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115TH CONGRESS 2d Session } HOUSE OF REPRESENTATIVES { REPORT 115–1118

DUE PROCESS RESTORATION ACT OF 2017

JANUARY 2, 2019.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. HENSARLING, from the Committee on Financial Services, submitted the following

R E P O R T

together with

MINORITY VIEWS

[To accompany H.R. 2128]

The Committee on Financial Services, to whom was referred the bill (H.R. 2128) to amend the Securities Exchange Act of 1934 to permit private persons to compel the Securities and Exchange Commission to seek legal or equitable remedies in a civil action, instead of an administrative proceeding, and for other purposes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

PURPOSE AND SUMMARY

The ability for the U.S. Securities and Exchange Commission (SEC) to control the forum in which an action is brought raises due process concerns because the SEC's in-house tribunals do not guarantee respondents the same types of rules and processes that help ensure fairness in the U.S. justice system. For example, SEC administrative proceedings do not afford respondents the same protections as they would receive under the Federal Rules of Civil Procedure and the Federal Rules of Evidence, and respondents do not have the opportunity to have a jury trial. To address these concerns, on April 25, 2017, Representative Warren Davidson introduced H.R. 2128, the "Due Process Restoration Act to provide respondents in actions brought by SEC in an "in-house" administrative proceeding with the ability to have their case removed to a federal district court. The legislation requires the "clear and con-

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vincing evidence" standard of proof to be used in an action brought by the SEC in an administrative proceeding.

BACKGROUND AND NEED FOR LEGISLATION

Investor protection is a serious issue, and it merits the level of seriousness other violations of the law require in our legal system. Accordingly, the goal of H.R. 2128 is to afford respondents in SEC civil enforcement cases with fair and transparent processes when accused of wrongdoing by providing the ability of the respondents to remove cases to federal district court. Nothing in the bill requires a respondent to remove a case, and nothing in the bill inhibits the SEC's ability to pursue the action in civil court.

Specifically, H.R. 2128 would: (1) grant a defendant in a SEC administrative proceeding against whom a cease and desist order and a penalty may be issued the right to terminate the proceeding, not later than 20 days after receiving notice of such proceeding; (2) permit the SEC to bring the same action in federal court against that person who terminated the administrative proceeding and seek the same remedy that might have been imposed; and (3) raise the burden of proof for cases that remain in SEC administrative proceedings to a higher 'clear and convincing' standard.

Under the prior Administration, the SEC increasingly turned to its own administrative law judges (ALJs)—rather than the federal courts—to adjudicate enforcement actions. SEC administrative proceedings are quasi-judicial proceedings in which ALJs appointed by the SEC adjudicate enforcement actions under SEC rules. Under former-SEC Chair Mary Jo White, senior SEC officials in the Enforcement Division praised the efficiency of these administrative proceedings and confirmed that they will be used more extensively in the future. During FY 2014, the SEC's Enforcement Division won all six of its litigated administrative proceedings, compared to only 11 of its 18 cases brought in federal court. While the SEC under the leadership of Chairman Jay Clayton has been more measured in its reliance on ALJs, a different Commission could revert back to the troubling trend relied on by former-Chair White.

The shift from litigation in federal court to administrative proceedings has afforded the SEC distinct "home court" advantages that, if abused, could undermine the United States' reputation for transparent and open capital markets and a blind justice system. First, administrative proceedings are handled by ALJs hired and employed by the SEC pursuant to SEC procedural rules that favor the agency's lawyers—*i.e.,* the use of hearsay and other unreliable evidence and limits on pretrial discovery and common defense motions allowed in courts. Because administrative proceedings overwhelmingly favor the SEC, and because appeals impose significant burdens on respondents, the SEC has used these proceedings at times to entice the targets of its enforcement actions to settle. In fact, a former head of the Enforcement Division publicly admitted in 2014 that "there have been a number of cases in recent months where [the SEC has] threatened administrative proceedings, it was something we told the other side we were going to do and they settled."

Section 929P of the Dodd-Frank Act amended the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940 and the Investment Company Act of 1940 and made administrative proceedings even more attractive for the SEC by greatly expanding the SEC's authority to obtain civil penalties in administrative proceedings against *any* person or entity. Before the enactment of Section 929P, the SEC could only obtain civil money penalties in administrative proceedings against regulated entities such as brokers, dealers, investment companies, and investment advisers. Now, Section 929P authorizes the SEC to obtain civil money penalties in administrative proceedings against any person or entity who violates the federal securities laws.

While the SEC has publicly supported administrative proceedings as a more efficient way to resolve enforcement matters, critics have decried the inherent unfairness of the SEC's use of administrative proceedings. Former-SEC Commissioner Michael Piwowar has pointed out that the change to administrative proceedings "has the appearance of the Commission looking to improve its chances of success by moving cases to its in-house administrative system." After all, in federal court cases seeking penalties, a defendant not only can take full discovery—including depositions of all the key individuals—he has a right to a jury trial presided over by a federal judge appointed pursuant to Article III of the U.S. Constitution. Administrative proceedings, on the other hand, may not permit all depositions a respondent thinks may be necessary and are heard before an ALJ—who is an employee of the SEC whose decision is subject to an appeal to the full Commission that employees the ALJ and authorized the enforcement action in the first place; only then can a defendant appeal to a U.S. Court of Appeals. In testimony before the Subcommittee on Capital Markets, Securities, and Investment, Andrew Vollmer highlighted the concerns with the ALJ process saying,

> 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 evenhanded 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.

As Bradley J. Bondi outlined in testimony before the same Subcommittee hearing:

> The perceived unfairness may be due to the fact that the SEC appears to have won more frequently in administrative proceedings than in district court. In 2015, The Wall Street Journal reported that from October 2010 through March 2015, the SEC won 90% of its administrative proceedings, while in the same period the SEC prevailed in only 69% of the cases it brought in federal district court. Furthermore, a 2016 study suggested that, after Dodd-Frank, the SEC has shifted weaker cases from district

court to administrative proceedings or has brought actions as administrative proceedings that it would not have brought at all before Dodd-Frank.

Such criticisms have led SEC Commissioners, market participants, and at least two federal judges to question the constitutionality of SEC administrative proceedings. In June 2015, a federal district court in Atlanta found that the SEC's use of an in-house judge to preside over an insider-trading case was "likely unconstitutional" because the SEC's appointed ALJ was hired through its office of in-house judges, rather than being appointed by the five commissioners. Similarly, a Manhattan federal judge ruled on August 12, 2015, in a separate case that a proceeding presided over by an SEC ALJ was "likely unconstitutional." Like his counterpart in Atlanta, this judge questioned the validity of the SEC's process for appointing ALJs, on the ground that the Commissioners who run the SEC should choose the ALJ, rather than less senior people within the agency.

On August 9, 2016, the U.S. Court of Appeals for the District of Columbia Circuit issued its opinion in *Lucia* v. *SEC*, which held that the SEC's use of ALJs is constitutional. The D.C. Circuit ruled that the SEC's use of ALJs does not violate the Appointments Clause of the Constitution because, rather than acting as officers of the United States, the SEC's ALJs act as employees who lack the authority to issue "final decisions." Under the Constitution, the President must appoint "inferior officers", the head of a federal agency or by a court. But in November 2017, the Trump administration stopped defending the SEC's position, telling justices that the agency's judges are officers subject to the appointments clause and urged the Supreme Court to hear the case because other agencies also employ judges in a manner similar to the SEC. Following this reversal, the SEC has attempted to ratify its prior appointment of the five current administrative law judges to avoid challenges over pending administrative proceedings. In January 2018, the Supreme Court agreed to take up an appeal of *Lucia* and heard oral argument on April 23, 2018.

The Supreme Court issued a decision of June 21, 2018, stating that ALJs are "officers" who must be appointed to their position by the "heads of Departments" under the Constitution's Appointments Clause. However, the Supreme Court did not rule on whether the Commission's ratification of its prior ALJ appointments was valid. Following the decision, the SEC put a stay on all pending administrative proceedings. The SEC lifted the stay on August 22, 2018. Respondents in SEC pending administrative proceedings now are afforded the opportunity to be reheard before another ALJ.

While H.R. 2128 addresses a distinct issue regarding the fairness of administrative proceedings than at the heart of *Lucia*, this court case underscores the importance of ensuring administrative proceedings are not perceived as biased. H.R. 2128 does ensure important protections in that regard. Further, while the SEC did implement some revisions to its rules of practice that govern administrative proceedings, those revisions—as set forth above—fall short of the procedural safeguards that underscore the trust market participants have in the U.S. federal court system. The SEC's changes to its rules of practice neglect to establish—at least publicly—criteria for when the SEC will bring an action in an administrative proceeding rather than in federal court.

In response to the SEC's shift toward administrative proceedings under the prior Administration and the fact that no safeguards exist from another Commission to follow such a course, the Committee on Financial Services first considered legislation to provide for the removal of SEC administrative proceedings to federal court during the 114th Congress. Stanford University professor Joseph Grundfest testified before the Subcommittee on Capital Markets and Government Sponsored Enterprises on December 2, 2015, about the legislation and noted that the, "agency's push to administrative proceedings raises a concern that it is on a mission systematically to substitute its interpretation of the federal securities laws for that of the federal judiciary." In the 115th Congress, H.R. 10, the Financial CHOICE Act of 2017, included language similar to Rep. Davidson's H.R. 2128, the Due Process Restoration Act. H.R. 2128 provides legal certainty and predictability to respondents in SEC enforcement actions and in doing so, ensures that they receive all of their Constitutional due process protections.

HEARINGS

The Committee on Financial Services held a hearing examining matters relating to H.R. 2128 on April 26 and 28, 2017 and June 13, 2018.

COMMITTEE CONSIDERATION

The Committee on Financial Services met in open session on September 13, 2018, and ordered H.R. 2128 to be reported favorably to the House without amendment by a recorded vote of 31 yeas to 20 nays (recorded vote no. FC–209), a quorum being present.

Record vote no. FC-209

Representative	Yea	Nay	Present	Representative	Yea	Nay	Present
Mr. Hensarling	X			Ms. Maxine Waters (CA)		X	
Mr. McHenry	X			Mrs. Carolyn B. Maloney (NY)		X	
Mr. King	X			Ms. Velázquez		X	
Mr. Royce (CA)				Mr. Sherman		X	
Mr. Lucas	X			Mr. Meeks			
Mr. Pearce				Mr. Capuano			
Mr. Posey	X			Mr. Clay			
Mr. Luetkemeyer	X			Mr. Lynch		X	
Mr. Huizenga	X			Mr. David Scott (GA)		X	
Mr. Duffy	X			Mr. Al Green (TX)		X	
Mr. Stivers	X			Mr. Cleaver			
Mr. Hultgren	X			Ms. Moore		X	
Mr. Ross	X			Mr. Ellison			
Mr. Pittenger				Mr. Perlmutter		X	
Mrs. Wagner	X			Mr. Himes		X	
Mr. Barr	X			Mr. Foster		X	
Mr. Rothfus	X			Mr. Kildee		X	
Mr. Messer	X			Mr. Delaney		X	
Mr. Tipton	X			Ms. Sinema		X	
Mr. Williams	X			Mrs. Beatty		X	
Mr. Poliquin	X			Mr. Heck		X	
Mrs. Love	X			Mr. Vargas		X	
Mr. Hill	X			Mr. Gottheimer			
Mr. Emmer	X			Mr. Gonzalez (TX)		X	
Mr. Zeldin	X			Mr. Crist		X	
Mr. Trott	X			Mr. Kihuen		X	
Mr. Loudermilk	X						
Mr. Mooney (WV)	X						
Mr. MacArthur	X						
Mr. Davidson	X						
Mr. Budd	X						
Mr. Kustoff (TN)	X						
Ms. Tenney	X						
Mr. Hollingsworth	X						

Committee Votes

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. The sole recorded vote was on a motion by Chairman Hensarling to report the bill favorably to the House without amendment. The motion was agreed to by a recorded vote of 31 yeas to 20 nays (Record vote no. FC–209), a quorum being present.

Committee Oversight Findings

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the findings and recommendations of the Committee based on oversight activities under clause 2(b)(1) of rule X of the Rules of the House of Representatives, are incorporated in the descriptive portions of this report.

Performance Goals and Objectives

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee states that H.R. 2128 will ensure fairness and protect substantive rights by enhancing procedural due process rights for defendants in SEC enforcement matters.

New Budget Authority, Entitlement Authority, and Tax Expenditures

The Committee has not received an estimate of new budget authority contained in the cost estimate prepared by the Director of the Congressional Budget Office pursuant to Sec. 402 of the Congressional Budget Act of 1974. In compliance with clause 3(c)(2) of rule XIII of the Rules of the House, the Committee opines that H.R. 2128 will not establish any new budget or entitlement authority or create any tax expenditures.

Congressional Budget Office Estimates

The cost estimate prepared by the Director of the Congressional Budget Office pursuant to Sec. 402 of the Congressional Budget Act of 1974 was not submitted timely to the Committee.

Federal Mandates Statement

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995.

The Committee has determined that the bill does not contain Federal mandates on the private sector. The Committee has determined that the bill does not impose a Federal intergovernmental mandate on State, local, or tribal governments.

Advisory Committee Statement

No advisory committees within the meaning of section 5(b) of the Federal Advisory Committee Act were created by this legislation.

Applicability to Legislative Branch

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of the section 102(b)(3) of the Congressional Accountability Act.

Earmark Identification

With respect to clause 9 of rule XXI of the Rules of the House of Representatives, the Committee has carefully reviewed the provisions of the bill and states that the provisions of the bill do not contain any congressional earmarks, limited tax benefits, or limited tariff benefits within the meaning of the rule.

Duplication of Federal Programs

In compliance with clause 3(c)(5) of rule XIII of the Rules of the House of Representatives, the Committee states that no provision of the bill establishes or reauthorizes: (1) a program of the Federal Government known to be duplicative of another Federal program; (2) a program included in any report from the Government Accountability Office to Congress pursuant to section 21 of Public Law 111–139; or (3) a program related to a program identified in the most recent Catalog of Federal Domestic Assistance, published pursuant to the Federal Program Information Act (Pub. L. No. 95–220, as amended by Pub. L. No. 98–169).

Disclosure of Directed Rulemaking

Pursuant to section 3(i) of H. Res. 5, (115th Congress), the following statement is made concerning directed rule makings: The Committee estimates that the bill requires no directed rule makings within the meaning of such section.

Section-by-Section Analysis of the Legislation

Section 1. Short title

This section cites H.R. 2128 as the "Due Process Restoration Act of 2017".

Section 2. Private parties authorized to compel the securities and exchange commission to seek sanctions by filing civil actions

This section amends the Securities Exchange Act of 1934 by adding 'SEC. 40' to allow an individual who is a party to an administrative proceeding brought by the Commission to terminate that proceeding within 20 days of receiving notice and, in such instances, to authorize the SEC to bring a civil action against the person. The section also permits a legal or equitable penalty to be imposed upon a person against whom an action is brought in an administrative proceeding only if the Commission provides clear and convincing evidence that the person violated the law.

Changes in Existing Law Made by the Bill, as Reported

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, and existing law in which no change is proposed is shown in roman):

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (new matter is printed in italic and existing law in which no change is proposed is shown in roman):

SECURITIES EXCHANGE ACT OF 1934

TITLE I—REGULATION OF SECURITIES EXCHANGES

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SEC. 40. PRIVATE PARTIES AUTHORIZED TO COMPEL THE COMMISSION TO SEEK SANCTIONS BY FILING CIVIL ACTIONS.

(a) TERMINATION OF ADMINISTRATIVE PROCEEDING.—In the case of any person who is a party to a proceeding brought by the Commission under a securities law, to which section 554 of title 5, United States Code, applies, and against whom an order imposing a cease and desist order and a penalty may be issued at the conclusion of the proceeding, that person may, not later than 20 days after receiving notice of such proceeding, and at that person's discretion, require the Commission to terminate the proceeding.

(b) CIVIL ACTION AUTHORIZED.—If a person requires the Commission to terminate a proceeding pursuant to subsection (a), the Commission may bring a civil action against that person for the same remedy that might be imposed.

(c) STANDARD OF PROOF IN ADMINISTRATIVE PROCEEDING.—Notwithstanding any other provision of law, in the case of a proceeding brought by the Commission under a securities law, to which section 554 of title 5, United States Code, applies, a legal or equitable remedy may be imposed on the person against whom the proceeding was brought only on a showing by the Commission of clear and convincing evidence that the person has violated the relevant provision of law.

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MINORITY VIEWS

H.R. 2128 would undermine the Securities and Exchange Commission's (SEC) enforcement efforts based on the erroneous belief that Wall Street bad actors are being treated unfairly. Specifically, the bill would allow a party subject to a cease-and-desist order and a monetary penalty in an SEC administrative enforcement action to require the SEC to bring the case in federal court. Moreover, the bill would subject the SEC to a heightened burden of proof if the respondent chose to keep the case in an administrative forum. As a result, alleged violators of federal securities laws could select a venue based on their own interests, rather than the interests of the public.

The SEC uses administrative enforcement proceedings to quickly stop financial bad actors and prevent them from causing further harm to investors and the U.S. capital markets. These proceedings have the benefit of conserving valuable agency resources by allowing the SEC to efficiently resolve enforcement actions, which could drag on for years in the congested federal court system. During a recent hearing before the Subcommittee on Capital Markets, Securities, and Investment, the Majority's own witness, securities lawyer Bradley J. Bondi, who represents public companies and financial institutions in SEC enforcement matters, testified about the importance of administrative resolution of securities cases. According to Mr. Bondi, "not all enforcement actions require the formality of federal district court. Some cases, such as those involving disciplinary actions against registered investment professionals and so-called 'follow-on' actions following a criminal prosecution, could be adequately brought as administrative proceedings, thereby avoiding adding to the already crowded federal docket." [1]

If H.R. 2128 were enacted, an alleged wrong-doer could choose between exploiting the delays involved in federal court litigation or receiving the benefit of a higher standard of proof in the SEC's administrative forum. Compared to the current standard, pursuant to which more that 50% of the evidence (*i.e.,* a "preponderance of the evidence") must support the SEC's claims, the bill's evidentiary burden would require the SEC to prove that its allegations are highly and substantially likely to be true. This so-called "clear and convincing evidence" standard would make it harder for the SEC to enforce securities laws and regulations and would create a disparity between the standards applied by an administrative judge and a federal judge when adjudicating the same violation.

There is no justification for thus tipping the scales of justice in favor of alleged securities fraudsters. Contrary to the assertions of

[1] Written Testimony of Bradley J. Bondi before the Subcommittee on Capital Markets, Securities, and Investment on "Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement" (June 13, 2018), *available at* https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-bbondi-20180613.pdf.

unfairness underlying H.R. 2128, SEC administrative proceedings are subject to substantial due process requirements, including protections that are not available to civil defendants in federal court. For example, in an administrative proceeding, SEC enforcement staff must turn over to the respondent any exculpatory material in the government's possession. This production is not required in federal civil litigation. Additionally, administrative judge decisions are subject to *de novo* review (*i.e.,* without any deference) by the full Commission, either at the respondent's request or on the Commission's own initiative. If the respondent disagrees with the Commission's final decision, they can challenge it before a federal court of appeals.

H.R. 2128 is an unwarranted bill that would hamper the SEC's ability to hold bad actors accountable, protect investors, and maintain market integrity. Financial Services Committee Democrats, who rejected similar legislation in the 114th Congress, unanimously voted against H.R. 2128 when the bill was marked up. Americans for Financial Reform, Public Citizen, Center for Justice and Democracy, Consumer Action, Consumers for Auto Reliability and Safety, Main Street Alliance, and National Association of Consumer Advocates, also oppose the changes contemplated by this legislation. Similarly, state securities regulators represented by the North American Administrators Association, urged the Committee to reject H.R. 2128, stating that the bill, "would disrupt our securities markets and the efficient functioning of the federal judiciary."

For these reasons, we oppose H.R. 2128.

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