HEARING BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND INVESTMENT

OF THE COMMITTEE ON FINANCIAL SERVICES

OF THE HOUSE OF REPRESENTATIVES

Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement

Testimony of Andrew N. Vollmer

June 13, 2018

Chairman Huizenga, Ranking Member Maloney, and Members of the Subcommittee:

I am pleased to have an opportunity to comment on several timely and important issues about the approach of the Securities and Exchange Commission to enforcing the federal securities laws. I will address (1) general problems with SEC enforcement, (2) disgorgement, limitations periods, and the length of investigations, (3) the role of administrative proceedings in enforcement of the federal securities laws, and (4) the role of civil enforcement of securities laws by states.

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

Enforcement of the federal securities laws should be vigorous but fair. Fair treatment of defendants increases accuracy of results, promotes the legitimacy and acceptability of the enforcement process, fosters respect for the law, and therefore advances the statutory goals of encouraging capital formation while protecting investors and markets. The SEC enforcement process should be based on the rule of law and should provide each defendant with adequate advance notice of specific and identifiable standards of conduct, a meaningful opportunity to prepare and present a defense, and an ability to bring cases that lack merit to a rapid close. Fairness to

defendants should be one of the highest values protected by the process used to enforce the federal securities laws.

General

In an article a few years ago, I suggested several ways to improve the SEC enforcement process. Four Ways To Improve SEC Enforcement, 43 Sec. Reg. L.J. 333 (2015). The article said that the SEC could extend more fairness and consideration to defendants without any damage to tough enforcement by:

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

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

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

Disgorgement, limitations periods, and the length of investigations

One of my concerns about the SEC enforcement process is with the length of investigations. This is an area in which attention from Congress could be helpful.

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

Too frequently, however, the Commission does not complete an investigation within five years and initiates an enforcement action based on alleged misconduct many years old. The staff of the Division of Enforcement often avoids the effect of the limitations period by entering into one or more tolling agreements. In a tolling agreement, the person being investigated agrees with the staff to suspend the running of time for purposes of calculating any limitations period. See SEC Division of Enforcement, Enforcement Manual 3.1.2 (November 28, 2017).

Long investigations and the use of tolling agreements signal a need for stricter application of limitations periods. "Statutes of limitation are vital to the

welfare of society and are favored in the law. They are found and approved in all systems of enlightened jurisprudence. They promote repose by giving security and stability to human affairs." Wood v. Carpenter, 101 U.S. 135, 139 (1879). Important public policies lie at their foundation: "repose, elimination of stale claims, and certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities." Rotella v. Wood, 528 U.S. 549, 555 (2000). "A federal cause of action "brought at any distance of time" would be "utterly repugnant to the genius of our laws." Adams v. Woods, 2 Cranch 336, 342 (1805). As time goes by, evidence becomes less reliable, and the results of investigations and litigation become less accurate. "Just determinations of fact cannot be made when, because of the passage of time, the memories of witnesses have faded or evidence is lost. In compelling circumstances, even wrongdoers are entitled to assume that their sins may be forgotten." Wilson v. Garcia, 471 U.S. 261, 271 (1985).

Long investigations cause other social harms. They create uncertainty, which can lead businesses to fail or postpone research and investment in potentially beneficial goods and services. Individuals suffer. They can be fired or put on administrative leave during investigations even when no misconduct occurred. The existence of an investigation can become public, injuring reputations and causing investors to withdraw money and customers to abandon a company. The longer an investigation, the worse these problems are.

For these reasons, Congress should be reluctant to lengthen limitations periods for SEC cases. It should lengthen the limitations period for the SEC only if it receives convincing data that a substantial problem with the current five-year

period exists and that five years is not sufficient for an effective enforcement program. Has the SEC been unable to obtain adequate relief in a large number of cases because of the limitations period? Even if some such cases exist, does that justify extending the limitations period for all SEC cases? A longer limitations period is likely to lead to longer and longer investigations. A ten-year period seems inordinately long given the catalogue of ills from lengthy investigations and litigation based on old conduct.

If Congress is convinced that the five-year period prevents obtaining effective relief in a sufficient number of cases, the better approach would be to define specific exceptions from the five-year period. Exceptions should be few. The SEC should be obliged to prove that a case involved serious and widespread misconduct and that the SEC could not reasonably have commenced an action within a five-year period for an alleged violation occurring more than five years ago.

Congress also should address additional matters if it is inclined to reconsider the limitations period for SEC cases. First, a limitations period should apply to the power of the SEC to commence an enforcement case and should not apply to any particular form of relief. The statute of limitations should not be tied to fines, disgorgement, injunctions, or other relief. That is how section 2462 operates now, but that statute presents a variety of interpretive difficulties and is not the best approach. The expiration of a limitations period should stop the SEC from suing.

Second, a limitations period should apply to SEC enforcement cases brought in district court or as administrative proceedings. The litany of social harms from

long investigations and ancient misconduct exists no matter what forum the SEC uses.

Third, a limitations period should not be connected to compensation for investor losses. The Kokesh opinion did that for purposes of analyzing the language in section 2462, but Congress has no reason to connect the two. It has authority to set a limitations period of reasonable length and reasonable terms without linking the period to the return of funds to harmed investors.

Congress has never given the SEC power to calculate a monetary recovery based on investor loss or damage. Congress has given the SEC many different forms of relief, but they have all related to prevention and deterrence, such as injunctions, civil penalties, and revocation of a person's registration as a broker-dealer or investment adviser. Private actions recover loss, but private actions provide a defendant with a variety of procedural protections not available in SEC enforcement cases. Those protections include the plaintiff's need to prove reliance, loss, and loss causation and to meet higher pleading standards. Granting the SEC the power to sue for compensation for investor damage would be a sharp break from precedent with unpredictable consequences.

Fourth, a new statute of limitations should restrict and control tolling agreements. The staff currently uses them to prolong the five-year limitations period. Congress might not want to prohibit all tolling agreements, but they should be rare.

The role of SEC administrative proceedings in enforcement of the federal securities laws

SEC administrative enforcement proceedings have been the subject of serious criticism and complaint for decades. Congress should take action to address the concerns and has several different approaches it could take.

The basic problem with SEC administrative proceedings (APs) is that they are either inherently unfair to defendants or appear to be unfair. Defendants caught up in the process emerge with a sense that they did not receive the same even-handed and impartial consideration from an AP that they would have received in district court. The first level of adjudication is before an administrative law judge (ALJ) who has or appears to have reasons to favor the SEC. The second level of adjudication is before the Commission itself, which is the same body that voted to charge the defendant. A defendant could be forgiven for questioning whether the body – sometimes the very same Commissioners -- that sued him is entirely open-minded on the ultimate question of whether he committed the violation.

In addition, the procedures used at the ALJ level hamper a defendant's ability to prepare and present a full defense. The SEC staff spends years investigating potential violations. They have subpoena power and often amass an enormous investigative record. Only part of that record is available to a defendant before the SEC sues. After the SEC sues, APs are on a short time schedule. That short schedule can have advantages over district court litigation but generally favors the SEC because the staff is already more familiar with the facts and evidence than the

defendant. The SEC must disclose most (but not all) of the record to the defendant, but the shortness of time seriously impairs considered review of the record, especially in large or complicated matters.

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

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

The SEC rules of practice also do not provide a defendant with an early mechanism to test the legal validity of a claim. In district court, the motion to dismiss is a common first step.

A jury is not available in an SEC AP. Some would argue that the unavailability of a jury is a disadvantage of APs.

Empirical research has only a limited ability to sort through a comparison of the fairness of APs and district court cases. The results in district court cases cannot

just be compared to the results of APs because the allocation of enforcement cases between court and APs is not random. The SEC staff and the Commissioners decide on the allocation. They are human and make decisions for many different reasons. They could be sending easier or more difficult cases to APs, or the likelihood of success in the two categories of cases could be the same. An amicus brief in the Supreme Court in Lucia v. SEC filed by Professors Velikonja and Grundfest discuss the research issues (page 6).

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

A second approach would be to make APs as fair to defendants as district court cases. Whether that could be accomplished is not clear. The SEC Rules of Practice would need to be overhauled to give defendants an adequate opportunity

to obtain information and to prepare and present a complete defense. Congress could require SEC APs to use the Federal Rules of Civil Procedure and the Federal Rules of Evidence after having a group of experts modify the Rules specifically for use before ALJs. The Federal Rules are highly regarded, treat all parties equally, and have held up well over time. ALJs would need to be independent from the Commission, but constitutional problems with appointment and removal would need to be resolved. More thought should be given to the triple role of SEC Commissioners. They adopt substantive rules of conduct, initiate enforcement cases, and then make final determinations of violations when reviewing ALJ decisions. Concentrating that much power and discretion in the same small group of individuals cannot be healthy or appropriate in our system of government. I discussed the due process issues from the combination of charging and adjudicating functions in a recent paper: Accusers as Adjudicators in Agency Enforcement Proceedings, http://ssrn.com/abstract=3171674 and forthcoming in 52 U. Mich. J.L. Reform.

A third approach would be to give defendants in APs the right to move the case to district court. This is the removal concept. The idea has several variations, including the one in H.R. 2128, which gives a defendant in an AP an absolute right to require the SEC to proceed in court but only if the AP seeks a cease-and-desist order and a penalty. Other variations create complicated removal procedures that rely on vague and subjective standards to be applied by the district court. The more complicated versions could add cost, delay, and uncertainty to the enforcement process.

My preference is to let the SEC make the initial forum selection, as it does now, but then give a defendant in any type of AP a right to transfer the case to district court. The right would be unqualified and unreviewable. The approval of the district court would not be needed. This approach would be simple and fast and would allow each defendant to consider the specifics of the particular case and decide whether an AP or a district court would produce a more accurate and fairer result. Under this approach, the number of cases each year that would be entitled to use a removal right would not be too large and should not burden the federal courts. The right would matter only when a defendant intended to contest the SEC charges and would not be used when a defendant settled at the time of initiation or very soon after initiation.

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

The role for civil enforcement of securities laws by states

The final topic concerns the extent to which federal law should pre-empt civil enforcement of securities laws by states. Currently, federal law has a complicated arrangement with state law in the securities area, but federal law generally preserves the power of state securities authorities to investigate and bring enforcement actions (section 18(c)(1) of the Securities Act and section 28(f)(4) of the Exchange Act).

State enforcement of securities laws can be valuable, especially when a problem is limited to one or a small number of states and involves local activities, such as the actions of a few local securities sellers or employees of a broker-dealer or investment adviser. Many times, however, state enforcement targets a perceived problem that exists nationwide and might be the subject of an SEC or FINRA investigation. In those cases, state enforcement can lead to novel theories of liability and standards of conduct or to piling on to the efforts of other regulators.

H.R. 5037 is on the right track. It properly concentrates on the need for national uniformity of legal standards and the need to reduce and minimize the costly overlap and duplication of the federal and state systems of regulating the securities area. The bill is limited to securities fraud, broadly defined, and to securities listed on major national stock exchanges. That would be an important first step, but the principles underlying the bill usefully could be extended to all regulatory obligations in addition to the anti-fraud provisions and to all securities transactions other than those having a distinctly local nature.

Background

I am Professor of Law, General Faculty, and Director of the John W. Glynn, Jr. Law & Business Program at the University of Virginia School of Law. I teach Securities Regulation, Advanced Topics in Securities Regulation, and Securities Litigation and Enforcement. I was Deputy General Counsel of the Securities and Exchange Commission from mid-2006 to March 2009 and was a partner in the securities litigation and enforcement practice of Wilmer Cutler Pickering Hale and Dorr LLP before and after my time at the SEC. While at the Commission, one of my main areas of responsibility was to advise the Commissioners and the Division of Enforcement on legal aspects of contemplated enforcement proceedings. While in private law practice, I represented many individuals and companies that were in SEC investigations and private securities litigation or that discovered potential misconduct before an investigation or private litigation began.

I have written on various aspects of the SEC enforcement process:

Accusers as Adjudicators in Agency Enforcement Proceedings, http://ssrn.com/abstract=3171674 and forthcoming in 52 U. Mich. J.L. Reform.

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

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

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

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

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