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## The Choice is (Not) Yours: Why the SEC Must Further Amend Its Rules of Practice to Increase Fairness in Administrative Proceedings

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# THE CHOICE IS (NOT) YOURS: WHY THE SEC MUST FURTHER AMEND ITS RULES OF PRACTICE TO INCREASE FAIRNESS IN ADMINISTRATIVE PROCEEDINGS

## ABSTRACT

*The Securities and Exchange Commission (SEC) plays an extremely important role within the securities industry—it oversees the financial markets, protects consumers, and maintains market efficiency. One of the most important (and recently one of most criticized) responsibilities of the SEC is its duty to enforce the securities laws and punish violators. During the past two decades, and especially after the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the SEC’s Division of Enforcement has grown substantially and has utilized administrative enforcement proceedings at an increasing rate. However, this utilization has been occurring without any substantial change to its Rules of Practice and without any formal process by which it chooses a forum. The SEC recently amended its Rules of Practice in hopes to hush the critics and restore confidence, but the underlying problems still have not been completely remedied. In order to rectify these issues, this Note argues the SEC must further revise its Rules of Practice in order to create stricter guidelines regarding choice of forum, extend the discovery timeline for respondents, increase the number of depositions allotted to respondents, and reduce the admissibility of hearsay.*

## INTRODUCTION

The Securities and Exchange Commission (SEC or Commission) has many responsibilities within the securities industry, but perhaps currently its most important is its duty to enforce and ensure compliance with securities laws and regulations.<sup>1</sup> During the past two decades, and especially after the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), the SEC’s Division of Enforcement has grown substantially and has utilized administrative enforcement proceedings at a steadily increasing rate.<sup>2</sup> Although the U.S. Chamber of Commerce,<sup>3</sup> as well as investors and other market participants, recognize that

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1. See *About the SEC: What We Do*, U.S. SEC. & EXCH. COMM’N (June 10, 2013), <http://www.sec.gov/about/whatwedo.shtml#create> [hereinafter *About the SEC*].

2. Jean Eaglesham, *SEC Wins With In-House Judges*, WALL ST. J. (May 6, 2015, 10:30 PM), <http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803>.

3. The Chamber of Commerce is a lobbying entity that works with more than 1,500 volunteers from member corporations, organizations, and the academic community who serve on committees, subcommittees, task forces, and councils to develop and implement policy on major issues affecting

this enforcement process sufficiently protects the public from violators of the federal securities laws,<sup>4</sup> recently, there has been a rising concern as to whether the SEC is abusing its power as a regulator and creating a biased forum in which defendants' cases are heard.<sup>5</sup>

The U.S. Chamber of Commerce is particularly concerned about the SEC's recent use of its enforcement powers and has issued official recommendations to the SEC as to how it can fix the present flaws in its administrative process.<sup>6</sup> The Chamber of Commerce recognized problems such as inconsistencies of law and policy between the SEC's administrative process and federal district courts, loose guidelines concerning choice of forum, the admissibility of hearsay, and a considerably shorter discovery period as compared to that found in federal procedure.<sup>7</sup> This Note argues that changes must be made to the SEC's administrative proceedings in order to ensure fairness, due process, and consistency. To solve these problems, the SEC should further revise its Rules of Practice in order to create stricter guidelines regarding choice of forum, extend the discovery timeline for respondents, increase the number of depositions allotted to respondents, and reduce the admissibility of hearsay.

Part I of this Note discusses the history of the SEC to illustrate the evolution of its enforcement authority; from its limited foundations in 1934 to the expansive authority the SEC exhibits today. Part II outlines the SEC's current administrative hearing process post-Dodd-Frank, highlighting the duties and powers of an administrative law judge (ALJ), the appeal process, and the discovery limitations. Part III explores the policy-based criticisms facing the SEC in connection with its administrative hearing process and examines whether the U.S. Chamber of Commerce's recommendations achieve the goal of addressing these recent concerns about the SEC's proceedings. Part IV describes the amendments the SEC has adopted in response to such criticisms and recommendations. Finally, Part V introduces alternative solutions for improving the SEC's administrative proceedings, including extending the overall length of the proceedings, increasing the amount of permitted depositions, prohibiting the admissibility of hearsay, and implementing a rigid procedure for choosing a forum.

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business. See *About the U.S. Chamber: Advocacy*, U.S. CHAMBER OF COMMERCE, <https://www.uschamber.com/about-us/about-us-chamber/advocacy> (last visited Sept. 15, 2016).

4. See *U.S. Chamber's CCMC Releases Report on SEC Enforcement Practices, Provides Recommendations for Improvement*, U.S. CHAMBER OF COMMERCE (July 15, 2015, 9:15 AM), <https://www.uschamber.com/press-release/us-chamber-s-ccmc-releases-report-sec-enforcement-practices-provides-recommendations>.

5. See Jean Eaglesham, *SEC is Steering More Trials to Judges It Appoints*, WALL ST. J. (Oct. 21, 2014, 9:40 AM), <http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it-appoints-1413849590> [hereinafter Eaglesham, *SEC Steering More Trials*].

6. See generally CTR. FOR CAPITAL MKTS. COMPETITIVENESS, EXAMINING U.S. SECURITIES AND EXCHANGE COMMISSION ENFORCEMENT: RECOMMENDATIONS ON CURRENT PROCESSES AND PRACTICES (2015) [hereinafter RECOMMENDATIONS ON CURRENT PROCESSES].

7. *Id.* at 3-4, 21.

## I. HISTORY OF THE SEC AND ITS ADMINISTRATIVE PROCEEDINGS

### A. CREATION OF THE SEC

On July 2, 1934, the Federal Trade Commission voted to create the SEC<sup>8</sup> following various Congressional hearings that were held in order to increase investor confidence, which had crashed along with the stock market in 1929.<sup>9</sup> Congress passed the Securities Act of 1933<sup>10</sup> and subsequently the Securities Exchange Act of 1934 (collectively, the Acts),<sup>11</sup> which together created the SEC.<sup>12</sup> The principle functions of the SEC at this time were simple—it aimed to ensure that public companies disclosed the truth about their businesses, securities, and risks in order to ensure that players within the securities industry, specifically retail investors, were treated fairly.<sup>13</sup>

The Acts initially did not grant the SEC extensive enforcement powers and thus it could only punish securities laws violators by seeking injunctions in federal district court.<sup>14</sup> The only way the SEC could utilize its administrative proceedings “was to suspend or expel members or officers of national securities exchanges.”<sup>15</sup> Over the next few decades, the number of actions brought by the SEC increased and thus, so did the need for a larger, yet more focused, enforcement division.<sup>16</sup> Therefore, in 1972, the Commission combined all of its scattered enforcement programs into its own single division called the Division of Enforcement, which now has the authority to oversee all enforcement actions brought by the SEC.<sup>17</sup>

### B. THE INSIDER TRADING SANCTIONS ACT OF 1984 AND THE INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988

Up until the 1980s, the only power that the SEC had to combat securities law violators was to seek an injunction in federal district court,<sup>18</sup> which usually accomplished nothing more than an order that the defendant must

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8. 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, 368, n.1 (2008).

9. See *About the SEC*, *supra* note 1.

10. See generally Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)).

11. See generally Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a–78pp (2012)).

12. See *About the SEC*, *supra* note 1.

13. *Id.*

14. See Jed S. Rakoff, Judge, U.S. Dist. Court S. Dist. of N.Y., Keynote Address at the PLI Regulation Institute: Is the SEC Becoming a Law Unto Itself? (Nov. 5, 2014).

15. *Id.*

16. See Atkins & Bondi, *supra* note 8, at 374.

17. See *id.*

18. See *id.* at 386.

comply with the law in the future.<sup>19</sup> However, as the amount of insider trading cases grew, injunctions were no longer considered adequate because they did not punish the violator. Since the violator was “placed in no worse position than the honest man” who did not break the law, the deterrent effect was minimal.<sup>20</sup> Therefore, Congress passed the Insider Trading Sanctions Act of 1984 (ITSA),<sup>21</sup> which allowed the SEC to penalize violators through treble damage awards in federal insider trading cases and increased the maximum fine for Exchange Act violations from \$10,000 to \$100,000.<sup>22</sup>

It did not take long for the SEC and Congress to realize that ITSA was not doing enough to deter violators.<sup>23</sup> Therefore, only four years later, Congress passed the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA).<sup>24</sup> ITSFEA’s paramount advancement was its authorization of the SEC to bring an action in federal district court and impose civil penalties on “a person who, at the time of the violation, directly or indirectly controlled the person who committed such violation.”<sup>25</sup> This meant that broker-dealer and investment advisory firms, although merely the employers of the violators who actually committed insider trading, were now liable under the SEC’s enforcement provisions. ITSFEA also intensified criminal penalties by increasing the maximum fine for violations from \$100,000 to \$1 million.<sup>26</sup>

### C. THE SECURITIES ENFORCEMENT REMEDIES AND PENNY STOCK REFORM ACT OF 1990

Until this point, the SEC’s main purpose for its enforcement actions “was to provide remedial relief for aggrieved investors and to deter future violations.”<sup>27</sup> However, by the late 20th century, it was evident that the SEC was pushing toward a new justification for enforcing the securities laws—to punish the violators.<sup>28</sup> The SEC sought, and Congress granted, the ability to issue cease-and-desist and disgorgement orders against any violator of a

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19. *See id.*

20. *Id.*

21. *See generally* 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.).

22. *Id.*

23. *See Atkins & Bondi, supra* note 8, at 387 (“In the mid-1980s, insider-trading scandals dominated the financial news and involved such high-profile Wall Street traders as Ivan Boesky, Michael Milken, and Dennis Levine. [It] became the focus of Congressional hearings in June and July 1986 and continued to be the focus of hearings for the next several years.”).

24. *See generally* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 1, 102 Stat. 4677 (1988) (codified as amended in scattered sections of 15 U.S.C.).

25. *Id.* § 3.

26. *See id.*

27. *Atkins & Bondi, supra* note 8, at 383.

28. *See id.*

securities law,<sup>29</sup> through the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Remedies Act).<sup>30</sup>

Through the Remedies Act, Congress greatly increased the SEC's punitive power, but did so while taking certain precautions.<sup>31</sup> First, the Remedies Act authorized the SEC to impose monetary penalties through its administrative proceedings, but only when the violator was an entity directly registered with the SEC, such as a broker-dealer or investment advisor.<sup>32</sup> Second, if the SEC wished to seek civil monetary penalties from entities not registered with the SEC, its only choice of forum was federal district court.<sup>33</sup> Due to these specific enforcement provisions, the SEC only brought four actions in federal district court seeking monetary penalties against issuers between 1990 and 2002, with the amount of penalties not exceeding \$5 million.<sup>34</sup>

#### D. THE SARBANES-OXLEY ACT OF 2002

After major corporate scandals involving large companies such as Enron Corp. and WorldCom Inc.,<sup>35</sup> Congress further extended the SEC's power to enforce both old and new securities laws.<sup>36</sup> Congress passed the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley),<sup>37</sup> which not only "imposed significant, additional requirements on corporations and their officers and directors" to strengthen their corporate governance, but also "greatly expanded . . . the criminal penalties for violating the federal securities laws."<sup>38</sup>

Specifically, Sarbanes-Oxley granted the SEC the authority to bar persons from serving as officers and directors, a power that was previously vested solely in the federal courts.<sup>39</sup> However, perhaps the most significant expansion of the SEC's enforcement authority was granted through Section 308(a) of Sarbanes-Oxley, otherwise known as the "Fair Funds" provision.<sup>40</sup> This provision gave the SEC power to require violators to pay a civil penalty,

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29. *Id.* at 392.

30. See Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990) (codified at 15 U.S.C. § 77a (2012)).

31. See Atkins & Bondi, *supra* note 8, at 392.

32. 25 MARC I. STEINBERG & RALPH C. FERRARA, SECURITIES PRACTICE: FEDERAL & STATE ENFORCEMENT § 6:1 (2015).

33. *The Dodd-Frank Act Reinforces and Expands SEC Enforcement Powers*, GIBSON DUNN (July 21, 2010), <http://www.gibsondunn.com/publications/pages/Dodd-FrankActReinforcesAndExpandsSECEnforcementPowers.aspx> [hereinafter *Dodd-Frank Act Reinforces SEC*].

34. See Atkins & Bondi, *supra* note 8, at 394.

35. See generally Dan Ackman, *WorldCom, Tyco, Enron—R.I.P.*, FORBES (July 1, 2002, 9:32 AM), <http://www.forbes.com/2002/07/01/0701topnews.html>.

36. See Atkins & Bondi, *supra* note 8, at 394–95.

37. See generally Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, and 28 U.S.C.).

38. Atkins & Bondi, *supra* note 8, at 395.

39. See *id.*; see also Sarbanes-Oxley § 1105(a), 15 U.S.C. § 78u-3 (2012).

40. Sarbanes-Oxley § 308(a), 15 U.S.C. § 7246(a).

which would be paid out to harmed shareholders, but only if disgorgement<sup>41</sup> was present.<sup>42</sup> Congress purposely required disgorgement before the SEC could issue civil penalties so it would focus on paying shareholders back, not only punishing the wrongdoers.<sup>43</sup> However, the SEC would often dodge this requirement by imposing a disgorgement amount of \$1 and then choosing whichever large civil penalty it desired.<sup>44</sup> Consequently, the Fair Funds provision has had a paradoxical effect on shareholders—when the SEC issues large monetary penalties against securities law violators, this amount ultimately comes out of the shareholders' pockets.<sup>45</sup>

Notwithstanding the negative ramifications of the Fair Funds provision, the SEC was not deterred from penalizing violators. The SEC's expanded powers had a dramatic effect on the securities industry. In the years following the enactment of Sarbanes-Oxley, there was a substantial increase in the amount of monetary penalties the SEC imposed,<sup>46</sup> as well as an increased number of officer and director bars.<sup>47</sup>

### **E. THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010**

During the early 2000s, many entities were lending out subprime mortgages due to weakened mortgage underwriting standards.<sup>48</sup> This abundance of bad credit led to the bursting of the "housing bubble" and then, ultimately, the recession in 2008.<sup>49</sup> After this period of economic turbulence, it was time yet again for Congress to promulgate legislation to address the underlying causes. In July 2010, President Obama signed into law Dodd-

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41. Disgorgement is "a repayment of ill-gotten gains that is imposed on wrong-doers by the courts. Funds that were received through illegal or unethical business transactions are disgorged, or paid back, with interest to those affected by the action. Disgorgement is a remedial civil action, rather than a punitive civil action." *Definition of Disgorgement*, INVESTOPEDIA, <http://www.investopedia.com/terms/d/disgorgement.asp#ixzz3pW8c3P9z> (last visited Sept. 16, 2016).

42. *See Atkins & Bondi, supra* note 8, at 395; *see also* Sarbanes-Oxley § 308(a).

43. U.S. SEC. AND EXCH. COMM'N, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES OXLEY ACT OF 2002 1, <https://www.sec.gov/news/studies/sox308creport.pdf>.

44. *See Atkins & Bondi, supra* note 8, at 398.

45. *Id.*

46. *See id.* at 400 ("The total amount of issuer penalties in 2003 and 2004 was greater than the total amount of all penalties imposed by the SEC for the prior fifteen years combined. From 2003 through 2007, approximately \$13.8 billion in disgorgement and civil penalties were ordered to be paid to the SEC, courts, or other appointed trustees."); *see also* U.S. SEC. & EXCH. COMM'N, 2007 PERFORMANCE AND ACCOUNTABILITY REPORT 2 (2007).

47. *See Atkins & Bondi, supra* note 8, at 399 (citing U.S. CHAMBER OF COMMERCE, REPORT ON THE CURRENT ENFORCEMENT PROGRAM OF THE SECURITIES AND EXCHANGE COMMISSION 25 (2006) ("In 2004, 170 director and officer bars were entered—more than three times as many entered in 2001.")).

48. *See* Jeff Holt, *A Summary of the Primary Causes of the Housing Bubble and the Resulting Credit Crisis: A Non-Technical Paper*, 8 J. BUS. INQUIRY 120, 120 (2009).

49. *See id.*

Frank, which further expanded the enforcement powers of the SEC.<sup>50</sup> Perhaps the most important provision of Dodd-Frank is Section 929P, Strengthening Enforcement by the Commission, which broadly expanded the SEC's authority to utilize its administrative proceedings.<sup>51</sup> Through this provision, Congress authorized the SEC to bring civil monetary actions against any player within the securities industry, registered or non-registered, in its own administrative forum.<sup>52</sup> Dodd-Frank also gave the SEC the power to impose liability on those who recklessly aided and abetted securities law violators,<sup>53</sup> award whistleblowers for informing the SEC of illegal conduct,<sup>54</sup> and bar directors and officers within its administrative proceedings.<sup>55</sup>

## II. CURRENT SEC ADMINISTRATIVE PROCEEDINGS

The SEC has the option to bring a case in one of two forums: an SEC administrative proceeding or federal district court. After the passage of Dodd-Frank, the SEC increased the amount of cases brought within its own administrative proceedings, since the Commission was now allowed to seek penalties from any individual or entity, not only those registered with the SEC.<sup>56</sup> If the SEC chooses to bring a case within its own administrative proceedings, the Federal Rules of Civil Procedure and Evidence do not apply; instead, the SEC uses its own Rules of Practice.<sup>57</sup>

### A. ADMINISTRATIVE LAW JUDGES AND HEARING OFFICERS

Cases brought within the SEC's administrative proceedings are presided over by a hearing officer, and if so ordered by the SEC, an ALJ.<sup>58</sup> ALJs are not elected by the citizens of the United States, but rather are selected by the Chief Administrative Law Judge, whose powers are designated by the SEC.<sup>59</sup>

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50. See generally Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 7, 12, 15, 18, 22, 31, and 42 U.S.C.).

51. Nate Raymond, *U.S. Judge Criticizes SEC Use of In-House Court for Fraud Cases*, REUTERS (Nov. 5, 2014, 1:37 PM), <http://www.reuters.com/article/sec-fraud-rakoff-idUSL1N0S V2LN20141105>.

52. Dodd-Frank § 929P(a) (amending Securities Act § 8A, Securities Exchange Act § 21B(a), Investment Company Act § 9(d)(1), and Investment Advisers Act § 203(i)(1)).

53. *Id.* § 929O (amending Securities Act § 15(b), Securities Exchange Act § 20(e), and Investment Company Act § 48(b)).

54. *Id.* § 922 (amending Securities Exchange Act § 21).

55. *Id.* § 925 (amending Securities Exchange Act §§ 15(b)(6)(A), 15B(c)(4) and 17A(c)(4)(C), and Investment Advisers Act § 203(f)).

56. See Mark Kornfeld, Jessie Gabriel & David Choi, *Administrative Proceedings Remain Likely for SEC Enforcement Actions*, N.Y. L.J. (Sept. 21, 2016), <http://www.newyorklawjournal.com/id=1202767976167/Administrative-Proceedings-Remain-Likely-for-SEC-Enforcement-Actions?mcode=1202615326010&curindex=1&curpage=ALL>.

57. See generally Rules of Practice, 17 C.F.R. §§ 201.100–900 (2016).

58. *Id.* § 201.110.

59. *Id.* §§ 201.30–10.

Since there is no right to a jury trial,<sup>60</sup> the hearing officer or ALJ presides over the entire proceeding and makes the initial decision.<sup>61</sup> In addition to the general responsibility of ensuring the “fair and orderly conduct of the proceedings,”<sup>62</sup> the SEC granted hearing officers and ALJs the powers of:

(a) [a]dministering oaths and affirmations; (b) [i]ssuing subpoenas . . . (c) [r]eceiving relevant evidence and ruling upon the admission of evidence . . . (e) [h]olding prehearing and other conferences . . . (h) [s]ubject to any limitations set forth elsewhere in these Rules of Practice, considering and ruling upon all procedural and other motions . . . [and] (i) [p]reparing an initial decision. . . .<sup>63</sup>

The Rules of Practice outline additional powers of hearing officers and ALJs, and also highlight that the list is not exhaustive.<sup>64</sup>

## B. GENERAL PROCEDURE

Once the SEC chooses the administrative proceeding as its forum, the SEC, in its discretion, has either 120, 210, or 300 days from the date of the service order to file an initial decision, which determines whether or not the defendant is guilty of the alleged violation.<sup>65</sup> When choosing a time period, the SEC considers “the nature, complexity, and urgency of the subject matter, and with due regard for the public interest and the protection of investors.”<sup>66</sup> Under the 300-day timeline, after a hearing officer or ALJ issues a service order, there must be a hearing within four months.<sup>67</sup> Therefore, the time between order issuance and a hearing only decreases as the time period for filing an initial decision decreases.<sup>68</sup> If a hearing officer does not feel that the given time period grants sufficient time to gather all of the evidence and make a well-informed initial decision, he or she can request an extension from the Chief Administrative Law Judge.<sup>69</sup> The Rules of Practice specify that only a hearing officer may request an extension; respondents in a case do not have the same ability to request an extension.<sup>70</sup>

However, if the respondent is not pleased with the initial decision, then the respondent can file a “petition for review” with the SEC.<sup>71</sup> This petition for review is basically an appeal to the SEC; the Division of Enforcement can also file such a petition in the event that the SEC is not satisfied with the

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60. *See id.* § 201.110.

61. *See id.* § 201.360(a)(1).

62. *Id.* § 200.14(a).

63. *Id.* § 201.111.

64. *See id.*

65. *See id.* § 201.360(a)(2).

66. *Id.*

67. *Id.*

68. *See id.*

69. *See id.* § 201.360(a)(3).

70. *See id.*

71. *Id.* § 201.410(a).

initial ruling.<sup>72</sup> The SEC can “affirm, reverse, modify, set aside or remand for further proceedings, in whole or in part,” a hearing officer’s or ALJ’s initial decision.<sup>73</sup> The SEC also has the power to review an initial decision “on its own initiative,” even if neither party appealed.<sup>74</sup> If neither party files a petition for review, and the SEC chooses not to review the matter, then the SEC “will issue an order that the decision has become final as to that party.”<sup>75</sup> After this order is issued, the decision is final.<sup>76</sup>

If the respondent has petitioned for SEC review and is still not pleased with the final decision, then he or she may appeal again to the U.S. Court of Appeals within sixty days of the final decision’s issuance, in the respondent’s residential circuit or in the District of Columbia Circuit.<sup>77</sup> Once this petition is filed, the circuit court has exclusive jurisdiction “to affirm or modify and enforce or to set aside the order in whole or in part.”<sup>78</sup> The circuit court also has the power to remand the matter back to the SEC if either party shows that there is additional, material evidence that was not introduced during the administrative hearing and there is a “reasonable ground” for failure to introduce this evidence.<sup>79</sup>

### III. CURRENT ISSUES WITH THE SEC’S ADMINISTRATIVE PROCEEDINGS

Recently, the SEC’s administrative proceedings have been the target of abundant criticism.<sup>80</sup> Some opponents have condemned the SEC and its administrative process for shaping securities laws in whichever way it chooses, at times even discounting what federal courts have ruled on identical issues.<sup>81</sup> Other critics, such as the U.S. Chamber of Commerce, have credited the SEC’s extremely high success rate in its administrative proceedings solely to its unfettered discretion in choosing a forum.<sup>82</sup> There are also

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72. *See id.*

73. *Id.* § 201.411(a).

74. *Id.* § 201.411(c).

75. *Id.* § 201.360(d)(2).

76. *See id.*

77. *See* 15 U.S.C. § 78y(a)(1) (2012).

78. *Id.* § 78y(a)(4).

79. *Id.* § 78y(a)(5).

80. *See generally* Rakoff, *supra* note 14 (claiming that federal courts are in a better position than the SEC to impartially interpret securities laws); *see also* Eaglesham, *supra* note 2 (explaining that when the SEC brings a case before its own judges, the chances of SEC success increases).

81. *See* Geoffrey F. Aronow, *Back to the Future: The Use of Administrative Proceedings for Enforcement at the CFTC and SEC*, FUTURES & DERIVATIVES L. REP., Jan.–Feb. 2015, at 1; RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 9.

82. *See* RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 18; *see also* Raymond, *supra* note 51; *Heading to Court, But Which One?*, INVESTMENT NEWS (Mar. 1, 2015, 12:01 AM), <http://www.investmentnews.com/article/20150301/REG/303019994/heading-to-court-but-which-one> [hereinafter *Heading to Court*].

procedural criticisms concerning the admittance of hearsay and the very short time period allotted to respondents for discovery.<sup>83</sup>

### A. POLICY CONCERNS WITH CONSISTENCY AND DEFERENCE

One of the problems that stems from the SEC's administrative process is its ability to develop securities law in its own way, in some cases essentially disregarding precedent promulgated by federal courts on identical issues.<sup>84</sup> Since it is an expert on securities regulation, the SEC obviously has abundant knowledge to interpret its own statutes and regulations. However, it has recently been argued that deference to the SEC's expertise has gone too far.<sup>85</sup> The SEC's discretion in statutory interpretation has "even applied in cases in which the Commission adopts a legal position that is inconsistent with or directly contradicts existing appellate court rulings."<sup>86</sup>

In *Chevron, U.S.A., Inc. v. Natural Reserve Defense Council, Inc.*,<sup>87</sup> the Supreme Court provided guidelines as to when a federal court should defer to a government agency's interpretation of its own regulation.<sup>88</sup> First, the court must consider whether Congress has already determined a clear interpretation of the matter at hand.<sup>89</sup> If it has, then the court and the agency must abide by Congress' express intent.<sup>90</sup> If Congress has not addressed the issue, the court cannot apply its own meaning or definition to the regulation or statute.<sup>91</sup> Instead, the question for the court becomes "whether the agency's answer is based on a permissible construction of the statute."<sup>92</sup> The opinion reiterates that the Supreme Court has accepted the longstanding "principle of deference to administrative interpretations" and that it should give "considerable weight" to an executive agency's construction of a statute.<sup>93</sup> The Court concluded that,

[w]hen a challenge to an agency construction of a statutory provision, fairly conceptualized, really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail. In such a case, federal judges—who have no constituency—have a duty to respect legitimate policy choices made by those who do. The responsibilities for assessing the wisdom of such policy choices and resolving the struggle between competing views of the public

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83. See RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 16, 21.

84. See Aronow, *supra* note 81, at 3.

85. See Rakoff, *supra* note 14.

86. RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 9.

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

88. See *id.* at 842–45.

89. See *id.* at 842.

90. See *id.* at 842–43.

91. See *id.* at 843.

92. *Id.*

93. *Id.* at 844.

interest are not judicial ones: Our Constitution vests such responsibilities in the political branches.<sup>94</sup>

Through this holding, the Supreme Court established that executive agencies are better equipped to assess their own regulations and address public policy arguments; such is not the duty of the courts.<sup>95</sup> However, the SEC, as well as federal district courts, may be extending the “*Chevron* deference” beyond the Supreme Court’s intended scope.

The reality is that these administrative proceedings within the SEC allow for a full briefing and oral argument and end with a decision made by a hearing officer or ALJ. These decisions are sometimes given more weight by federal district courts than the decisions made by federal courts themselves.<sup>96</sup> For example, in *VanCook v. SEC*,<sup>97</sup> the Second Circuit gave deference to the SEC’s interpretation of a certain rule although the same court had previously interpreted it differently.<sup>98</sup> The Second Circuit stated that “this later interpretation . . . ‘trumps’ our prior interpretation.”<sup>99</sup> While some may take the position that these hearing officers and ALJs have superior expertise in securities law and should make these decisions, many believe that the law is better off being developed by the federal courts.<sup>100</sup> Administrative decisions are presumed correct “unless the decision is not within the range of reasonable interpretations.”<sup>101</sup> However, decisions of federal district courts are subject to *de novo* review by the Court of Appeals, and then possibly again by the Supreme Court.<sup>102</sup> This stricter standard of review, as compared to “the range of reasonable interpretations” standard, ensures consistency and stability in the legal system. The disparity between decisions of the SEC and federal courts “hinders the balanced development of the securities laws.”<sup>103</sup>

## B. U.S. CHAMBER OF COMMERCE RECOMMENDATIONS FOR THE SEC

In July 2015, the U.S. Chamber of Commerce Center for Capital Markets Competitiveness released a report examining the SEC’s enforcement practices and providing recommendations to improve them.<sup>104</sup> Since Congress passed Dodd-Frank in 2010, the SEC has obtained the power to

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94. *Id.* at 866 (internal quotation marks omitted).

95. *See id.* at 864.

96. *See* Aronow, *supra* note 81, at 3.

97. *See* *VanCook v. SEC*, 653 F.3d 130 (2d Cir. 2011).

98. *See id.* at 140.

99. *Id.* at 140 n.8.

100. *See* Aronow, *supra* note 81, at 3.

101. Rakoff, *supra* note 14.

102. *See id.*

103. *Id.*

104. *See* Marie Cabural, *U.S. Chamber of Commerce Urges SEC to Improve Enforcement Practices*, VALUE WALK (July 15, 2015, 7:06 PM), <http://www.valuwalk.com/2015/07/u-s-chamber-of-commerce-sec/>.

bring an enforcement action in either district court or as an administrative proceeding.<sup>105</sup> As evidenced by the SEC's unique administrative hearing process, the difference between forums "can have a significant impact on the procedural rights of a defendant/respondent and, ultimately, on the respondent's ability to obtain a full, fair, and impartial adjudication."<sup>106</sup> In its recommendations, the Chamber of Commerce attempts to present solutions to these discrepancies while keeping the mission of the SEC—"promoting investor protection, competition, and capital formation"<sup>107</sup>—in mind. The following discussion focuses on only the first, second, and fourth of the twenty-eight total recommendations the Chamber of Commerce made, since these specific recommendations pertain to the issues this Note analyzes.<sup>108</sup>

### **1. Recommendation One: Adoption of Formal SEC Forum Selection Policy**

The Chamber of Commerce's first recommendation concerns the need for a solidified procedure the SEC must follow when choosing a forum.<sup>109</sup> Beyond the SEC's winning record, the current, flexible choice of forum process creates an inconsistent interpretation of securities law and policy between the SEC's interpretations and those of the federal courts.<sup>110</sup> This Chamber of Commerce recommendation urges the SEC to "adopt a policy to refrain from using its administrative forum as an avenue to adopt new interpretations of the federal securities laws or to apply existing interpretations to new or unique factual circumstances."<sup>111</sup> The Chamber of Commerce has also provided some guidelines for this new proposed policy.<sup>112</sup> It recommends that the SEC should use its administrative proceedings when the matter is "based upon well-established legal principles that have been adopted by Article III courts," when the facts of the allegation are similar to those that have been adjudicated in previous enforcement actions, and when the matter does not subject the respondent to "an extensive investigative record" that he or she could not possibly review in its entirety within the allotted time given for discovery by the Code of Federal Regulations (C.F.R.).<sup>113</sup>

The Chamber of Commerce acknowledges that this recommendation is contrary to the belief that regulatory agencies have expertise over certain matters and laws and thus should have the power to interpret the laws that

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105. See RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 3.

106. *Id.* at 9.

107. *Id.* at 2.

108. See *id.* at 8.

109. See *id.* at 18.

110. See *id.*

111. *Id.*

112. See *id.*

113. *Id.*

they promulgate.<sup>114</sup> However, the Supreme Court has previously stated that a government can still benefit from the expertise of agencies without being ruled by them.<sup>115</sup> It may be time to recognize that the benefits of consistent laws outweigh the risks of allowing federal agencies to create and interpret new laws without a review and check by a federal judiciary.<sup>116</sup> The SEC is given broad discretion when choosing a forum, and Congress has not supplied any guidelines to the SEC on how to make this choice.<sup>117</sup> Recently, the SEC has been hearing more cases under its own administrative proceedings.<sup>118</sup> The SEC brought over 80% of enforcement actions within its administrative proceedings, rather than federal court, in the fiscal year ending September 30, 2014, while ten years ago the SEC brought less than 50% of cases within its administrative proceedings.<sup>119</sup>

Other than the efficiency and ease of bringing a case in an administrative proceeding instead of district court, the high rate of success is also a recently apparent factor behind the SEC's choice of forum. "In the 12 months through September [2014], the SEC won all six contested administrative hearings where verdicts were issued, but only 61%—11 out of 18—federal-court trials."<sup>120</sup> Perhaps in an effort to address the current criticism, the SEC's Division of Enforcement posted a document on the SEC website entitled, "Division of Enforcement Approach to Forum Selection in Contested Actions" in May 2015.<sup>121</sup> The SEC admitted that although "there is no rigid formula dictating the choice of forum," it does consider certain factors when making its choice and applies them on a case-by-case basis.<sup>122</sup> Four of the factors listed in this document were: (1) "the availability of the desired claims, legal theories, and forms of relief in each forum;" (2) whether the respondent is registered with the SEC or associated with an entity registered with the SEC; (3) the costs, resources, and time of litigation in each forum; and (4) which forum could provide a "fair, consistent, and effective resolution of securities law issues and matters."<sup>123</sup>

While these factors may shed some light on the reasoning behind the SEC's choice of forum, they still do not provide a concrete procedure that it must follow. Such a procedure could be critical in not only protecting a respondent's due process rights, but also in ensuring the integrity of the SEC.

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114. *See id.* at 18–19.

115. *See* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 561 U.S. 477, 499 (2010).

116. *See* RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 19.

117. *See id.*

118. *See* Eaglesham, *SEC Steering More Trials*, *supra* note 5.

119. Eaglesham, *supra* note 2.

120. Eaglesham, *SEC Steering More Trials*, *supra* note 5.

121. *Division of Enforcement Approach to Forum Selection in Contested Actions*, SEC. & EXCH. COMM'N, DIV. OF ENFORCEMENT, <https://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf> (last visited Nov. 1, 2016) [hereinafter *Approach to Forum Selection*].

122. *Id.*

123. *Id.*

In March 2015, SEC Commissioner Michael Piwowar publicly recognized that the SEC should issue choice of forum guidelines, which many critics believe would be beneficial to the SEC's public perception.<sup>124</sup> Instituting guidelines would bring transparency to the choice of forum process and help deter the recent criticisms that the SEC brings cases within its own administrative process "just to increase its winning record."<sup>125</sup>

## 2. Recommendation Two: Choice of Forum Procedure for Respondents

Another of the Chamber of Commerce's recommendations also concerns choice of forum, but focuses on the respondent's complete lack of input in the forum selection.<sup>126</sup> Although the SEC may choose to bring a case either within its own administrative proceedings or in federal district court, the respondent has no say in the matter.<sup>127</sup> The respondent must comply with the SEC's decision, and can only bring the matter to a federal court of appeals once the SEC makes a final decision.<sup>128</sup> Thus, the Chamber of Commerce recommends that the SEC "should create a procedure to enable respondents to challenge the choice of forum by filing a motion for change of forum with the Commission prior to institution of the proceeding."<sup>129</sup>

The Chamber of Commerce has proposed guidelines that provide respondents with a "procedural opportunity" to contest the SEC's discretion.<sup>130</sup> First, once the SEC chooses to bring the case in an administrative proceeding, it must notify the parties and allow them to file a "motion for reconsideration of the forum decision."<sup>131</sup> If the SEC grants the motion, then it will allow the Division of Enforcement to "submit a new recommendation to the Commission for authorization of a civil action."<sup>132</sup> If the SEC denies the motion, then the Division of Enforcement will have the opportunity to "file an order instituting proceedings."<sup>133</sup>

While this recommendation attempts to mirror traditional court proceedings by giving the respondent some say in the choice of forum in which the case can be heard, it is very unlikely that the SEC will adopt any sort of procedure that will allow a respondent to challenge its choice of forum. One of the main reasons that the SEC brings cases "within its own walls" is the speed of the administrative proceedings.<sup>134</sup> It is more likely to

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124. *See Heading to Court, supra* note 82.

125. *Id.*

126. *See* RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 19.

127. *See id.*

128. *See* 15 U.S.C. § 78y(a)(1) (2012).

129. RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 19.

130. *Id.*

131. *Id.* at 20.

132. *Id.* at 19–20.

133. *Id.* at 20.

134. *See Approach to Forum Selection, supra* note 121.

bring a case in the administrative forum because it can use its resources more effectively and hold hearings more quickly.<sup>135</sup> Allowing respondents to challenge this choice would only delay the proceedings and cause one of the key factors for bringing an action within administrative proceedings to be irrelevant.

### 3. Recommendation Four: Sufficient Discovery and Depositions

An additional Chamber of Commerce recommendation deals with the SEC's Rules of Practice generally, with an emphasis on pre-trial discovery and depositions.<sup>136</sup> The Chamber of Commerce notes that the Rules of Practice have not been substantially amended since 1993, and now that Sarbanes-Oxley and Dodd-Frank have substantially expanded the SEC's authority and reach, it may be time for an update.<sup>137</sup> The current procedures in place allow the SEC to perform extensive discovery before serving an order on the respondent, and therefore, once the SEC decides to initiate an enforcement action, it has already accumulated an "extensive investigative record."<sup>138</sup> While it is possible for ALJs to issue subpoenas, they often do not since they only have a maximum of 300 days to file an initial decision from the date of the service.<sup>139</sup> Under this timeline, which is already the longest and most beneficial available to respondents within an administrative proceeding, there are approximately four months between the issuance of an order and the hearing, roughly two months for both parties to obtain the transcript and submit briefs, and then approximately another four months after the briefing for the hearing officer or ALJ to make the initial decision.<sup>140</sup>

When these rules were adopted, neither Congress nor the SEC anticipated the complex and fact-intensive cases that are now brought within the SEC's administrative proceedings. Given the mass quantities of electronic documents produced in discovery, and the fact that respondents have only four months to review and analyze such documents,<sup>141</sup> timelines for review must be extended. This recommendation is perhaps the most reasonable out of the three discussed in this Note. SEC General Counsel Anne Small recently acknowledged that since the SEC has been granted extensive authority to hear more cases, especially those involving insider trading, it is

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135. *See id.*

136. *See* RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 21.

137. *See id.* at 21; *see also* *Dodd-Frank Act Reinforces SEC*, *supra* note 33 (explaining that Congress originally gave the SEC the power to impose civil money penalties only on those persons who were directly regulated by the SEC, such as broker-dealers and investment advisers, but now under Dodd-Frank, the SEC can impose such remedies on any person).

138. RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 20.

139. *See* 17 C.F.R. § 201.360(a)(2) (2016).

140. *Id.*

141. *See* RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 16.

“entirely reasonable” to make changes in the procedures to reflect the current situation in order to “make sure the process is fair.”<sup>142</sup>

This recommendation also stresses that if the SEC were to extend the time permitted for pre-trial discovery, then it only makes sense to increase the overall time allotted for the completion of an administrative proceeding.<sup>143</sup> The Chamber of Commerce suggested that if the SEC compiles an extensive record before it initiates an action, or if “it is clear that the respondent is entitled to adequate pre-trial discovery to ensure a fair and impartial proceeding,” then it should increase the time apportioned to the hearing.<sup>144</sup>

The Chamber of Commerce further proposed that “[t]he rules should also require all evidence introduced to be based on personal knowledge of the witnesses or the creator of the document, unless subject to specific exceptions to well-established evidentiary exclusion rules.”<sup>145</sup> This recommendation stems from another common criticism of the administrative process, which is its permissible use of hearsay. The SEC Rules of Practice’s regulation regarding the admissibility of evidence is extremely vague. It allows the Commission or the hearing officer to “receive relevant evidence and shall exclude all evidence that is irrelevant, immaterial or unduly repetitious.”<sup>146</sup> This diverges from the Federal Rules of Evidence, which do not permit the admission of hearsay evidence, outside of certain limited exceptions,<sup>147</sup> and proclaim that a witness may only testify to a matter if he or she has sufficient knowledge of that matter, as supported by evidence.<sup>148</sup>

#### IV. SEC PROPOSED AND ADOPTED AMENDMENTS TO THE RULES OF PRACTICE

On October 5, 2015 the SEC responded to the various criticisms of its administrative proceedings, and perhaps also to the Chamber of Commerce’s recommendations, by announcing proposed amendments to its Rules of Practice.<sup>149</sup> After taking public comments into consideration, the SEC issued its final amendments on July 29, 2016, which became effective on September

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142. Daniel Wilson, *SEC Administrative Case Rules Likely Out of Date, GC Says*, LAW360 (June 17, 2014, 5:55 PM), <http://www.law360.com/banking/articles/548907/sec-gc-praises-analysis-improvements-after-rule-disputes>.

143. See RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 21.

144. *Id.*

145. *Id.*

146. 17 C.F.R. § 201.320 (2016).

147. See FED. R. EVID. 802. The Federal Rules of Evidence define “hearsay” as “a statement that: (1) the declarant does not make while testifying at the current trial or hearing; and (2) a party offers in evidence to prove the truth of the matter asserted in the statement.” FED. R. EVID. 801(c)(1)–(2).

148. FED. R. EVID. 602.

149. See Amendments to the Commission’s Rules of Practice, 80 Fed. Reg. 60,091 (proposed Oct. 5, 2015) (to be codified at 17 C.F.R. pt. 201).

27, 2016.<sup>150</sup> The overall thrust of the amendments focuses on the timeline of hearings, the time allotted for discovery and depositions, and the rules concerning hearsay.<sup>151</sup> While the amendments make changes to various rules under C.F.R. Part 201, for the purpose of this Note, the discussion will concern Rules 360, 233, and 320.

### A. RULE 360

The SEC proposed to amend Rule 360, which outlines the timelines for the pre-hearing period, the hearing, the post-hearing brief-submitting period, and the initial decision filing, in three ways.<sup>152</sup> As discussed earlier, a hearing officer can choose, at its discretion, from three different time periods within which to file his or her initial decision: 120 days, 210 days, or 300 days.<sup>153</sup> Previously in the Rules of Practice, this timeline began on the date of service of an order instituting proceedings (OIP).<sup>154</sup> The SEC first proposed to amend Rule 360(a)(2) by changing the start date of the timeline from the date of service of an OIP to the “date of completion of post-hearing or dispositive motion or a finding of a default.”<sup>155</sup> The SEC is able to take as much time as it needs to investigate the matter before it serves the parties involved, while the respondents only have a limited time for discovery within each particular timeline.<sup>156</sup> Essentially, this amendment would “divorce” the initial decision deadline from all other phases of the administrative proceeding.<sup>157</sup> However, due to the divorce of these phases, the earlier time periods to file an initial decision are no longer relevant. Therefore, the SEC further proposed to amend the designated time period for preparing the initial decision to 30, 75, or 120 days from the completion of post-hearing or dispositive motion briefing or a finding of a default.<sup>158</sup> In its final rule, the SEC adopted this part of Rule 360(a)(2) exactly as proposed.<sup>159</sup>

Second, the proposed amendment to Rule 360(a)(2) expanded the time period of the pre-hearing stage of the proceeding.<sup>160</sup> In the SEC’s proposal, it doubled the maximum time period from four months to eight months under its 120-day timeline, increased the time period from two-and-a-half to six months under the 75-day timeline, and quadrupled the time period from one month to fourth months under the 30-day timeline.<sup>161</sup> The SEC hoped that

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150. See Amendments to the Commission’s Rules of Practice, 81 Fed. Reg. 50,212 (July 29, 2016) (to be codified at 17 C.F.R. pt. 201).

151. See Amendments to the Commission’s Rules of Practice, 80 Fed. Reg. at 60,091.

152. See *id.* at 60,091–92.

153. See 17 C.F.R. § 201.360(a)(2) (2016).

154. See *id.*

155. Amendments to the Commission’s Rules of Practice, 81 Fed. Reg. at 50,213.

156. See RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 20.

157. Amendments to the Commission’s Rules of Practice, 80 Fed. Reg. at 60,092.

158. Amendments to the Commission’s Rules of Practice, 81 Fed. Reg. at 50,213.

159. See *id.* at 50,214.

160. See Amendments to the Commission’s Rules of Practice, 80 Fed. Reg. at 60,092.

161. Amendments to the Commission’s Rules of Practice, 81 Fed. Reg. at 50,213.

this amendment, by increasing the length of the proceeding's pre-hearing period, would satisfy the critics' pleas for change because it provided more time for respondents to conduct depositions and review electronic documents.<sup>162</sup> However, this extended maximum timeline still was not enough to satisfy the commenters to the proposals.<sup>163</sup> Therefore, in its final rule, the SEC modified Rule 360 to allow a hearing to commence within a maximum of ten months—instead of the proposed eight—after the date of service under the 120-day timeline.<sup>164</sup> The SEC amended Rule 360 as to 75- and 30-day timelines as proposed.<sup>165</sup>

Third, the SEC proposed to amend Rule 360(a)(3) to allow a hearing officer to “extend the initial decision deadline by up to 30 days for case management purposes.”<sup>166</sup> The SEC intended to allow flexibility for hearing officers, who may have to issue many initial decisions within the same time frame.<sup>167</sup> The hearing officer must issue the extension no later than thirty days before the expiration of the initial decision deadline; however, if the SEC does not agree with the extension, it must issue an order to the contrary within fourteen days after receiving the certification for extension.<sup>168</sup> If the SEC does not issue a contrary order, then the extension shall take effect.<sup>169</sup> In its final rule, the SEC adopted Rule 360(a)(3) as proposed.<sup>170</sup>

## B. RULE 233

The SEC also proposed to amend Rule 233, which concerns the procedure of conducting depositions during the pre-hearing phase.<sup>171</sup> Previously, a party was only permitted to take a deposition of a witness if the witness was unable to testify at the hearing.<sup>172</sup> However, the proposed rule would allow both parties to conduct a limited number of additional witness depositions, even of witnesses that will attend the hearing.<sup>173</sup> There is a cap, however, on how many depositions each party can conduct.<sup>174</sup> Under a 120-day timeline, if the proceeding involves one respondent, then the respondent

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162. *See* Amendments to the Commission's Rules of Practice, 80 Fed. Reg. at 60,092.

163. *See* Amendments to the Commission's Rules of Practice, 81 Fed. Reg. at 50,213 (noting that many commentators argued for pre-hearing periods of twelve or eighteen months and some advocated to give hearing officers the discretion to set the pre-hearing period and grant extensions of the period on a case-by-case basis).

164. *Id.* at 50,214.

165. *See id.*

166. Amendments to the Commission's Rules of Practice, 80 Fed. Reg. at 60,104.

167. *See id.* at 60,092.

168. Amendments to the Commission's Rules of Practice, 81 Fed. Reg. at 50,215.

169. *Id.*

170. *See id.*

171. *See* 17 C.F.R. § 201.233 (2016).

172. *See id.* § 201.233(a).

173. *See* Amendments to the Commission's Rules of Practice, 80 Fed. Reg. 60,091, 60,092 (proposed Oct. 5, 2015) (to be codified at 17 C.F.R. pt. 201).

174. *See id.*

and the SEC are each allowed to conduct up to three depositions. If the proceeding involves more than one respondent, then the SEC is allowed up to five depositions, and the respondents collectively may conduct up to five.<sup>175</sup> The SEC hoped that this amendment would allow parties to develop their arguments more fully and condense the issues that will be examined during the hearing.<sup>176</sup> Although many commenters urged the SEC to further increase the number of depositions allowed to each side to mirror the Federal Rules of Civil Procedure, which allows ten depositions per side or per party,<sup>177</sup> the SEC adopted the amendment as proposed in its final rule, with some minor adjustments.<sup>178</sup> The final rule allows either party to move for two additional depositions, which will be granted at the hearing officer's discretion, taking into consideration whether the matter contains unique issues or facts.<sup>179</sup> The final rule also imposes a seven-hour time limit to depositions, instead of the originally proposed six.<sup>180</sup>

### C. RULE 320

Lastly, the SEC proposed to amend Rule 320, which concerns the admissibility of evidence.<sup>181</sup> The previous rule states, “[t]he Commission or the hearing officer . . . shall exclude all evidence that is irrelevant, immaterial or unduly repetitious.”<sup>182</sup> The amendment would add “unreliable” to the end of the list of types of excluded evidence.<sup>183</sup> However, despite the Chamber of Commerce's urging, the SEC did not actually prohibit the admission of hearsay evidence, but instead added a new Rule 320(b) to clarify that it can only be permitted “if it is relevant, material, and bears satisfactory indicia of reliability so that its use is fair.”<sup>184</sup> Therefore, under this regime, hearsay is still admissible, but it now must pass a stricter threshold of reliability. The SEC adopted the amendments to Rule 320 as proposed.<sup>185</sup>

## V. SOLUTION: FURTHER AMENDMENTS TO THE SEC RULES OF PRACTICE

Many critiques of the SEC's administrative proceedings concern their short timeframe, the informal process by which the SEC chooses a forum, and the admissibility of hearsay evidence. These criticisms boil down to the

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175. *Id.*

176. *See id.*

177. *See* FED. R. CIV. P. 30(a)(2).

178. *See* Amendments to the Commission's Rules of Practice, 81 Fed. Reg. 50,212, 50,216 (July 29, 2016) (to be codified at 17 C.F.R. pt. 201).

179. *Id.*

180. *Id.*

181. *See* Amendments to the Commission's Rules of Practice, 80 Fed. Reg. at 60,095.

182. 17 C.F.R. § 201.320 (2016).

183. Amendments to the Commission's Rules of Practice, 80 Fed. Reg. at 60,095.

184. *Id.*

185. *See generally* Amendments to the Commission's Rules of Practice, 81 Fed. Reg. at 50,226.

overall fairness of the administrative proceedings and whether these proceedings violate a respondent's right to due process by not providing them with a meaningful judicial review of their claims.<sup>186</sup> To ensure that its administrative process is fair, the SEC should amend the Rules of Practice to further provide a lengthened timeline for administrative proceedings, increase the scope of discovery practices, preclude the admissibility of hearsay, and require a rigid choice of forum procedure.

#### A. EXTEND THE LENGTH OF ADMINISTRATIVE PROCEEDINGS

The SEC's recent amendment to Rule 360 to expand the time period of each administrative proceeding will likely not be sufficient. Time becomes increasingly important for respondents during the pre-hearing period, during which discovery is conducted. The SEC is able to obtain a comprehensive investigative record, through investigation of a respondent's records and issuance of investigative subpoenas, before ever initiating an enforcement action.<sup>187</sup> However, respondents have only a few months, even under the new amendments, to gather all of the facts they need to build a defense.<sup>188</sup>

The SEC's chief argument supporting in-house proceedings is the speed of the process.<sup>189</sup> However, the SEC has often been criticized for its delay in completing enforcement investigations.<sup>190</sup> Dodd-Frank amended the Securities Exchange Act by requiring SEC staff to file an action against a party within 180 days after providing that party with an initial written notification of a potential violation.<sup>191</sup> The SEC is allowed, however, to extend this time period by another 180 days if the case is overly complex.<sup>192</sup> This shows that the SEC essentially has an investigative advantage before initiating an action, and then further has the authority to extend its investigation another six months. On the other hand, under the 120-day timeline, the respondent, after receiving the OIP, only has ten months maximum to conduct discovery, and that is only if the SEC decides to grant that extended time.<sup>193</sup> The SEC elucidated in a footnote that not every 120-day matter brought by the SEC will qualify for the maximum ten-month period.<sup>194</sup> It explained that the decision is within the hearing officer's

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186. See *Thunder Basin Coal Co. v. Reich*, 510 U.S. 200, 214 (1994).

187. See RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 20.

188. *Id.*; see also Amendments to the Commission's Rules of Practice, 81 Fed. Reg. at 50,214.

189. See Amendments to the Commission's Rules of Practice, 81 Fed. Reg. at 50,214 ("While we recognize that some might view the maximum ten-month prehearing period as not long enough, the Commission believes that the final rule strikes the appropriate balance between the time needed to conduct discovery and prepare for a hearing and the Commission's goal of timely and efficiently resolving administrative proceedings.").

190. See *Dodd-Frank Act Reinforces SEC*, *supra* note 33.

191. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub. L. No. 111-203, § 929U, 124 Stat. 1376 (2010) (codified at 15 U.S.C. § 78d-5 (2012)).

192. *Dodd-Frank Act Reinforces SEC*, *supra* note 33.

193. See Amendments to the Commission's Rules of Practice, 81 Fed. Reg. at 50,214.

194. See *id.* at 50,214 n.18.

discretion, considering factors such as the number of securities law violations, the size of the investigative record, and the facts behind the allegations.<sup>195</sup> The SEC stressed that “the maximum prehearing period should be the exception rather than the norm.”<sup>196</sup> Additionally, although this limited amount of discovery may have been sufficient in the past, in today’s technological world that is no longer the case. In some cases, especially those concerning more complex issues, respondents could have millions of pages to review because of the use of electronic documents.<sup>197</sup> While increasing the time for pre-hearing discovery is an improvement, this amendment is a far cry from how much time is allotted in a district court case, which is oftentimes a year or longer, and the amendment does not extend the time enough for a respondent to formulate a strong defense.<sup>198</sup>

The Chamber of Commerce presented only a general recommendation regarding the extension of the pre-hearing time period, but it strongly advocated that this revision was necessary due to the SEC’s broadened authority under Dodd-Frank, its experience with the use of its administrative proceedings, the increased amount of investigation materials, and, of course, to ensure an unbiased forum.<sup>199</sup> Thus, the SEC should further amend Rule 360 to allow for a pre-hearing discovery time of twelve months, on a case-by-case basis, giving each side the option of extending this time another two months, depending on the complexity of the case. Additionally, if the respondent moves to extend the time period and the hearing officer denies the request, the respondent should have the ability to appeal to the SEC, which must then decide whether to grant or deny the extension within thirty days. This amount of time for discovery is necessary, especially in matters with complex issues or those with millions of documents stored electronically that respondents must sift through.<sup>200</sup> This extension will make the administrative process fairer and protect the respondent’s due process rights.

## **B. INCREASE THE AMOUNT OF PERMITTED DEPOSITIONS**

An additional concern with the restricted discovery within an administrative proceeding is the inadequate amount of depositions permitted to respondents. While the SEC has taken a small step in amending Rule 233 to allow parties to take depositions of witnesses who will also testify in the hearing, this small change is not enough.<sup>201</sup> The rule “does not even come close to leveling the playing field” since it allows for the same amount of

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195. *See id.*

196. *Id.*

197. *See* RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 16.

198. *See* William F. Johnson, *SEC Behind Times in ‘Modernizing’ Administrative Proceedings*, N.Y. L.J. (Nov. 5, 2015), <http://www.newyorklawjournal.com/id=1202741460509/SEC-Behind-Times-in-Modernizing-Administrative-Proceedings?slreturn=20151021135531>.

199. RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 20.

200. *See id.* at 16.

201. *See* Amendments to the Commission’s Rules of Practice, 81 Fed. Reg. at 50,216.

depositions for both the respondents and the SEC, yet this amount of depositions is hardly enough for a respondent to collect all relevant facts.<sup>202</sup> Since such a small number of depositions are allowed, “figuring out which witnesses to depose may involve a large degree of guesswork if the agency took testimony from a number of people in its investigation, as is often the case.”<sup>203</sup> Further, while respondents have only months to conduct discovery and build a defense, it has been shown that the SEC, in most cases, already had years to investigate the matter and construct its investigative record.<sup>204</sup>

To correct this incongruity, the SEC should instead amend its Rules of Practice by allowing each party to an action to conduct six depositions. This change should also apply to cases where there is more than one respondent; respondents within the same case should be allowed six depositions each, not collectively. This number of depositions brings the Rules of Practice closer to the Federal Rules of Civil Procedure’s rule of allowing ten depositions to each party, and also maintains the SEC’s interest in conducting timely and efficient administrative proceedings.<sup>205</sup> Since this solution has already extended the pre-hearing discovery period, then the parties will surely have time to conduct more depositions and bring more concise issues to court, which will ensure a speedier hearing period.

### C. PROHIBIT THE ADMISSIBILITY OF HEARSAY

One of the major critiques of the SEC’s amendments is that they still allow hearsay as admissible evidence.<sup>206</sup> The first problem with hearsay is that the process by which it is permitted is completely subjective; the ALJs have complete discretion to decide whether or not evidence is relevant, material, and reliable.<sup>207</sup> The second problem is that even under amended Rule 320, various statements that were made outside of the hearing may still be permissible within an SEC proceeding without having the speaker attend the hearing at all.<sup>208</sup> This process eliminates the opportunity for cross-examination, where a witness could possibly admit something contradicting

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202. Johnson, *supra* note 198.

203. 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?\\_r=0](http://www.nytimes.com/2015/09/29/business/dealbook/a-small-step-in-changing-sec-administrative-proceedings.html?_r=0).

204. See RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 20; see also Randall J. Fons, *Administrative Proceedings vs. Federal Court: The SEC Provides Limited Transparency Into Its Choice of Forum*, MORRISON & FOERSTER LLP (May 13, 2015), <http://www.mondaq.com/unitedstates/x/396864/Securities/Administrative+Proceedings+Vs+Federal+Court+The+SEC+Provides+Limited+Transparency+Into+Its+Choice+Of+Forum>.

205. See Amendments to the Commission’s Rules of Practice, 81 Fed. Reg. at 50,216.

206. See Daniel V. Ward, Jon A. Daniels & Alexandria Perrin, *Inside SEC’s New In-House Court Rules*, LAW360 (Aug. 1, 2016, 11:54 AM), <http://www.law360.com/articles/823479/inside-sec-s-new-in-house-court-rules>.

207. See Johnson, *supra* note 198.

208. See Henning, *supra* note 203.

prior testimony and thus lose credibility.<sup>209</sup> Finally, when the SEC has already had ample opportunity to gather evidence before commencing a proceeding, then allowing hearsay only intensifies the lack of fairness and equality between respondents and the SEC.<sup>210</sup>

To fix this subjective element of administrative proceedings, the SEC should adopt hearsay procedures according to the Federal Rules of Evidence. Although under the Administrative Procedure Act agencies are allowed to permit hearsay,<sup>211</sup> in a time when the SEC is under scrutiny from parties, attorneys, and the interested public, it should have taken this opportunity to create “an administrative fact-finding system that distinguishes itself in a positive way, instead of hiding behind an archaic, unfair process.”<sup>212</sup> To continue to allow hearsay within administrative proceedings in this manner is to continue an unfair process where ALJs have complete discretion to decide which evidence is reliable.

#### D. IMPLEMENT FORMAL PROCEDURE FOR CHOOSING A FORUM

Finally, in order to remedy the broad discretion that the SEC has when choosing a forum, as well as the securities law consistency problem, the SEC should adopt a formal procedure for determining whether to bring a case in its own administrative proceedings or in federal district court. One of the largest criticisms of the SEC is the high frequency with which it adjudicates cases within its own administrative proceedings and the high probability of SEC success when a case is brought within its own walls.<sup>213</sup>

The Chamber of Commerce has suggested a framework and the SEC has provided the public with factors it considers when choosing a forum.<sup>214</sup> However, there has yet to be an official process that the SEC is required to follow. In fact, within the SEC’s official document that provides the approach used to select a forum, it states that “[t]here is no rigid formula” to forum selection and that it “may in its discretion consider any or all of the factors in assessing” which forum to choose.<sup>215</sup> Implementing a formal procedure will not only help rebuild public confidence in the SEC and its administrative proceedings, but it will also help remedy the inconsistency between administrative and judicial interpretations of securities laws.

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209. *Id.*

210. See Johnson, *supra* note 198.

211. See 5 U.S.C. § 556(d) (2012) (“Any oral or documentary evidence may be received, but the agency as a matter of policy shall provide for the exclusion of irrelevant, immaterial, or unduly repetitious evidence.”).

212. Johnson, *supra* note 198.

213. See Eaglesham, *supra* note 2.

214. See RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 18; see also *Approach to Forum Selection*, *supra* note 121.

215. *Approach to Forum Selection*, *supra* note 121.

The first two criteria that the SEC considers when selecting a forum do not seem to raise any new controversy.<sup>216</sup> They provide that the SEC should examine the availability of claims, legal theories, and relief in each forum and whether the charged party is a registered entity.<sup>217</sup> However, the second two still seem to give the SEC too much discretion in choosing a forum, and that is if the SEC even elects to consider them. The third and fourth guidelines concern the efficient use of the SEC's "limited resources" and the "fair, consistent, and effective resolution of securities law issues and matters."<sup>218</sup> Each of these general factors, when analyzed by the SEC, blatantly weighs in favor of its own administrative proceedings. The in-house administrative process is more time and cost efficient, at least according to the SEC, and the SEC also asserts that it is the better entity to decide discrepancies in securities laws.<sup>219</sup> However, both of these contentions are debatable.

First, the cost and time efficiency of SEC administrative proceedings has been recently disputed. Although the procedures offered by the Rules of Practice technically provide for a quicker proceeding than those offered in federal court, a respondent in an administrative proceeding frequently must wait years until there is a hearing to review the facts and legal theories within the case.<sup>220</sup> Second, the SEC's assertion that it is the better forum to decide the interpretation of securities laws is seriously misguided.<sup>221</sup> The Chamber of Commerce's recommended framework urges that the SEC should only use its own administrative proceedings if the matter concerns legal principles that have already been decided by federal courts or if there is precedent within the SEC's administrative proceedings.<sup>222</sup>

The proposed rigid forum selection procedure solidifies the SEC's four suggested guidelines, and then also adds sub-criteria to the third and fourth prongs, which will consider the length of the investigative record as well as which forum would provide for a consistent development of securities law. When the SEC is considering the cost and time efficiency of a certain forum, it cannot just take its own needs into consideration; it must also consider the respondent's need for depositions, witness testimony, and time to review electronic documents. Although the SEC provided that it might take these factors into consideration, it also asserted that it does not have to.<sup>223</sup> Under this formal framework, the SEC would be required to realistically assess, on a case-by-case basis, whether an administrative proceeding provides the respondent with adequate time for pre-hearing discovery.<sup>224</sup>

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216. See Fons, *supra* note 204.

217. *Approach to Forum Selection*, *supra* note 121.

218. *Id.*

219. *See id.*

220. See Fons, *supra* note 204.

221. *See generally* Rakoff, *supra* note 14.

222. *See* RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 18.

223. *Approach to Forum Selection*, *supra* note 121.

224. *See* RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 18.

The SEC should also integrate the Chamber of Commerce's suggestions into the fourth prong of its suggested approach to forum selection. The SEC asserted that its own proceedings are the appropriate forum to address questions of federal securities laws or interpretations of SEC rules, while federal courts are typically only appropriate when the matter concerns a state law or "specialized areas of federal law."<sup>225</sup> However, using administrative proceedings to develop securities law provides for an "unchecked expansion of existing legal policy that is not adequately overseen for a truly impartial third-party judicial forum."<sup>226</sup>

This solution affirms the Chamber of Commerce's emphasis that the SEC should resist using its administrative proceedings to develop new law and make an effort to not abuse the choice of forum power granted by Dodd-Frank.<sup>227</sup> Although the SEC is an expert in securities law, and should no doubt be deferred to for certain issues, its authority over the securities law is not absolute. A government can still benefit from agency expertise "without being ruled by experts."<sup>228</sup> Therefore, when choosing a forum, the SEC should select its administrative proceedings only if the matter concerns an established legal principle implemented by federal courts, or if the alleged violations are similar to those already adjudicated and upheld in previous SEC enforcement actions.<sup>229</sup>

## CONCLUSION

Through recent amendments to its Rules of Practice, conceivably in response to the recommendations by the Chamber of Commerce, the SEC has taken a small step in increasing the fairness, consistency, and transparency of its administrative proceedings. However, that step may not have been big enough. In order to truly ensure that the SEC does not abuse its choice of forum power, and that its administrative proceedings are indeed fair to all parties (if chosen), the SEC must first further revise its Rules of Practice to extend the time provided for discovery. In order to counteract the advantage gained by the SEC as a result of a pre-discovery investigation, the SEC should allow for a pre-hearing discovery time of twelve months, on a case-by-case basis, giving the SEC and respondents the option of a two-month extension. Second, the Rules of Practice should also be amended to increase the amount of permitted depositions to six for each party. This change brings the Rules of Practice closer to the Federal Rules of Civil Procedure, and thus allows respondents of a complex case the opportunity to build a stronger defense. Third, the SEC should adopt hearsay procedures more closely aligned with the Federal Rules of Evidence. This is preferable to the current

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225. *Approach to Forum Selection*, *supra* note 121.

226. RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 19.

227. *See id.*

228. *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 499 (2010).

229. *See* RECOMMENDATIONS ON CURRENT PROCESSES, *supra* note 6, at 18.

solution, which is to simply attach “unreliable” to the end of the of the excluded evidence list. Finally, instead of only providing an unofficial set of guidelines, with factors that the SEC may choose to consider at its own discretion, the SEC should implement a formal procedure for choosing a forum. Without the aforementioned changes, the SEC will continue to abuse its regulatory power and consumer and investor confidence in the SEC will surely diminish even further.

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