68. *See also* Edmond v. United States, 520 U.S. 651, 663 (1997) (holding that military trial and appellate judges are inferior officers under the Appointments Clause).

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decisions are not final until they are adopted by the Commission.<sup>69</sup> In addition, the SEC reviews the decisions of its ALJs de novo.<sup>70</sup> In rejecting the challenge to its ALJs, the SEC relied on the D.C. Circuit's decision in *Landry v. Federal Deposit Insurance Corp.*,<sup>71</sup> which held that the FDIC's ALJs were not inferior officers because they did not have the authority to render final decisions. *Landry* itself is open to question, as the special trial judges in *Freytag* also lacked the authority to enter final decisions in most cases. It is not clear how the Supreme Court would interpret *Freytag* in the context of the SEC's ALJs. As a practical matter, however, any defect in the appointment of the SEC's ALJs can be easily corrected by having the Commissioners appoint the ALJs. The SEC has resisted that solution, presumably because it would call into doubt many previously-resolved cases, but Commission appointment of the ALJs would eliminate that constitutional question going forward.<sup>72</sup>

The second Appointments Clause issue, relating to Presidential oversight, is also unlikely to derail the SEC's use of administrative proceedings. The SEC's ALJs can only be removed by the Commission for "good cause," as "established and determined" by the Merit Systems Protection Board ("MSPB").<sup>73</sup> The Commissioners themselves can only be removed by the President for "inefficiency, neglect of duty, or malfeasance in office."<sup>74</sup> The same limits apply to removal of the MSPB board members by the President.<sup>75</sup> Thus, if the President wanted to remove an SEC ALJ from his or her position, the President would face substantial obstacles.

The insulation that ALJs have from removal by the President looks a lot like the protections previously enjoyed by the members of the Public Company Accounting Oversight Board ("PCAOB") until the Supreme Court struck down those restrictions on removal.<sup>76</sup> The Supreme Court had previously upheld for-cause restrictions on removal of inferior officers against constitutional attack. However, *PCAOB* held that two layers of for-cause restrictions—i.e., SEC Commissioners could only be removed for cause, and PCAOB members could only be removed for cause by SEC Commissioners—unduly infringe on executive power.<sup>77</sup> Although ALJs employed by independent agencies seem to enjoy at least as much protection, Chief Justice Roberts's opinion for the Court

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69. *Raymond J. Lucia Cos. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016).

70. *In re Raymond J. Lucia Cos.*, Exchange Act Release No. 75,837, 2015 WL 5172953 (Sept. 3, 2015).

71. *Id.* (citing *Landry v. FDIC*, 204 F.3d 1125, 1132 (D.C. Cir. 2000)).

72. The Federal Trade Commission has already implemented this fix for its ALJs to ward off challenges. See Alison Frankel, *Unlike SEC, FTC Makes Quick Fix To Ward off ALJ Constitutional Challenges*, REUTERS BLOG (Sept. 16, 2015), <http://blogs.reuters.com/alison-frankel/2015/09/16/unlike-sec-ftc-makes-quick-fix-to-ward-off-alj-constitutional-challenges>.

73. See 5 U.S.C. § 7521(a) (2012).

74. *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 487 (2010).

75. 5 U.S.C. § 1202(d) (2012).

76. *Free Enter. Fund*, 561 U.S. at 477.

77. See *id.* at 509-10.

in *PCAOB* distinguished their situation because “unlike members of the [PCAOB], many administrative law judges of course perform adjudicative rather than enforcement or policymaking functions, or possess purely recommendatory powers.”<sup>78</sup> Justice Breyer, in dissent, challenged this distinction, arguing that the PCAOB did perform adjudicative functions, such as disciplining accountants and audit firms.<sup>79</sup> Whatever the merits of the distinction drawn by the majority, it is unlikely that the Supreme Court would have the collective stomach to invalidate the authority of the thousands of ALJs who allow the modern administrative state to function. Doing so would threaten to send a flood of trivial cases, such as Social Security benefits denials, into federal courts.<sup>80</sup> To avoid that headache, the Court is likely to find some form of “adjudication exception” to the prohibition of double “for-cause” removal, as foreshadowed in *PCAOB*. Alternatively, the Court could determine that the ALJs are employees rather than inferior officers, and therefore it is permissible to restrict their removal.

The upshot of these constitutional challenges is that they are likely to be much ado about nothing: SEC administrative procedures are here to stay. The weakness of the constitutional arguments bolsters the importance of the policy question raised by the SEC’s shift to administrative proceedings.

#### *D. Policy Justifications and Criticisms*

On that policy question, Andrew Ceresney, head of the SEC’s Division of Enforcement, defended the SEC’s shift in a speech delivered to the American Bar Association.<sup>81</sup> He identified a number of advantages of administrative proceedings, including faster decisions, the use of specialized factfinders, and more flexible evidentiary rules.<sup>82</sup> He also argued that developing the law through the administrative process was appropriate given the expertise that SEC Commissioners have with the securities laws and the review provided by circuit court judges.<sup>83</sup>

The last point was an apparent response to Judge Jed Rakoff, a former federal prosecutor, who had criticized the SEC’s expanded use of administrative proceedings.<sup>84</sup> In Judge Rakoff’s view, ALJs might be inclined

78. *See id.* at 507 n.10.

79. *See id.* at 530-31 (Breyer, J., dissenting).

80. *See id.* at 520-21 (Breyer, J., dissenting).

81. *See Ceresney, supra* note 52.

82. *See id.*

83. *See id.* (“SEC commissioners have great expertise in the securities and the administrative agency structure that Congress created leverages that expertise to help shape the law’s development.”).

84. The Honorable Jed S. Rakoff, PLI Securities Regulation Institute Keynote Address: Is the S.E.C. Becoming a Law unto Itself? (Nov. 5, 2014), <http://media.jrn.com/documents/secaddress.pdf>.

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to a “narrow, tunnel vision view of the law.”<sup>85</sup> Expertise might come at the expense of independence. The deference given to SEC interpretation of the securities law by appellate courts is also generally cited among scholars and practitioners as a key feature of the SEC's purported “home court” advantage.<sup>86</sup>

Other criticisms of the SEC's administrative proceedings are based on perceived procedural unfairness to respondents.<sup>87</sup> One often-cited concern is the tight deadlines that the SEC imposes on its ALJs. ALJs are required to issue an initial decision within 120, 200, or 300 days from the time the Enforcement Division files charges.<sup>88</sup> The Division, of course, has had plenty of time to prepare its case through both informal and formal investigation (which gives the Division subpoena power): most investigations will last more than a year, and several years is not uncommon.<sup>89</sup> Defendants must scramble to catch up once the case is filed, as they may not know the scope of the Division's case before receiving a Wells Notice (which typically occurs shortly before filing).<sup>90</sup> Trials before ALJs typically begin about four months after filing.<sup>91</sup> That can be a challenging timeline if the case involves a substantial number of documents (as is typical with the advent of electronic discovery) or requires expert testimony. Defendants have also claimed that the minimal discovery available in administrative proceedings limits their ability to obtain exculpatory evidence from the SEC.<sup>92</sup> Although defendants may be given access to the Division's investigative file, that investigation has been shaped by the Enforcement Division attorneys who conducted the investigation. Depositions of witnesses, a routine part of civil litigation in federal court, are not typically available to defendants in administrative proceedings before the SEC unless the witness will not be available to testify at the administrative hearing.<sup>93</sup> Although the SEC is also unable to depose witnesses, it typically collects substantial evidence through interviews prior to instituting the administrative proceedings. Overall, the process is considerably more streamlined than the procedures

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85. Stephanie Russell-Kraft, *Rakoff Continues Crusade Against SEC Admin Courts*, LAW360, (Nov. 21, 2014 1:46 PM), <http://www.law360.com/articles/598561/rakoff-continues-crusade-against-sec-admin-courts> (reporting on Judge Rakoff's remarks at a panel at Columbia Law School).

86. See *supra* note 33 and accompanying text; see also *Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984).

87. See *supra* note 33.

88. SEC Rule of Practice 360(a)(2), 17 C.F.R. § 201.360 (2016).

89. Exchange Act § 21(a)(2).

90. A Wells Notice is a letter sent by the SEC to a party against whom the SEC plans to bring an enforcement action. See U.S. Chamber Com., *supra* note 33.

91. See Amendments to the Commission's Rules of Practice, Exchange Release No. 34-78319, SEC. & EXCHANGE COMMISSION (July 13, 2016), <https://www.sec.gov/rules/final/2016/34-78319.pdf>.

92. See 17 C.F.R. § 201.230(a). See also Stephen A. Best, Paul F. Enzinna & Evan N. Turgeon, *Imposing Brady-Like Obligations on the SEC*, CORP. & SEC. L. ADVISOR (June 2014), <http://www.brownrudnick.com/uploads/1279/doc/111514.pdf>.

93. See Amendments to the Commission's Rule of Practice, *supra* note 91; Peter J. Henning, *A Small Step in Changing S.E.C. Administrative Proceedings*, N.Y. TIMES (Sept. 28, 2015), <http://www.nytimes.com/2015/09/29/business/dealbook/a-small-step-in-changing-sec-administrative-proceedings.html>.

followed in federal court. For simple cases, this may not afford the SEC much of an advantage. For more complex cases, defendants may feel considerable pressure to settle if they perceive the deck to be stacked against them in administrative proceedings.

The SEC recently responded to the criticisms of its procedures by amending its Rules of Practice.<sup>94</sup> The new rules relax the deadlines for administrative proceedings in three ways: (1) the deadline for the ALJ's initial decision now runs from the time that the post-hearing briefing is completed, rather than the date the proceeding was filed;<sup>95</sup> (2) the timing of the initial hearing is now a range of four months to eight months after filing, rather than a strict four months;<sup>96</sup> and (3) extensions of the initial decision deadline of up to thirty days are available.<sup>97</sup>

The second change expands the availability of depositions in administrative proceedings. The new rule allows the Division and respondents to depose three people per side in matters involving a single respondent, and five people in matters involving multiple respondents.<sup>98</sup> In addition, either side can petition the hearing officer for leave to conduct up to two additional depositions.<sup>99</sup> Parties can also request that the ALJ issue a subpoena for documents in conjunction with the deposition.<sup>100</sup>

The SEC's reforms blunt the most serious criticisms of the administrative process, but they do not make administrative proceedings the equivalent of a federal court action. The timing of these changes is no accident; they were proposed by the SEC in the wake of the constitutional challenges to its authority to bring cases in administrative proceedings discussed above. These challenges may have created a public relations problem, causing the agency to reform its procedures. The SEC may also have been anxious to head off a legislative response. Stiffer reforms have been introduced in Congress, including most notably a proposal to allow respondents in administrative proceedings the option of removing their cases to federal court.<sup>101</sup> The proposed legislation highlights the question: has Congress made the right policy choice in giving the SEC essentially unfettered discretion in choosing between administrative proceedings and federal court? In the next Part, we provide empirical data relevant to that question. What has the shift to administrative proceedings meant for SEC enforcement actions and the public companies targeted in those actions?

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94. See Amendments to the Commission's Rule of Practice, *supra* note 91.

95. See *id.* (amending SEC Rule of Practice 360(a)(2)(i)).

96. See *id.* (amending SEC Rule of Practice 360(a)(2)(ii)).

97. See *id.* (amending SEC Rule of Practice 360(a)(3)(ii)).

98. See *id.* (amending SEC Rule of Practice 233(a)(1)(2)).

99. See *id.* (amending SEC Rule of Practice 233(a)(3)).

100. See *id.* (amending SEC Rule of Practice 232).

101. Due Process Restoration Act of 2015, H.R. 3798, 114th Cong. (introduced on Oct. 22, 2015).

## II. Empirical Assessment of the Shift to Administrative Proceedings

### A. Hypotheses

What does the SEC maximize with its enforcement choices? Assuming that there are more securities law violations than the SEC has resources to pursue, the SEC must choose among the cases available to it. Although the underlying substance of a case may drive the SEC's enforcement-related decisions, it is also possible that other factors, including the political environment and the need to be seen as "doing something," particularly after a financial scandal, may affect the SEC's enforcement priorities. One obvious incentive for the SEC (at least since Sarbanes-Oxley) has been the pursuit of monetary penalties.<sup>102</sup> As noted above, the SEC trumpets its financial take in its year-end report to Congress.<sup>103</sup> The SEC depends on Congress for its funding, and the agency needs to show results to support its annual budget requests.<sup>104</sup> In addition, both the SEC and Congress focus on case numbers as a metric of the Enforcement Division's performance, so the agency has an incentive to maximize the number of cases brought.<sup>105</sup>

Sheer numbers of cases, however, may not tell the whole story, even if large penalties are assessed; the SEC would also want to bring cases that are highly salient and therefore likely to attract media attention. For example, the SEC pursued backdating cases against public companies even when the marginal deterrent impact of those cases was attenuated.<sup>106</sup> Insider trading is another example; the SEC pursues such cases even when the amount of disgorgement and penalties available is trivial.<sup>107</sup> What backdating and insider trading have in common is the media attention that they draw.<sup>108</sup> Violations that are easy to understand, perhaps because of perceived abuse of trust by violators, are also easy to condemn. Of course, penalties and salience may be self-reinforcing: the agency may attract more headlines in cases in which it extracts the largest settlement amounts, even for less culpable conduct.

For our analysis, we assume that the SEC seeks to maximize not only the sheer number of cases, but also the aggregate amount of monetary penalties it imposes, as well as positive media attention from its enforcement actions.

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102. See *SEC Announces Enforcement Results for FY 2015*, SEC. & EXCHANGE COMMISSION (Oct. 22, 2015), <https://www.sec.gov/news/pressrelease/2015-245.html> (noting the SEC had orders totaling approximately \$4.2 billion in disgorgement and penalties).

103. See *id.*

104. See *FY 2017 Congressional Budget Justification*, SEC. & EXCHANGE COMMISSION (2016), <https://www.sec.gov/about/reports/secfy17congbudgetjust.pdf>.

105. See *id.*

106. See Stephen J. Choi, A.C. Pritchard & Anat C. Wiechman, *Scandal Enforcement at the SEC: The Arc of the Option Backdating Investigations*, 15 AM L. & ECON. REV. 542 (2013) (examining the role of media scrutiny on the SEC's option backdating enforcement actions).

107. See, e.g., *SEC v. Blackwell*, Litigation Release No. 20130 (announcing disgorgement, interest, and a penalty totaling \$10,630.89) (May 25, 2007).

108. See Choi, Pritchard & Wiechman, *supra* note 106.



Given this assumption, our first hypothesis is that the SEC would use its additional enforcement powers under the Dodd-Frank Act as leverage to obtain greater monetary penalties in administrative proceedings (the “SEC Leverage” hypothesis). Prior to Dodd-Frank, the agency could only seek monetary penalties against some actors in federal court.<sup>109</sup> We predict that Dodd-Frank would increase the penalties the SEC collects in administrative proceedings by widening the range of defendants subject to penalties. Greater leverage for the SEC would also lead defendants in administrative proceedings to be more willing to cooperate with the SEC in an effort to reduce sanctions. The SEC’s leverage in administrative proceedings post-Dodd-Frank also implies that respondents may be more receptive to adopting remedial changes to their operations. Companies cooperate on both of these dimensions in the hope of getting a reduction in the settlement amount. Thus, the SEC Leverage hypothesis predicts more monetary penalties and more cooperation from defendants.

The Dodd-Frank Act may change the SEC’s decision on which cases to bring in the administrative forum. A resource-constrained SEC that seeks to maximize its monetary penalties would weigh the expected sanction against the cost of winning. Our second hypothesis is that post-Dodd-Frank, the SEC would bring more complex and thus costlier-to-prosecute actions as administrative proceedings because of the increased prospect of monetary sanctions (the “Case Complexity” hypothesis). In complex cases, the SEC may see administrative proceedings, which offer a quicker avenue to imposing sanctions, as a cheaper alternative to federal court. As a result, the SEC would be more likely to shift more complicated cases, regardless of their evidentiary strength or salience, from civil court to administrative proceedings. In addition, the greater prospect of monetary penalties may lead the SEC to bring more complex and costlier-to-prosecute actions in administrative proceedings that the SEC may not have brought at all prior to the Dodd-Frank Act, due to resource constraints.

Our third hypothesis deals with another way the SEC may have changed its decision on which cases to bring in the administrative forum. Under this hypothesis, the SEC would shift toward weaker cases—in which the SEC has a lower chance of prevailing compared with administrative proceedings in the pre-Dodd-Frank period—or cases that are less likely to garner media attention (the “Case Strength/Salience” hypothesis). These are cases that the SEC would not have brought at all pre-Dodd-Frank because of the high cost of bringing these actions relative to their benefits for the agency. Those benefits include prospective monetary sanctions, furtherance of the SEC’s enforcement priorities because of the violation’s impact on investors, and media attention. We postulate that the SEC will be willing to bring more cases with weak

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109. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(a), 15 U.S.C. § 77h-1 (2012).

## The SEC's Shift to Administrative Proceedings

evidence of violations, marginal wrongdoing, or low salience in administrative proceedings post-Dodd-Frank. The threat of penalties post-Dodd-Frank might encourage respondents to settle administrative proceedings that they previously would have been inclined to fight. That leverage would allow the SEC to resolve these cases more economically and thus justify bringing them in the first place. If the respondent is willing to settle, the SEC has an incentive to bring the case to pad its enforcement numbers and penalty dollars, regardless of its deterrent impact.

The SEC may have also shifted relatively weaker cases that it would have brought in civil court prior to Dodd-Frank into the administrative forum after Dodd-Frank. We assume that prior to Dodd-Frank the SEC brought its strongest cases (i.e., cases with the best evidence or most egregious misconduct) and/or most salient cases (i.e., cases most likely to garner media attention) against public companies in court because penalties were available there, whereas administrative proceedings only afforded remedial sanctions. The categories of case strength and salience do not necessarily overlap: think of a garden variety “pump and dump” scheme, for which the SEC’s evidence will typically be strong and the violations egregious. Because the violators are minor figures, media attention to the SEC’s enforcement efforts will typically be scant. Obviously, such cases do have an important investor protection rationale. In many cases, however, case strength and salience may be congruent. Egregious misconduct generally makes for good headlines.

This leads to the prediction that if the “home court” advantage of administrative proceedings is real, the SEC would respond to the discretion afforded to it by Dodd-Frank by shifting (1) weaker cases and (2) less salient cases from court into administrative proceedings. The theory is that the administrative proceeding would either allow the SEC a better likelihood of prevailing (important in weak cases) or allow it to prevail with fewer resources (devoting more resources to higher-profile cases brought in federal court). This theory is particularly applicable if the respondent is a public company, anxious to minimize the attention brought to the case because of adverse business consequences.<sup>110</sup> If these hypotheses are correct, a shift toward administrative proceedings would leave a mix of stronger and more salient cases remaining in civil court post-Dodd-Frank.

### *B. Data*

To assess the consequences of the SEC’s shift from court to administrative proceedings, we focus on enforcement actions involving public companies that are not financial institutions (defined as companies with Standard Industrial Classification (“SIC”) Code 6000 to 6999). Prior to the

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110. See Choi, Pritchard & Wiechman, *supra* note 106, at 554 (examining the stock price reactions to SEC announcements of investigations).

Dodd-Frank Act, the SEC could impose monetary civil penalties in administrative cease-and-desist proceedings only against registered entities (including broker-dealers, among other financial entities) and persons associated with these registered entities.<sup>111</sup> The Dodd-Frank Act gave the SEC authority to impose monetary civil penalties in all administrative cease-and-desist proceedings.<sup>112</sup>

Our focus on non-financial public companies enables us to discern the impact of the Dodd-Frank Act on SEC actions involving enforcement targets most affected by the Act. It also allows us to examine an important potential consequence of the SEC's enforcement efforts: Are enforcement actions filed as administrative proceedings different from those filed in court, particularly after the enactment of the Dodd-Frank Act?

To do our analysis, we began by collecting enforcement actions filed by the SEC against public companies (other than SIC 6000s) that are tracked by the Center for Research in Security Prices ("CRSP").<sup>113</sup> We collected all cases initiated against these companies between January 1, 2005 and December 31, 2015. We obtained information about these actions from the NYU Securities Enforcement Empirical Database ("SEED"), the SEC's website, and Bloomberg Law (including information from court dockets tracked in Bloomberg Law).<sup>114</sup> We started with a total of 324 SEC actions in our dataset.

We divided our dataset into two categories: civil cases filed in federal court and administrative proceedings before ALJs. Figure 1 below shows the trend over time of SEC enforcement actions against public companies.

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111. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(a), 15 U.S.C. § 77h-1 (2012).

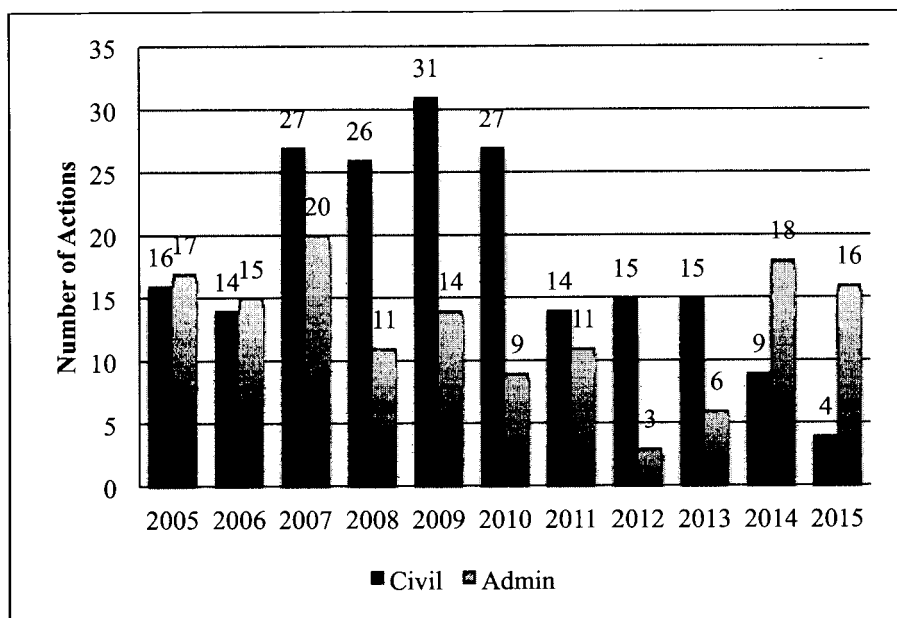
112. See *id.*

113. CRSP tracks companies that are traded on the NYSE, NYSE MKT, NASDAQ, and ARCA exchanges.

114. The SEED database is available at *Securities Enforcement Empirical Database*, N.Y.U. L. (last visited Nov. 20, 2016), <http://seed.law.nyu.edu>.

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Figure 1: SEC Actions Against Non-Financial Public Companies by Initiation Year



We see an increase in civil actions resolved in court against public companies through 2010 (the year Dodd-Frank was enacted), followed by a relatively rapid decline. In 2010, we tracked twenty-seven newly initiated SEC civil enforcement actions against public companies, while in 2015 we had only four civil actions, a drop of 85%. This decline could be consistent with a shift from court actions to administrative proceedings. Administrative proceedings ebbed in 2012, before rebounding in the period of 2013 through 2015. In 2010, we tracked nine newly initiated SEC administrative enforcement actions, while in 2015, the last year of our data sample, we had sixteen newly initiated administrative actions, an increase of 78%. Importantly, from 2006 to 2013, the number of civil actions against public companies was greater than the number of administrative proceedings. In 2014 and 2015, this relation reversed and the number of administrative proceedings was greater than the number of civil actions. These trends in initiated enforcement actions, however, might also reflect changes in the SEC's mix of cases between companies and individuals. Consequently, the raw number of filings against public companies, even though broken down between court actions and administrative proceedings, may not tell us too much, although the apparent decline in court actions relative to administrative proceedings post-Dodd-Frank is suggestive.

The Dodd-Frank Act, which gave the SEC wider penalty authority in administrative proceedings, was passed in July 2010.<sup>115</sup> Accordingly, to avoid anticipation effects, we exclude SEC actions that were initiated or resolved in 2010 for our statistical analysis and divide the remaining cases into pre-Dodd-Frank (2005-2009) and post-Dodd-Frank (2011-2015). For our analysis, we also drop proceedings that were commenced prior to 2010, but not completed until after 2010 (in fact, most of the cases are filed and simultaneously settled). The dataset for our analysis consists of a total of 338 separate SEC enforcement actions.

### *C. Empirical Results*

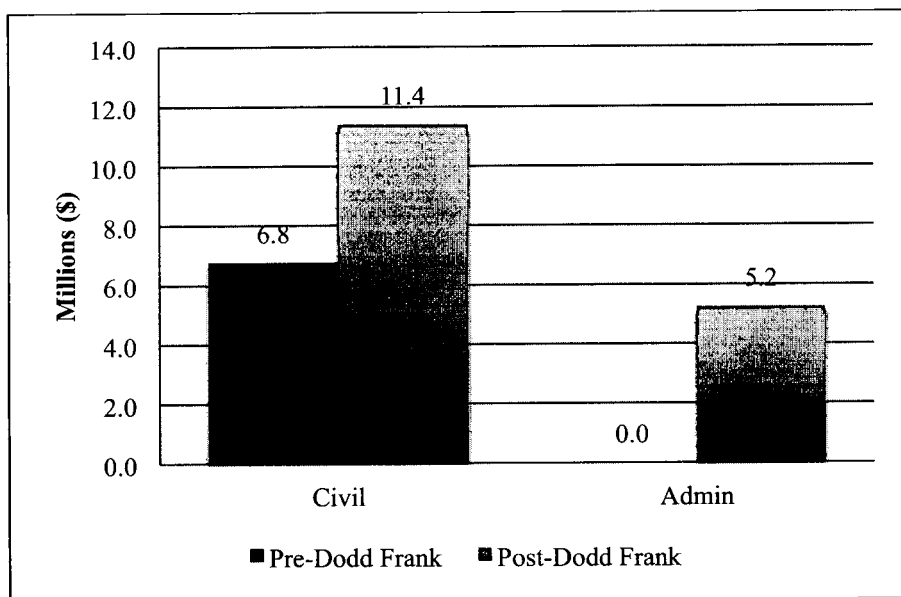
#### 1. Leverage Hypothesis

Our first hypothesis is that Dodd-Frank increased the SEC's leverage with defendants, leading to both greater monetary penalties and more willingness by defendants to cooperate with the SEC. We examine the monetary civil penalties assessed in these enforcement actions against public companies. Prior to Dodd-Frank, only entities directly regulated by the SEC (mainly broker-dealers and other financial entities) were subject to civil penalties in administrative proceedings; after Dodd-Frank, all public companies are included in the pool subject to penalties. In other words, the SEC has a wider range of potential targets for penalties in administrative proceedings after Dodd-Frank. To assess the specific effect of Dodd-Frank, we focus on non-financial industry firms, as defined above. Dodd-Frank had the most immediate effect on the SEC's ability to assess monetary penalties in an administrative proceeding against those firms. Figure 2 shows the trend in average penalties pre- and post-Dodd-Frank for non-financial services companies.

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115. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(a); *Wall Street Reform: The Dodd-Frank Act*, WHITE HOUSE (last visited Nov. 20, 2016), <https://www.whitehouse.gov/economy/middle-class/dodd-frank-wall-street-reform>.

Figure 2: SEC Average Civil Penalties for Non-Financial Public Company Defendants

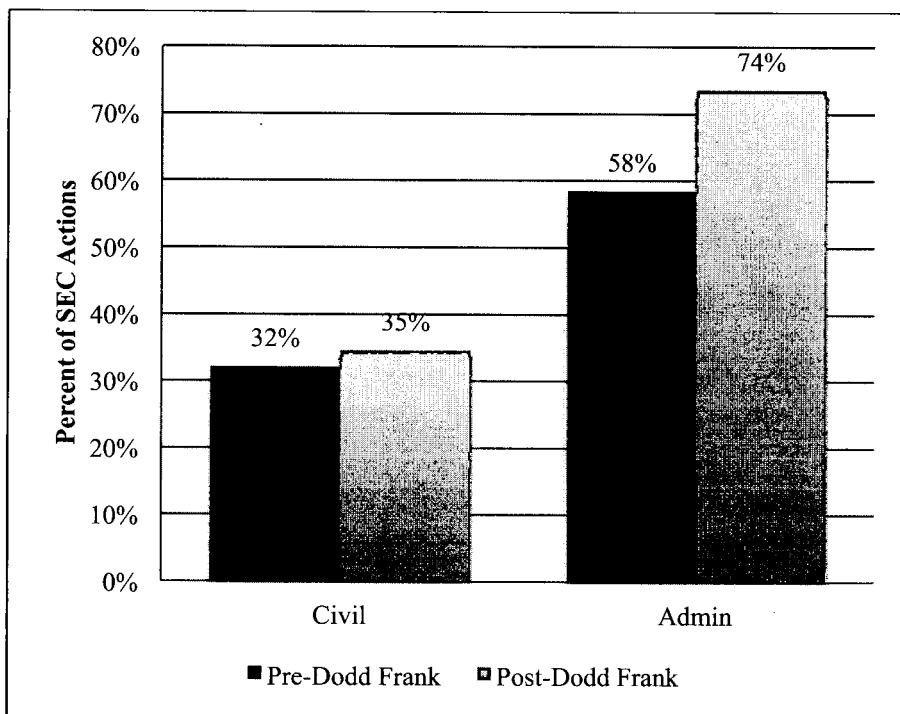


We see that Dodd-Frank had an effect on civil penalties against public companies in administrative proceedings. Average penalties for non-financial firms in administrative proceedings increased from \$0 in the pre-Dodd-Frank period to \$5.2 million post-Dodd-Frank. This change is statistically significant at the 10% confidence level—not surprising, given the baseline. We also see a \$4.6 million increase in average penalties in cases filed in federal court subsequent to Dodd-Frank. This change, however, is not statistically significant.

We also conjecture that the wider array of sanctions available to the SEC in administrative proceedings post-Dodd-Frank would induce cooperation from defendants. In Figure 3, we report the percentage of cases in which the SEC credited the corporation for cooperating with its investigation or engaging in remediation prior to the imposition of sanctions. Although defendants in SEC enforcement actions face pressure to cooperate or engage in remediation in all actions,<sup>116</sup> we use the SEC's mention of cooperation or remediation as a proxy for a high level of cooperation by the defendant.

116. Rebecca Files, *SEC Enforcement: Does Forthright Disclosure and Cooperation Really Matter?*, 53 J. ACCT. & ECON. 353, 355-56 (2012).

Figure 3: Cooperation for Non-Financial Public Company Defendants



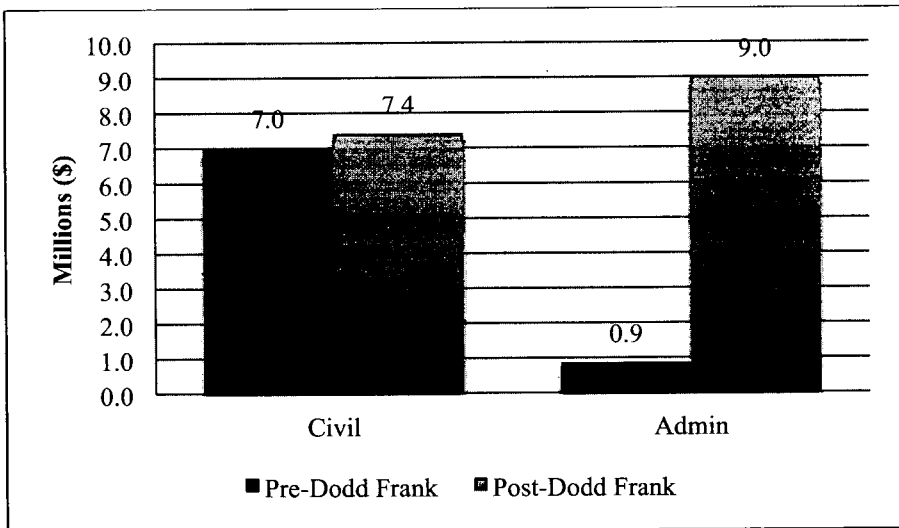
Consistent with our hypothesis, we see a sharp increase in cooperation or remediation by defendants in administrative proceedings post-Dodd-Frank. Although the SEC mentioned the cooperation or remediation by the defendants in 58% of the administrative actions prior to Dodd-Frank, the SEC mentioned cooperation or remediation in 74% of the administrative actions post-Dodd-Frank. The increase is significant at the 10% confidence level. In contrast, there is only a minimal change in the percentage of civil actions that mention cooperation or remediation by defendants during same period; it is not statistically significant. This evidence supports, to some extent, the view that the SEC is wielding greater leverage when negotiating settlements in administrative proceedings.

In addition to the increased SEC leverage, the increase in average civil monetary penalties and the incidence of cooperation in administrative proceedings is consistent with another explanation. The SEC may have changed the type of cases it brought against public companies in administrative proceedings. Such a change could involve either shifting cases that the agency would have brought in court in the past or targeting firms for enforcement that would not have been targeted pre-Dodd-Frank. The subsequent analysis explores these possibilities.

2. Case Complexity Hypothesis

Our second hypothesis is that the prospect of monetary penalties will lead the SEC to devote a greater amount of its limited resources to prosecute administrative proceedings, leading the SEC to bring cases involving more complex fact patterns. The prospect of greater monetary penalties will lead the SEC to view more of these costlier-to-prosecute cases as worthwhile post-Dodd-Frank. As a measure of case complexity, we look at disgorgement as a measure of the underlying profits from the alleged securities law violation. Violations that involve greater profits are likely to be longer running, involve more transactions, and have participants who have invested more in avoiding detection. All of these factors add to the SEC's burden of investigation and presentation of evidence. Both before and after Dodd-Frank, the SEC had the power to seek disgorgement of ill-gotten gains in both civil and administrative proceedings. Changes in disgorgement amounts, therefore, shed light on whether the relative complexity of cases changed post-Dodd-Frank. Figure 4 depicts the mean disgorgement amounts in millions of dollars for civil and administrative proceedings.

Figure 4: SEC Mean Disgorgement for Non-Financial Public Company Defendants



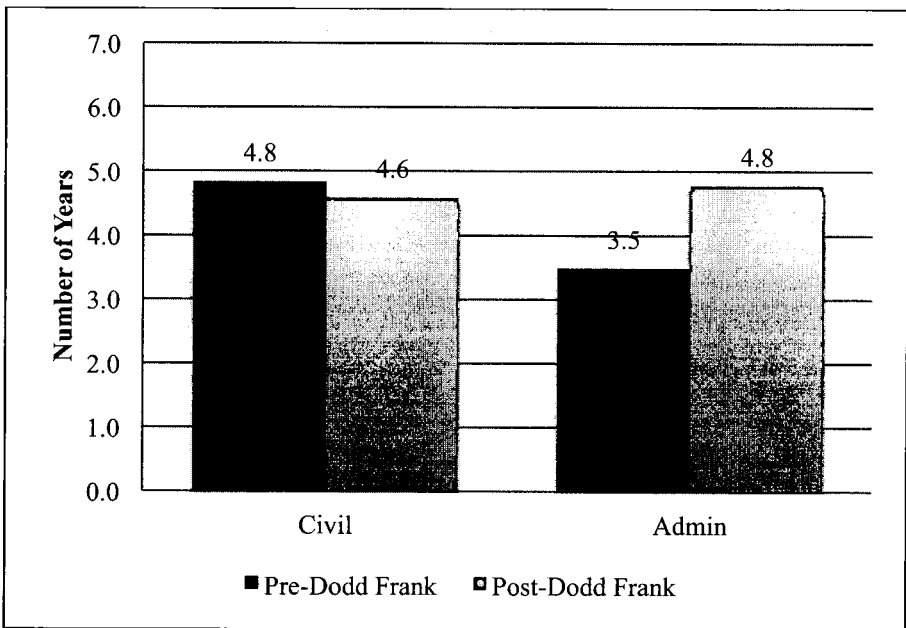
Note from Figure 4 that the mean disgorgement amount increases for both civil and administrative proceedings. The increase for civil actions of \$0.4 million is not statistically significant. The increase for administrative



proceedings is both quantitatively larger at \$8.1 million and statistically significant at the 5% confidence level. The Dodd-Frank Act corresponds with a shift by the SEC toward bringing more actions involving greater profits in administrative proceedings. This shift is consistent with the SEC bringing more-complex actions—more costly to investigate and litigate—in administrative proceedings after civil monetary penalties were made available.

Another measure of the case complexity is how long the alleged violation persisted. A pattern of securities law violations occurring over a number of years may pose greater evidentiary challenges than a single, discrete offense. A long-term violation suggests that the wrongdoers have worked hard to avoid detection or that the violation is a technical one and, therefore, non-obvious. Ponzi schemes collapse quickly, but accounting manipulations can persist for years. Figure 5 compares the average number of violation years for civil and administrative actions before and after the enactment of the Dodd-Frank Act.

Figure 5: Average Number of Violation Years for Non-Financial Public Company Defendants



Note from Figure 5 that the average number of violation years remains virtually unchanged for court actions, dropping from 4.8 years to 4.6 years. This difference is not statistically significant. In contrast, the average number of violation years increases by 37% from 3.5 years to 4.8 years for administrative proceedings. This difference is significant at the 5% confidence

level. The increase in the average number of violation years for administrative proceedings is consistent with the SEC bringing more complex and potentially more challenging cases in administrative proceedings after the enactment of the Dodd-Frank Act.

The shift by the SEC toward more complex actions in administrative proceedings is consistent with one of two possibilities. After Dodd-Frank, the SEC may have initiated administrative proceedings involving more complicated, but also more egregious or more salient violations that the agency previously would have filed in court. In this case, the shift toward more complex and costlier-to-prosecute administrative proceedings might be justified by the importance of the underlying securities law violation. Alternatively, the SEC may have initiated only marginal administrative proceedings involving technical violations that the SEC may have not brought at all prior to Dodd-Frank. Such actions may be costly for the SEC to pursue and for companies to defend, but offer less in the way of deterrent impact. We attempt to distinguish these two possibilities in the next section.

### 3. Case Strength/Salience Hypothesis

Our third hypothesis is that the SEC is bringing weaker and/or less salient cases in administrative proceedings after Dodd-Frank. The prospect of monetary penalties in a quick and low-cost forum may lead the SEC to bring cases that the agency would not have brought at all before Dodd-Frank. We look at several proxies for the strength and/or salience of the SEC action: (1) accounting claims, (2) the incidence of independent consultants in settlements, (3) the existence of a parallel proceeding by another regulator, and (4) the presence of an individual co-defendant.

First, we look at the nature of the underlying securities law violation and how it might affect investors. In particular, we focus on whether the SEC action involves an accounting claim because of the reliance that investors put on financial statements.<sup>117</sup> For that reason, accounting claims tend to be an important enforcement priority for the SEC's core mission of investor protection. We exclude accounting claims relating to the SEC's systematic efforts to address option backdating and FCPA violations. Both option backdating and FCPA enforcement, although involving accounting claims against public companies, may reflect SEC corporate governance priorities rather than solely investor protection.<sup>118</sup> We focus instead on bread-and-butter

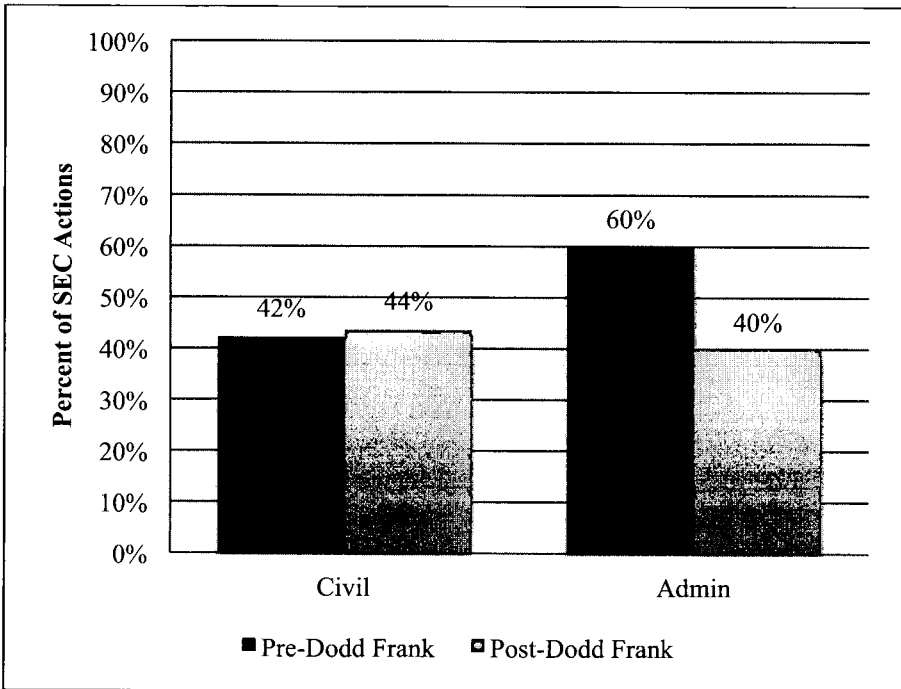
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117. Roberta S. Karmel, *When Should Investor Reliance Be Presumed in Securities Class Actions?*, 63 BUS. LAW. 25, 38 (2007).

118. See Choi, Pritchard & Wiechman, *supra* note 106 (exploring backdating investigations); Stephen J. Choi & Kevin E. Davis, *Foreign Affairs and Enforcement of the Foreign Corrupt Practices Act*, 11 J. EMPIRICAL LEGAL STUD. 409 (2015) (examining factors other than the egregiousness and extensiveness of bribes that affect FCPA sanctions, including the nature of the country in which the bribe is made and the wealth and strength of legal institutions in the home country of the company making the bribe).

accounting violations, which allow us to assess in what forum the SEC brings cases with the greatest impact on investors. Figure 6 compares the percentages of accounting violations for civil and administrative actions prior to and after the enactment of the Dodd-Frank Act.

Figure 6: Accounting-Related SEC Actions Against Non-Financial Public Company Defendants



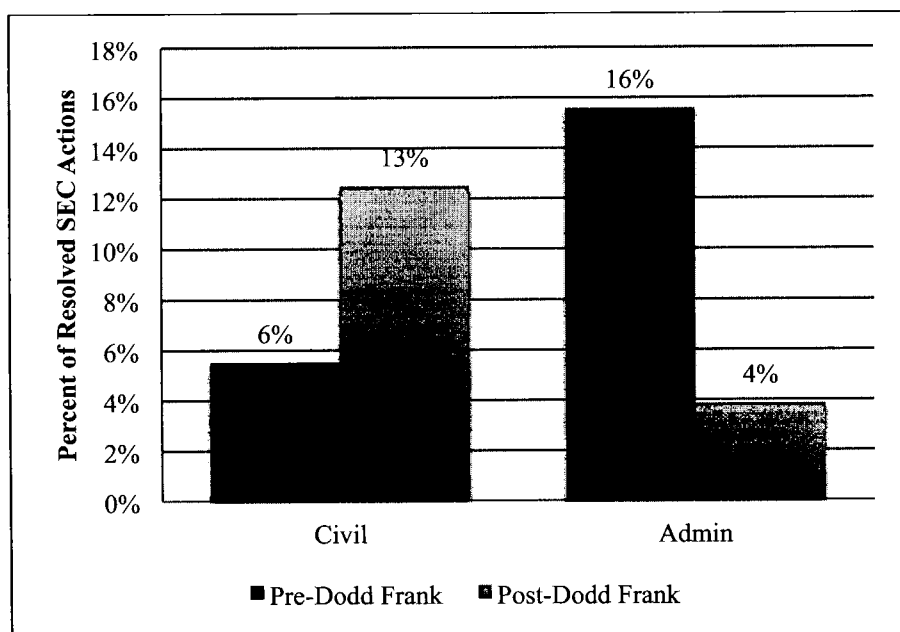
Note from Figure 6 that the fraction of court actions involving accounting claims remains largely unchanged after the enactment of Dodd-Frank. In contrast, the fraction of administrative proceedings involving accounting claims drops precipitously, going from 60% down to 40% of the administrative proceedings. This difference is significant at the 5% level. After the enactment of Dodd-Frank, the SEC dramatically reduced the proportion of accounting allegations brought against public companies as administrative proceedings. To the extent that the incidence of bread-and-butter accounting claims reflects the SEC’s focus on violations with the greatest impact on investors, this shift is consistent with the SEC bringing a diluted pool of violations as administrative proceedings post-Dodd-Frank.

Second, we examine the incidence of independent consultants in settlements. As part of a settlement, firms will sometimes agree to accept

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oversight by an independent consultant as a remedial measure to avoid repetition of the violations alleged in the enforcement action.<sup>119</sup> The SEC negotiates for independent consultants to promote compliance with the provisions of the federal securities laws and to evaluate the effectiveness of the companies' internal controls. Dealing with such consultants can be burdensome for management, interfering with their ability to focus on the day-to-day operations of the company. We conjecture that the SEC demands such settlement terms when the company is a high-priority enforcement target and in cases that are relatively strong for the agency, such as cases involving substantial evidence of a compliance failure by the company. Figure 7 breaks down the incidence of independent consultants before and after Dodd-Frank for non-financial public companies.

Figure 7: Independent Consultants in SEC Actions Against Non-Financial Public Companies



We see that independent consultants have become a more common feature of settlements after Dodd-Frank, but only for cases filed in court. The percentage of SEC civil actions that resulted in the public company accepting

119. See, e.g., Memorandum of Plaintiff in Support of Entry of Proposed Consent Judgment, SEC v. Bank of Am. Corp., No. 1:09-cv-06829-JSR, 2010 WL 430123 (S.D.N.Y. Feb. 4, 2010).

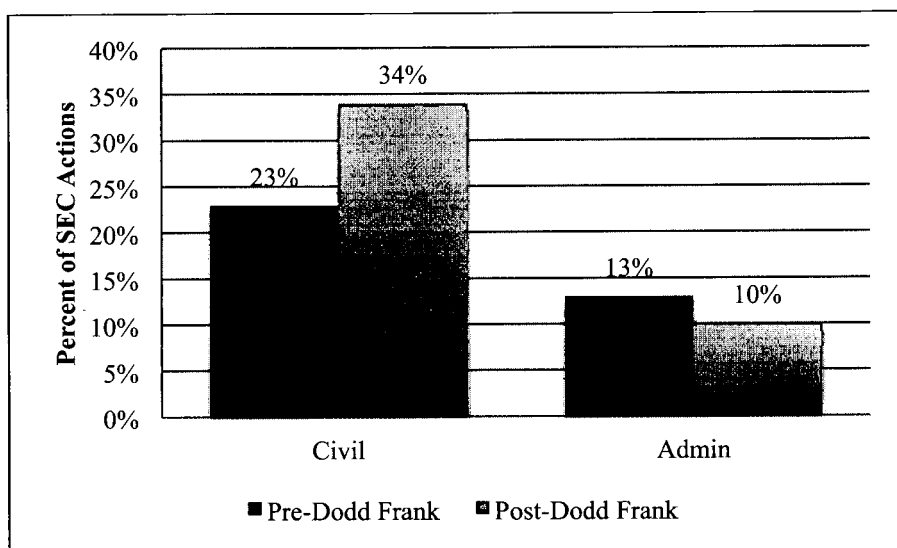
an independent consultant rose from 6% prior to Dodd-Frank to 13% after the enactment of Dodd-Frank. This is consistent with the SEC bringing cases with stronger evidence of wrongdoing or more salient violations in court after Dodd-Frank. The increase is beyond conventional levels of statistical significance at the 10.7% level. In contrast, independent consultants became less common in administrative proceedings after Dodd-Frank. The percentage of SEC administrative proceedings that resulted in the public company accepting an independent consultant decreased from 16% prior to Dodd-Frank to 4% after the enactment of Dodd-Frank. This difference is significant at the 5% level. After Dodd-Frank, the SEC had reason to bring some of its relatively weaker or less important cases against non-financial institutions in administrative proceedings, which might account for the lower incidence of consultants in administrative actions.

Third, we look at external indicia of the strength of the SEC's case. One marker of either a strong or salient case is a parallel proceeding brought by another regulator, such as a criminal proceeding brought by the DOJ or an action brought by a state attorney general or securities regulator. There is substantial jurisdictional overlap among these regulators; all else being equal, a consensus among regulators that wrongdoing has occurred suggests relatively strong evidence of misconduct (particularly for criminal violations).<sup>120</sup> Alternatively, the presence of an action by another regulator may indicate agreement among regulators that enforcement is needed and/or salient, i.e., will bring attention to the regulator. The parallel action indicates willingness by a fellow regulator to devote enforcement resources to targeting that public company. Figure 8 presents the percentages of SEC actions that also resulted in a penalty from another U.S. regulator before and after the enactment of Dodd-Frank for non-financial public companies.

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120. See Randall Smith, Susanne Craig & Deborah Solomon, *Wall Street Firms Settle Charges over Research in \$1.4 Billion Pact*, WALL ST. J. (Apr. 29, 2003), <http://www.wsj.com/articles/SB105154298989636300>.

Figure 8: Other U.S. Regulatory Penalties Against Non-Financial Public Companies

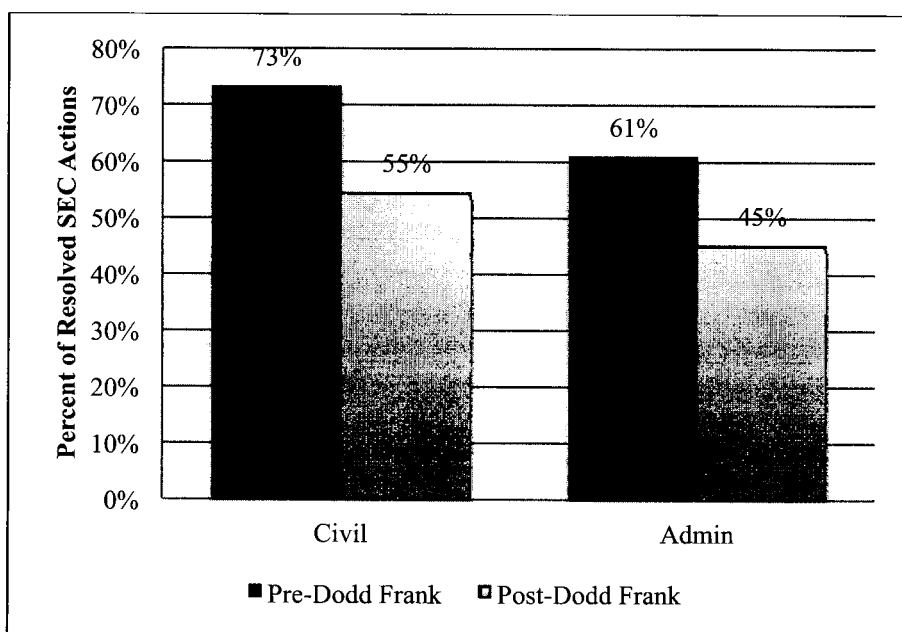


Overall, we see that the percentage of SEC court actions that also resulted in penalties from another regulator rose from 23% prior to Dodd-Frank to 34% after Dodd-Frank. This increase is consistent with the SEC bringing stronger and/or more salient cases in court after Dodd-Frank, but it is not statistically significant. In contrast, other regulators are less likely to pursue cases that the SEC brings as administrative proceedings. The incidence of other regulatory actions declined in administrative actions post-Dodd-Frank from 13% down to 10%. This pattern is consistent with weaker or less salient cases involving non-financial public companies migrating to administrative proceedings post-Dodd-Frank. The decrease for administrative proceedings, however, is not statistically significant. Nonetheless, the changes are in opposite directions, with an increase for court actions and a decrease for administrative actions. Consistent with changes in opposite directions, the change in the difference between the incidence of other U.S. regulatory penalties for court and administrative actions before and after Dodd-Frank is statistically significant at the 10% level, suggesting a shift in the case mix between the two fora.

Fourth, we examine whether an individual was charged as a defendant for actions relating to the same underlying conduct that led to the SEC's enforcement action against a public company. Naming an individual means that some *person* is guilty of wrongdoing. Corporations may be anxious to avoid liability for their officers and therefore may be willing to settle for larger

penalties in order to avoid individual liability.<sup>121</sup> When the SEC has strong evidence of individual culpability, however, the agency may feel that it needs to charge one or more individuals in order to send a deterrent message.<sup>122</sup> Alternatively, the charging of an individual by the SEC may indicate that the agency considers the enforcement action salient and is willing to devote resources to litigating it thoroughly. Figure 9 presents the percentages of SEC actions that also involve charges against an individual before and after the enactment of Dodd-Frank for non-financial public companies.

Figure 9: SEC Charges Against an Individual Relating to SEC Actions Against Non-Financial Public Companies



In both court actions and administrative proceedings, we see a decline in the fraction of SEC actions against public companies that also result in actions against individuals. The percentage decline in individual charges for administrative proceedings is consistent with the SEC bringing weaker or less salient actions against non-financial companies through administrative proceedings in the post-Dodd-Frank period. Notably, however, we also find a

121. The SEC denies making such tradeoffs. See Ceresney, *supra* note 52.

122. See Mary Jo White, Chair, SEC, Remarks to the NYC Bar Association's Third Annual White Collar Crime Institute (May 19, 2014), <https://www.sec.gov/news/speech/2014-spch051914mjw.html>.

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percentage decline in the incidence of individual actions for civil actions as well in the post-Dodd-Frank period, in contrast to our other measures of the strength or priority of the case, for which the changes have gone in opposite directions. The declines for civil actions and administrative proceedings are significant at the 5% and 10% confidence levels, respectively. Recall that we saw an increase in civil monetary penalties paid by non-financial public companies for both civil actions and administrative proceedings in the post-Dodd-Frank period, as depicted in Figure 2 above.

These two findings, taken together, suggest that the SEC may have placed less emphasis on individual liability, while pursuing greater corporate penalties post-Dodd-Frank in both court and administrative proceedings. It may also suggest that the SEC is able to extract larger penalties for less culpable conduct post-Dodd-Frank. Bigger penalties for public companies, combined with less culpability for individuals, suggests that the SEC is pursuing more marginal cases (i.e., those with weaker evidence). The deterrent value of these marginal cases is open to question.

### Conclusion

Congress has gradually expanded the SEC's ability to pursue its enforcement cases in its own administrative proceedings. The SEC has taken advantage of Dodd-Frank's grant of authority to seek civil penalties in administrative proceedings by shifting some of its cases from federal court to administrative tribunals. That shift has been met by constitutional challenges to the SEC's use of ALJs, criticism in the media, and legislative reforms proposed in Congress. The legal challenges have focused on collateral constitutional issues that the agency could easily fix. In an effort to head off legislative reform, the SEC has already adopted incremental reforms designed to make the process fairer for defendants.

Largely lost in the debate, however, is the question of the actual effect of the SEC's shift toward administrative proceedings. There has been some discussion about the SEC's relative win rates in court versus administrative proceedings. Win/loss rates, however, tell only a small portion of the story, as most defendants will choose to settle with the SEC rather than to litigate. The SEC will inevitably win the lion's share of its cases, regardless of the forum.

In this Article, we offer evidence on the consequences of the shift toward administrative proceedings on an important class of defendants: public companies. We show that the shift toward administrative proceedings has been accompanied by a substantial increase in the SEC's leverage in administrative proceedings. The average civil penalty imposed on non-financial public companies named as defendants has increased, both in court and in administrative proceedings. We also show a significant increase in the incidence of cooperation with the SEC, particularly for administrative proceedings.



We provide evidence that the complexity of cases, and thus the cost of litigating cases in administrative proceedings, increased after the enactment of Dodd-Frank. In contrast, the severity of the securities law violation is less for cases the SEC chooses to bring as administrative proceedings post-Dodd-Frank. This pattern is consistent with the SEC shifting more marginal cases from court to administrative proceedings or bringing actions as administrative proceedings that would not have been brought at all pre-Dodd-Frank.

Overall, we conclude that the SEC's ability to extract settlements has increased with the flexibility to choose its forum. The SEC appears to be bringing more cases against public companies using administrative proceedings instead of civil actions in the post-Dodd-Frank period, but it is not clear that the additional cases have the same deterrent value as the mix of cases that the SEC brought prior to Dodd-Frank. We do not see stronger evidence of culpability. Nor do we see other indicia that the SEC is imposing those higher penalties because the agency views the cases as higher priority.

Large penalties against public companies are intended to send a deterrent message to corporate actors generally, but the costs are born ultimately by the shareholders of the companies that pay the penalties. Those shareholders typically have done nothing wrong themselves, and they have little leverage to affect the compliance efforts of the public companies that they invest in. The rationale for sanctioning companies is that it sends a deterrent message to similarly situated public companies. Although we cannot directly measure the deterrent message delivered by the SEC's enforcement actions, it is plausible that the strength of that message likely varies with the culpability of the conduct, the resources the SEC invests in the particular action, and the sanctions imposed. If administrative proceedings have lower indicia of culpability or lesser sanctions, the deterrent message is diluted.

Ultimately, the deterrent value of the SEC's enforcement efforts cannot be measured; it is possible that the additional cases that the SEC is able to bring post-Dodd-Frank can be justified as a matter of enforcement policy. It is also possible (although less likely) that corporate wrongdoing has increased post-Dodd-Frank, and the SEC's efforts are simply a response. From the perspective of public companies and their shareholders, however, the SEC's shift to administrative proceedings appears to have resulted in an increase in the "enforcement tax" for securities violations.