Do Politics Matter to this Watchdog?
The Effects of Ideology on Civil Enforcement at the United States Securities and Exchange Commission

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ABSTRACT

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My goal in this dissertation is to examine whether the political ideology of the federal courts, as well as the ideology of political principals in Congress and the executive branch, affect the decision making and behavior of an independent U.S. agency. The agency’s decision making pertains specifically to the application of its powers both directly through its politically appointed leadership and bureaucrats, and indirectly through a private litigation regime, in a policy area – civil enforcement – that should normatively be mostly free from politics.

As a foundation for the study, I analyze the public civil enforcement program and related policy and procedural components of the United States Securities and Exchange Commission (SEC) to determine whether political ideology – and other factors – influence the agency’s strategic decision making and behavior relating to its direct bureaucratic powers of civil prosecution. I generally focus the analysis on the SEC’s selection of forum in enforcement cases. My research examines whether the agency is less likely to utilize the forum of federal court for civil enforcement actions, and will opt instead for an administrative forum, when the ideology of the court that will likely hear a case is conservative, and whether the agency is more likely to utilize the federal court system when the ideology of the court that will likely hear a case is liberal.

My analysis supports a conclusion that although the characteristics of individual civil enforcement cases play a prominent role in the SEC’s strategic decision making, the
impact of political ideology is significant and comparable in magnitude. The data analysis reveals that the ideology of the lower federal courts at the district level is a material factor in the strategic decision making of the SEC in its enforcement program. It also shows that the politics of some of the agency’s political principals – congressional committees responsible for the oversight and annual budget of the SEC – significantly affect the agency’s strategic enforcement behavior. This element of my research extends a line of political science literature that analyzes who controls the federal bureaucracy.

I then use a different research perspective to broaden my analysis of the SEC’s enforcement behavior by examining its measured role in private securities litigation as a strategic extension of its public civil enforcement program, and explain how the agency carefully leverages the private regime to help achieve its enforcement mission. In this part of the dissertation, I conclude that the SEC actively and directly participates in the private enforcement regime through a strategic program of filing amicus curiae briefs, and participates indirectly through the fruits of its public civil enforcement litigation. This component of the dissertation rounds out my analysis by revealing an unexpected strategic dimension the agency leverages to achieve its mission.
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Chapter 1
Introduction

My goal in this dissertation is to examine whether the political ideology of the federal courts, as well as the ideology of political principals in Congress and the executive branch, affect the decision making and behavior of an independent U.S. agency. The agency’s decision making pertains specifically to the application of its powers both directly through its politically appointed leadership and bureaucrats and indirectly through a private litigation regime in a policy area – civil enforcement – that should normatively be mostly free from politics.

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“A funny thing happened on the way to this forum…”

So began the July 11, 2011 opinion of federal Judge Jed S. Rakoff in the Southern District of New York (SDNY) in the litigation matter Rajat K. Gupta v. SEC.

Gupta was a high-profile defendant embroiled in a high-profile public civil enforcement case by the SEC. He was not a member of the Wall Street community, but was an elite businessman and extensive philanthropist. He was chairman of the

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1 Judge Rakoff derived this clever hook to his opinion from Stephen Sondheim’s Tony Award-winning musical, “A Funny Thing Happened on the Way to the Forum,” which opened on Broadway in May 1962.

consulting firm McKinsey & Co. and served on more than a dozen prominent boards of directors, including the Goldman Sachs Group and the Procter & Gamble Company.

Earlier in 2011, the SEC had filed an administrative proceeding against Gupta,\(^3\) accusing him of leaking material nonpublic information that he had obtained in Goldman Sachs and Procter & Gamble board meetings to Raj Rajaratnam, who in turn traded on the information and made illicit profits (and avoided losses) totaling more than $23 million.\(^4\)

Rajaratnam and Galleon themselves had been the targets of a massive insider trading investigation by the SEC and the U.S. Department of Justice (DOJ) that had resulted in the billionaire hedge-fund founder being convicted after a seven-week jury trial of all fourteen criminal counts of insider trading he was charged with, fined ten million dollars and sentenced to eleven years in jail – the longest term ever handed down by a federal court for insider trading.\(^5\) As the probe unfurled over two years, it ensnared – through an aggressive strategy of wiretapping whose application to financial fraud rather than organized crime was novel – twenty-two senior executives from companies and firms like I.B.M., Intel and Bear Stearns, and seven business entities who were flouting securities laws by illegally sharing and trading on material nonpublic information. This group included Gupta.

The key difference between Gupta and the other twenty-eight defendants in this legal drama, however, was that the SEC brought its charges in the case against its star

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\(^4\) The administrative proceeding was originally before the SEC’s Chief Administrative Law Judge (ALJ), Brenda Murray. I thank Chief ALJ Murray here for suggesting that this case captured the essence of a key part of my research (Chief ALJ Brenda Murray, Interview (2011)).

defendant through the forum of administrative proceedings, whereas the agency litigated against each of the remaining parties in the forum of federal court in the SDNY. The charges the SEC brought and remedies it sought against Gupta were substantially the same as for the other defendants – only the forum was different.

In response, Gupta filed a Complaint and Demand for Jury Trial in federal court in the SDNY, alleging, in part, that the SEC unjustly, and unconstitutionally, treated him differently than the other defendants in the related set of cases spawned by the Galleon investigation. Gupta also argued that the agency was attempting to apply remedy provisions of the new Dodd-Frank Act retroactively to alleged conduct of his that occurred prior to the passage of the Act. He claimed further that he would be denied his due process rights to oppose the first-ever application of these new provisions by the SEC because he would not have the option of a jury trial or the protections of the Federal Rules of Civil Procedure and Evidence – which govern discovery practice in federal court – in an administrative forum. Instead, the SEC Rules of Practice govern discovery in SEC administrative proceedings, and would potentially allow the admission of hearsay evidence while limiting Gupta’s options for taking depositions of witnesses and conducting a full range of discovery. In short, the Complaint claimed, “there is no benign and non-discriminatory explanation for the Commission’s…filing the action against (Gupta) administratively, rather than in federal court…(T)he only plausible

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6 Case 1:11-CV-01900-JSR, Document 1, Filed 3/18/11 (SDNY).

7 The Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, H.R. 4173 (July 21, 2010).

8 See note 65, infra, and accompanying discussion.
inference is that the Commission is proceeding…for the bad faith purpose of shoring up a meritless case by disarming its adversary.”

The SEC decided to respond by filing a Motion to Dismiss the Complaint, arguing that it was fundamentally empowered by federal statute to file a civil enforcement action in the forum of its choice regardless of the context of related cases. The agency reasoned further that if Gupta had a legal issue with the decision he would have to wait until the matter was ripe for appeal, that is, until the litigation ran its full, usual course – which included review by the Commissioners of the SEC. Gupta could then file an appeal to the Second Circuit federal court of appeals, which had the exclusive authority under the federal securities laws and the Administrative Procedure Act of 1946 (APA) to review administrative proceedings. The SEC thus claimed that district-level federal courts – like the SDNY – were not empowered to even consider a case like this because it had emerged from administrative proceedings.

Rakoff did not buy the agency’s position, but saw merit in one of the arguments put forth by Gupta. The judge decided to reject the SEC’s Motion to Dismiss and allow Gupta’s lawsuit to proceed. He narrowed the theory of the Complaint that could be argued in the suit to Gupta’s constitutional claim of equal protection, eliminating the need to create the first precedent in the federal courts on the legality of the retroactive application of the remedy provisions of the Dodd-Frank Act. This was a sound strategy because it could enable Rakoff instead to create precedent constraining the behavior of the SEC on constitutional grounds, giving his opinion input into the centuries-old debate on the separation of powers as well as on equal protection.

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After his initial humorous take in the opinion, Rakoff became critical of the behavior and decision making of the SEC. He discussed the potential in Gupta’s arguments that the agency may have violated his rights under the Equal Protection Clause of the U.S. Constitution since the SEC treated him differently from twenty-eight similarly situated defendants because it “decided it preferred its home turf.” In Chapter 2, I explain why the SEC does actually fare better in civil enforcement proceedings it brings before its administrative law judge (ALJ) corps – its ‘home turf’ – rather than in federal district court. According to Rakoff, the SEC’s strategy was a “seeming exercise in forum-shopping” that resulted in the “disparate” and possibly unconstitutional treatment of Gupta by the agency. He also implied that the agency utilized a home-field litigation advantage against this defendant because Gupta was “the one who most vigorously asserted his innocence.” Thus, the potential existed that the SEC did not act as a fair arbiter when deciding how to proceed with this case, but was perhaps motivated through internal politics to intimidate the defendant and others who would have the temerity to stand up rigorously to the agency in highly publicized – and therefore probably resource-intensive – civil enforcement actions.

Specifically, Rakoff emphasized that Gupta’s equal protection claim would not turn on whether the defendant actually committed the acts alleged by the SEC, or even on whether the SEC acted generally within its discretion to impose differential treatment on the defendant. Rather, the claim would be adjudicated based on “whether the SEC’s decision to treat Gupta differently…was irrational, arbitrary, and discriminatory.” It is worthwhile noting here that the agency could have acted ‘rationally’ in its own strategic interests on one level by trying to avoid a forum – federal district court – that was
potentially riskier than keeping the litigation in its administrative forum. On another level, however, the SEC could potentially appear to be making an ‘irrational’ decision if it could not justify its disparate treatment of the defendant under federal statutes and rules governing civil process in the case.

Also, Rakoff explained and qualified the nature of the district court’s jurisdiction in this matter. Contrary to the SEC’s arguments, Gupta did not have to wait for the administrative process to play out and appeal only to the federal circuit court of appeals. Since he alleged constitutional violations, the federal district court had “original jurisdiction” as granted by Congress in federal statute 28 U.S.C. §1331. Rakoff qualified this option by noting that a district court should not entertain every allegation of “selective prosecution” used merely as a diversionary tactic in litigation, and could readily dispose of questionable claims simply “through dismissal for failure to plead a plausible claim.” It appears that Congress intended, however, that its delegation of ‘original jurisdiction’ to the federal district courts apply precisely to this type of fact-pattern in a case. Rakoff implied this as he described why Gupta’s claim was worthy of at least a hearing:

Here…we have the unusual case where there is already a well-developed public record of Gupta being treated substantially disparately from 28 essentially identical defendants, with not even a hint from the SEC… why this should be so. A fear of abuse by litigants in other cases should never deter a federal court from its unfailing duty to provide a forum for vindication of constitutional protections…

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10 See discussion of this process in Chapter 2, “Option to Appeal Trial Outcome.”

11 Supra note 2 at 21.
Within a month following the Rakoff opinion, Gupta and the SEC agreed to a Joint Stipulation of Dismissal. Under the two-page agreement submitted to the district court, Gupta achieved his arguably short-sighted goal of compelling the SEC to drop its administrative proceeding against him. The SEC, for its part, was able to assert that it dropped the case solely in the “public interest,” thereby “avoid(ing) potential embarrassment from discovery of the reasons for its forum selection.” In addition to ‘avoiding embarrassment,’ it is likely that the SEC did not want to divulge its strategic decision making regarding forum selection and other critical elements comprising the development of a public civil enforcement case for future litigation opponents to study. If the agency had decided to litigate the issue of equal protection that Rakoff identified, it likely would have had to disclose details of its enforcement process during the discovery phase of the trial. The agency would have, perhaps, had to explicate the role that the ideology of the federal courts, the politics of Congress and the executive branch, and various case characteristics play in its internal deliberations regarding choice of forum.

Gupta won the proverbial battle, but did not win the war against the SEC. Ten weeks after the agreement, the SEC again brought insider trading charges against him, this time in the forum of federal court in the SDNY. The SEC’s charges closely tracked those it brought originally in the administrative forum. The SEC sought to compel Gupta through these civil charges to disgorge his illicit profits and pay steep penalties, and to essentially end his career in the private for-profit sector by permanently barring him from

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14 SEC Litigation Release No. 22140, October 26, 2011 (SEC v. Rajat K. Gupta and Raj Rajaratnam, Civil Action No. 11-CV-7566 (SDNY)).
serving on the board of directors of any public company and associating with any broker, dealer or investment adviser.

As I describe in Chapter 4, in the context of the forum of federal district court, the SDNY plays a key role in the enforcement strategy of the SEC. It is “unique geography” for the agency. The SEC views the SDNY as comprising a singularly experienced and intellectually sound set of judges. The district spawns many securities-fraud cases because the SEC field office in the SDNY is the agency’s largest, and myriad financial market issues arise from the district through the financial institutions based in Manhattan. The SEC will occasionally use the SDNY as well for statement cases for deterrence – as it did with the related defendants in the Galleon litigation prior to differentiating Gupta.

On the same day the SEC filed its civil enforcement action, the Federal Bureau of Investigation arrested Gupta after a federal grand jury indicted him on one count of conspiracy to commit securities fraud and five counts of securities fraud. The DOJ brought the charges through the U.S. Attorney’s Office for the SDNY. Rakoff was assigned the jury trial, and in June 2012 the jury convicted Gupta on the single count to commit conspiracy and on three counts of securities fraud. Rakoff sentenced Gupta, almost a year to the day he was arrested, to two years in prison, a year of supervised release and a five million dollar fine. As of this writing, Gupta is appealing his criminal conviction and the SEC’s civil claims against him remain pending.

The SEC’s Gupta litigation helps introduce and illustrate the magnitude of the issues at stake both to the agency and the individuals potentially affected by the behavior


and decision making of the SEC. The strategic decisions the SEC renders have ripple effects throughout the U.S. legal and political systems. The SEC places such a high value on protecting its strategic prerogative that it will expend substantial resources litigating against constraints on its authority to select particular forums in individual cases in order to maximize its chances of success in a program – civil enforcement – that plays a critical role in defining the agency and its mission to diverse, often competing, audiences.

Roots of Analysis – Influence of Ideology of Courts on Public Civil Enforcement Decision Making and Behavior of SEC

My research to determine whether the ideology of federal judges affects the decision making and behavior of the SEC pertaining to the agency’s direct powers of civil enforcement extends, in part, a line of political science literature analyzing who controls the federal bureaucracy. Its seed was planted from a study of the decisions of the Army Corps of Engineers (Army Corps) for granting permits to develop federal wetlands (Canes-Wrone 2003). That study took an original approach to identifying the potential effects of the political ideology of federal judges on agency decision making and behavior. It demonstrated that the ideology of the lower federal courts, even absent actual litigation involving the agency, did have an effect on the decisions of the Army Corps about whether to grant development permits (Id. at 213). Canes-Wrone (2006) followed this with subsequent research confirming the role of judicial ideology in influencing the behavior of the Army Corps, while adding the effect of congressional ideology to the analysis. She found that “Congress has more influence over bureaucratic
decision making than does the judiciary, but...the effect of the courts is of a comparable magnitude substantively” (Id. at 196).

A key behavioral implication from the Canes-Wrone research was that the Army Corps adapted its behavior based on how it anticipated federal courts, as guided by ideology, would ultimately respond to the agency’s decision making if the permitting process were to end in litigation. I expound upon and apply this concept to the models in my dissertation that test the determinants of SEC decision making in the context of its public civil enforcement program. I assume in the context of my theory that SEC bureaucrats and commissioners participating in the civil enforcement decision making process possess information about the ideological reputations of the federal courts they are contemplating in their strategic deliberations on the type of case to bring and the agency’s choice of forum. Also, included in the assumption is the notion that the participants in the SEC process have the inclination and ability to take advantage of the information about judicial ideology if it serves their strategic goals.

Shortly preceding Canes-Wrone (2003), Howard and Nixon (2002) showed that the Internal Revenue Service (IRS) changes its tax-audit strategy based on the median ideology of federal circuit courts. The power to commence an audit, and the potential impact it has on the target of the agency’s investigation, is a politically charged issue that is analogous to the power of civil prosecution that Congress delegated to the SEC through its enforcement authority. The authors demonstrated that the IRS shifts the focus of its audit program between wealthier and less-affluent taxpayers in response to the judicial ideology of the appellate court with jurisdiction for potential litigation involving an audit.

17 This study built on earlier research that found political change in the other branches of government affected the focus of IRS audit strategy (see Scholz and Wood 1998 (change in President and congressional committees from liberal to conservative shifts IRS relative audit focus from corporations to individuals)).
As a federal appellate court becomes more liberal, the IRS shifts its audit strategy in that circuit to emphasize “equity” in tax collection by increasing its audits on wealthier taxpayers while reducing them on the less-affluent. As a circuit court grows more conservative, the IRS adapts to emphasize “efficiency” in the circuit by increasing audits of the less affluent and reducing its scrutiny of wealthier taxpayers (Id. at 919). According to this study, the IRS changes its behavior because it is aware of, and acts on, the ideology of the circuit court to carry out a strategy of tax-litigation success.

The Canes-Wrone (2003, 2006) and Howard and Nixon (2002) studies “show that the availability of judicial review of agency actions, even if rarely invoked, is enough to change political outcomes and therefore transfer power from policymaking agencies to the judiciary” (Smith 2006, 286). These few studies, however, virtually comprise the extant literature that examines whether and how the ideology of federal courts affects agency behavior and decision making in the absence of direct litigation against an agency. My dissertation extends this literature while incorporating other critical independent variables into the framework of the analysis that are designed to provide a rich context to the potential influence of judicial ideology over agency decision making and behavior.

**Beyond Federal Courts – Potential Influences on SEC**

As part of my study of the SEC’s decision making and behavior as manifest through its public civil enforcement program, I analyze whether the respective ideologies of Congress and the executive branch influence the agency, and control for other possible significant effects such as case and litigation-party characteristics that may be more
important to outcome than political ideology. I draw naturally on some of the highlights of the literature analyzing who controls the bureaucracy, which has evolved perpetually over decades, to apply those concepts to my research.

Recent literature trends toward models where agency outcomes shift depending on fact patterns and involve multiple political principals exercising varying degrees of influence over bureaucracies in different circumstances (e.g., Whitford 2005). Much modern literature also tends to focus on providing explanations for how political principals address age-old issues that can be classified into roughly two key premises underlying their interactions with agencies – preference divergence (from ideology in some cases) and information asymmetry between political principal and bureaucratic agent (Huber and Shipan 2006; Moe 1985).

**Agency Autonomy**

Early on, Wilson (1887) argued normatively that decision making in public administration through a bureaucracy should not be influenced materially by politicians. He ultimately recognized, however, that agency decision making in practice was affected by politics. The basic inquiry thus evolved whether agencies are, and should be, responsive to political principals – or should they simply be apolitical, competent civil servants. This concept still underlies much of the theory and analysis of who controls and, implicitly, who should control, the bureaucracy. It is also reflected inherently in both my theory and choice of independent variables in this study.

Building on this timeless concept, the SEC’s public civil enforcement program is analogous to a federal criminal prosecutor, such as a U.S. Attorney’s Office supervised
by the DOJ, because of the magnitude of the impact its decision making and behavior can have on the life of an individual or business entity. A pillar of jurisprudence is that federal prosecutors’ offices – like the SEC’s Division of Enforcement – should be relatively free from politics to mitigate capricious outcomes. The civil-prosecutorial function of an independent federal agency should also be mostly devoid of politics in order for it to maintain a reputation as a fair arbiter and be credible with litigants, regulated parties, and the federal courts. This framework still provides the context for a robust analysis of whether political ideology affects the decision making and behavior of an independent agency like the SEC.

Some mid-twentieth century scholars actually lamented a perceived absence of politics in agency decision making, complaining that influences like agency capture (Bernstein 1955; and Huntington 1952) and iron triangles (Cater 1964; and Freeman 1965) on bureaucrats inordinately reduced the relative power of constitutional actors like

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18 See, e.g. Federal district court reminding SEC to "remember that a suit by the SEC is akin to a criminal prosecution in that it is accusing a private individual of wrong-doing. In such cases, the SEC acts as ‘the representative not of an ordinary party to the controversy, but of a sovereignty whose obligation to govern impartially is as compelling as its obligation to govern at all; and whose interest, therefore, in a criminal prosecution is not that it shall win a case, but that justice shall be done.’" SEC v. Heartland Advisers Inc., No. 03-C-1427, 2006 WL 2547090 (E.D. Wisconsin, August 31, 2006), p. 5 at n. 4.

Congress, the President and the federal courts. Lowi (1969), for instance, argued harshly that Congress had abdicated its constitutional role in the separation of powers and, as a result, agencies were not sufficiently accountable to the public or its representatives, and were a veritable fourth branch.

In light of this, research that grew out of the early literature characterized agencies as predominantly autonomous policy and decision-making entities. One rationale theorized that Congress and the President did not sufficiently review agency decision making directly, especially through formal procedures, and that this presumed absence of consistent oversight signaled a lack of interest (e.g. Dodd and Schott 1979). The political calculation inherent in these views was that certain principals would not make an effort to control agencies because they believed there would be, at best, a minimal political payoff. Another rationale, extending back at least through Weber (1946), cited the challenge of information asymmetry, where an agency controls technical know-how or confidential data that it does not make accessible to its political principals (see Arrow 1985). According to this notion, a political principal may not have the time or staff expertise to become sufficiently familiar with a complex issue to ensure that an agency aligns its behavior with the principal’s preferences.

The agency literature evolved eventually toward theories framed in principal-agent analysis where constitutional actors were political principals that rationally attempted to control their agents – the bureaucracy – at numerous points and for various

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20 While recognizing the potential pitfalls of asymmetry in the agency-politician relationship, Weber (1946) also acknowledged that bureaucracies are well-designed to work for the interests of those politicians in power if and when they figure out how to align preferences and behavior.

21 As is apparent in James Madison’s Federalist 51, the Framers preferred that members of Congress behave as political principals and, as a result, gave them the power to choose whether or not to delegate authority to executive branch agents. Thus, the principal-agent framework has served as an accurate way to portray these power relationships since the earliest days of the Republic.
policy ends (e.g., Moe 1982, 1985; Wood and Waterman 1991). The literature has explored the role of each of these principals over the last three decades and has reached varying conclusions regarding the identification of the most influential political principal and the relative roles of the principals in controlling federal agencies.

**Congressional Dominance**

“Congressional dominance” literature emerged in the 1980’s and still influences research on who controls the bureaucracy (see Weingast and Moran 1983 (coining phrase)). It challenged the notion of Congress as disinterested in or incapable of controlling federal agencies. A dearth of overt control such as politicized hearings does not, under this line of argument, necessarily signal a disengaged Congress. It may instead indicate that Congress has such firm control over certain agencies, through means like appropriations and oversight, that the agencies rarely act contrary to the interests of relevant members of Congress (*Id.*).

McCubbins and Schwartz (1984) famously framed this idea by explaining Congress does not neglect its oversight responsibility, but instead rationally prefers one form of oversight, “fire alarm,” over another form, “police patrol.” ‘Fire alarms’ are less costly and more sustainable as means to control bureaucrats who may benefit from information asymmetry. Congress sets rules and procedures up front to empower individuals and interest groups to monitor agencies and pursue remedies against those that violate congressional goals. The logic underlying fire alarm oversight is that legislators can minimize monitoring costs and maximize incentive compatibility with interest groups, so that the groups will monitor executive agency action (Krause 2010).
In contrast, ‘police patrol’ methods are centralized, direct and active, and compel Congress to expend finite resources. At its own initiative, Congress examines a sampling of executive agency decision making and behavior with the goal of detecting and remedying violations as well as discouraging such activities.

The ‘congressional dominance’ literature was also organized around the chronology of the means utilized to control agencies. Ex post controls, used by Congress to intervene in decision making after an agency has already acted (Weingast 1981; Calvert, Moran and Weingast 1987), include incentives to guide an agency towards policy Congress wants through a combination of rewards, such as annual budget increases, and controls or punishments, such as annual audits (Banks 1989), budget cuts, or legislation that restricts agency discretion (Hammond and Knott 1996). These contrast with ex ante controls, which Congress uses to influence agency decision making through the design of administrative procedures that guide bureaucratic preferences before an agency acts (McCubbins and Page 1987; McNollGast 1987).23

The Congress-agency literature also continued to delve into new areas during the last decade. Shipan (2004) provides a good example of this progression. The answer provided in his work as to whether Congress controls agencies is “(s)ometimes” (Id. at 478). Shipan found that, depending on political conditions, an oversight committee or the

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22 Empirical evidence testing legislative control of the bureaucracy through ex ante means has thus far provided mixed results (Krause 2010; Shipan 2004). One potential flaw in the theory could be that it does not account for the probable desire of members of Congress to trade off between latent ex ante controls and overt oversight, particularly when – in the case of relevant committee members - they can accrue political benefits from constituents for specific oversight activities involving agencies (Krause 2010 (citing Bawn 1997)).

23 For perspective on how far these concepts have evolved, see their use in formal model explaining the strategic allocation of responsibilities across agencies by legislatures in Ting (2002) (assignment of tasks to agencies cannot be explained solely through technical criteria; additionally, under certain assumptions, legislatures exert control by defining agency jurisdictions and setting ex ante budgets to delimit policy space, while choosing ex post contractual ‘payments’ to reward good performance that is closer in line with legislatures’ policy goals).
floor of Congress can influence an agency through threat of legislation, but sometimes the agency can behave autonomously. For instance, when an agency is located to the left of an oversight committee on a single continuum, which is in turn located to the left of the floor of the Congress, the agency must pay close attention to the preferences of the committee. And should the committee become more liberal, the agency will become more activist. Shipan found also that, in contrast, when the agency and committee are on opposite sides of the floor, the agency must be aware of the preferences of the floor (Id.). His model offers a more complex and contingent story about agency accountability than many of those offered by earlier principal-agent research focusing on Congress and agencies. Under the model, bureaucratic action with moderate preferences is unconstrained by congressionally imposed incentives (Miller 2005).

Thus, in the context of this long and still-evolving line of literature, I utilize independent variables that comprise the ideology of the subcommittees (and select committees as a robustness check) with primary oversight and budget responsibility for the SEC in the Senate and House to control for the effects of the ideology of Congress on that independent agency’s decision making and behavior.

**The Executive**

Similarly, I analyze whether the policy preferences of either of the political principals of the agency situated in the executive branch – the President, or the Commissioners of the SEC – significantly affect the decision making of the agency regarding public civil enforcement actions. Invigorated by Moe (1982, 1985), a line of bureaucracy literature identified the President as a key political principal whose role may
have not received sufficient attention in the congressional-dominance or agency-autonomy literature. Shipan (2004, 470), for instance, framed this concept through an assumption underlying a formal model stating that Presidents are in a stronger position relative to other political principals to set an agency’s ideal point, because they can take a variety of actions to influence an agency’s policy preferences. These actions have been categorized generally as “contextual tools” and “unilateral tools” (Durant and Resh 2010, 545).

‘Contextual tools’ comprise acts such as the President influencing an agency’s preferences and behavior by changing its composition, particularly through the appointment of the chair (Id.; Hammond and Knott 1996). In Chapter 2 I illustrate the significant amount of time needed by a new President to affirmatively change the make-up of the SEC and attempt to project policy preferences through a new SEC Chair and different Commissioners. The President’s ‘power of the purse’ – the agenda-setting authority that an administration has over an agency through the original budget estimate the President submits annually to Congress (Kiewiet and McCubbins 1991) – and more broadly, the oversight authority the President can project over an agency through the Office of Management and Budget (OMB), represent other significant contextual tools (Durant and Resh 2010).

The package of ‘unilateral tools’ the President can use to influence agency behavior and decision making includes executive orders, presidential bill signing statements and national security directives (Id.). I explain in Chapter 2 that Presidents in the modern era have tried to exert control over agencies through executive orders

24 Similarly, Mayer and Weko (2000, 179) refer to the President’s “ability to affect structures, processes and personnel” as the “‘politics of structure.’”
intended to impose procedural constraints and resource-intensive reporting requirements. I describe further, though, that Presidents have specifically exempted independent agencies like the SEC from the jurisdiction of executive orders that levy these constraints. The SEC is therefore free from many of the oversight and onerous reporting requirements – managed through the OMB and the White House – that other executive agencies are subject to through executive order. This removes an entry point of leverage for the President over the agency and helps the SEC retain some independence from the political tensions within an administration.

Recent literature has also noted that attempts by the President to influence executive agencies may have an identifiable “rhythm” as their intensity increases and then subsides for various reasons, such as a new administration wanting to get off to a fast start in a particular policy area, or the programs of an agency losing congressional or public support over time (Id.). These efforts can also be affected by changing relative positions of the President and Congress vis-à-vis an agency. As Whitford (2005) explains, when Congress is uncertain about a new, complex policy domain, it may initially delegate more authority to the agency implementing the policy via oversight committees or other means. As the President responds by beginning to use some of the myriad contextual and unilateral tools at the administration’s disposal, however, Congress may subsequently reduce the agency’s discretion over the identical policy area. So, the influence of a President over an agency may vary with time, but extant research makes a sufficient case that it is necessary to test for the significant presence of such effects, and to try to identify their source through independent variables like those included in my models in Chapter 4.
**Originally Derived Research Framework**

Multiple characteristics of the SEC’s civil enforcement process enable it to provide a strong, original foundation for this study. The agency plays a critical role in the efficient functioning of the U.S.’s, and the world’s, market-based economic systems by providing credibility necessary to maintain the confidence of market participants. Also, as the Gupta case exemplifies, the reputation of the SEC has become closely tied to its enforcement activities. I describe how the agency’s performance as civil prosecutor, for better or for worse, defines its mission and brand to the federal courts, Congress, the executive and the general public. The SEC is therefore subject to intense political pressure from players with competing interests. I identify whether some of these players succeed in affecting the decision making and behavior of the agency and, if so, how political ideology may enter the process.

In addition, the SEC’s choice-of-forum option comprises an uncommon legal structure that compels the strategic decision making process that emerges as a vehicle for this analysis. As the Gupta case also highlights, when the SEC decides to pursue a civil enforcement action, it is empowered to initiate the complaint in federal district court or through administrative proceedings before an ALJ. I compare the two public enforcement routes and conclude that the agency and securities litigants have potentially more at stake in district court. I find further, however, that the agency has a higher success rate before ALJ’s. As a result, I identify the SEC’s trade-off of the potential for earning more severe sanctions against a defendant in district court versus the relative security of a higher basic success rate before ALJ’s.
In support of this part of the analysis, I use original data and research on the SEC ALJ corps that to my knowledge has not been presented previously in any other scholarly work. I rely on the research to explain how the functions of ALJ’s differ across agencies, and argue that political science literature sometimes fails to take these differences into account. I further characterize the SEC’s ALJ corps as static and small, and conclude that using ALJ ideology as an independent variable in the analysis is not practicable or necessary.

The SEC’s statutory independence adds another material element to my study. I classify the sources of SEC independence into two categories: the agency’s objective structural design and legal authority, and its subjectively generated rhetorical independence. Agency independence is important in this analysis because it is intended to partially insulate the SEC from political pressure. I am thus able to test whether this insulation works sufficiently or whether political ideology inevitably circumvents agency independence and influences the decision making and behavior of the SEC.

**Addendum: Analysis of How SEC Leverages Civil Enforcement through Private Securities Litigation Regime**

As with public civil litigation, I present in the *Addendum* how political ideology affects the SEC’s leveraging of its role in private litigation, and whether the agency’s fundamental approach changes with a shift in the ideology of its political principals. I explain through comparative analysis how this component of the agency’s enforcement efforts distinguishes the SEC from many other federal agencies in that it balances its powerful, public role as civil prosecutor with a measured participation in private litigation. My research also illustrates that the agency has always embraced this dual role
publicly, but cautiously balances its rhetoric to avoid the appearance of favoring one class of litigant over another.

I identify two means through which the SEC participates in the private regime. The first, direct, means is through a strategic program of utilizing amicus briefs. I argue that this is natural from a rational economic perspective. The second means of participation is indirect, and the agency therefore has less control over it. The SEC participates in the private regime through the fruits of its public civil enforcement litigation that counsel for private plaintiffs can access and use, independent from the agency, to develop their own litigation strategies.

Changes in the ideology of the SEC’s political principals and the federal courts spawn inter-branch dynamics that trend towards redefining the scope of the private regime. Although there are competing views running along the ideological spectrum within the agency about the appropriate structure of this private regime and the SEC’s role therein, I find that key players in the agency, regardless of ideology, support its existence and do not challenge its utility.

Similarly, I explain how the ideologically conservative view in the federal judiciary and Congress is skeptical, though not dismissive, of the utility of private litigation to achieve a public policy goal, particularly where it involves civil prosecution. While accepting that private litigation is an important supplement to the SEC’s public enforcement regime, the conservative approach is to fine-tune its application by restricting its scope. This is consistent with the assumption incorporated into the theory of the dissertation that conservative federal courts are less likely than ideologically liberal courts to consistently favor the arguments of an independent regulatory agency like the
SEC in a prosecutorial setting, and thus would more likely tend to constrain its enforcement power. In contrast, I find the more expansive attitude of liberal federal judges, which trends toward extending the SEC’s civil enforcement program, reflected in their general support of an aggressive private litigation regime.

**Plan of the Dissertation**

In Chapter 2 I build the foundation for the theory and analytical models I use in the dissertation. The chapter explains why the SEC and its uncommon civil enforcement process work well for the analysis. I trace the origins of the SEC’s binary option for civil enforcement and compare the two enforcement paths, concluding that both the SEC and a defendant in securities litigation have more riding on a case in district court than in administrative proceedings. I also present original data showing that the agency fares better in the administrative setting, thereby setting up the SEC’s trade-off of the potential for more severe sanctions in court compared to a higher probability of success before an ALJ. In Chapter 2 I also explain the significance of the structure of the SEC as an independent regulatory agency to identifying the potential for influence by the agency’s political principals.

In Chapter 3 I present the framework of the theory and provide a hypothetical construct of the factors that drive the agency’s decision making and may, at times, affect its behavior. I initially illustrate the main theory by showing the strategic preferences of the independent SEC relative to the lower federal courts and the SEC’s ALJ corps. I then demonstrate through separate illustration how the exogenous effect of the Enron scandal may have temporarily shifted the political preferences of conservative courts relating to
SEC enforcement, and how such a change would affect the decision making of the SEC. I next illustrate an alternative view of the SEC for comparative theoretical purposes. In this portrayal, the decision making of the agency is affected by the ideology of its political principals.

Importantly, in this chapter I also present original data and research – which to my knowledge has not been presented previously in any other scholarly work – on the SEC ALJ corps. I explain why using ALJ ideology as an independent variable in my models is not practicable or necessary. As part of the discussion, I highlight how the role and function of federal ALJ’s differ across agencies and argue that political science literature often fails to take these variations into account.

In the last section of Chapter 3, I present the primary hypothesis and a set of seven secondary hypotheses that emerge naturally from the data and research model underlying the dissertation.

In Chapter 4, I estimate multivariate logit models to test my hypotheses to examine the extent to which my theory presents a reasonable picture of the causes of SEC decision making and behavior. I created an original primary data set drawn from over 1,600 enforcement cases spanning calendar years 1992 through 2007 for this central part of the analysis. I start the chapter by providing a detailed rationale for the scope of the primary data set and explain the random selection method I used to assemble the cases to be examined. I then describe the dependent variable and provide a detailed rationale for each independent variable. The description of the coding method and calculation of the primary independent variables, the ideology of the lower federal courts, is quite detailed. I tie each independent variable back to a specific hypothesis from Chapter 3 and then
present those hypotheses in terms of specific multivariate logit equations to be tested statistically.

The multivariate analysis in Chapter 4 indicates that while case characteristics of public civil enforcement actions cases play a prominent role in the SEC’s strategic decision making regarding choice of forum, the effect of political ideology is comparable in magnitude. The results reveal that the ideology of the lower federal courts, at both the district level and the circuit courts of appeals, is a material factor in the strategic decision making and behavior of the SEC. It also shows that the politics of certain political principals – congressional committees responsible for the oversight and annual budget of the SEC – significantly affect the agency’s enforcement behavior.

The analysis also demonstrates that an exogenous shock to the SEC-regulated financial community – the Enron scandal in October 2001 – can have a material impact on SEC decision making and behavior. Specifically, I theorize that in the wake of the shock, SEC civil enforcement cases become more attractive to personal policy preferences of conservative district court judges, and the agency becomes aware of this temporary shift. As a consequence, the preference of the agency for liberal over conservative federal courts becomes temporarily less distinguishable because its perception of the likelihood of a favorable outcome becomes similar for both ideological categories of courts as the courts come into alignment. This is indicative of a partial partisan reversal affecting the SEC’s relationship with conservative courts that fades over time as the effect of the shock wanes.

I conclude the major part of the study in Chapter 5.
In the *Addendum* I discuss the SEC’s role in private litigation as an indirect extension of its civil enforcement program, and analyze how the agency uses the private regime strategically to achieve its mission. This discussion also discerns whether and how political ideology affects the SEC’s leveraging of its unusual role in private litigation, and whether its fundamental approach changes with different political principals.

The *Addendum* explains the evolution and legal foundations of the private securities enforcement regime, as well as the SEC’s place in that regime, from the earliest days of the agency to the present. It describes how political ideology helps to frame the SEC’s role in private litigation and discuss in detail how the agency embraces that role and the caution it exercises – as a federal agency with profound civil prosecutorial powers – to take a balanced approach toward private litigants and their respective interests. I also put the private securities regime in context by comparing it to private regimes in other policy areas where agencies have varying degrees of influence over those regimes. Finally, I explain how the SEC actually participates in the private regime – both directly and indirectly – and use a brief but important case discussion to illustrate how the agency manages potential political influences that challenge its balanced approach.
Chapter 2

Essential Foundation for Theory and Methodology – Original Findings about SEC as Civil Prosecutor, Its Enforcement Process, and Its Significance as an Independent Agency

Introduction

In this chapter I summarize significant research and present original data to build a foundation for the theory and analytical models that I deploy in Chapters 3 and 4. This chapter explains why the SEC and, in particular, its public civil enforcement process, works well as a vehicle for the analysis of decision making by a federal bureaucracy and how politics may affect that process. It discusses the profound importance of the civil enforcement process to the mission of the SEC and describes the process in detail. I trace the origins and significance of the agency’s binary option for civil enforcement – that is, bringing cases in federal district court or through administrative proceedings before an ALJ. This is an authority vested in the SEC that makes the process a strong vehicle for this study.

Table 2.1 provides a comprehensive list of the “Major Federal Independent Regulatory Agencies” in the U.S. Importantly, the table also tracks whether each agency has the power to enforce through the forum of administrative proceedings (and whether each agency utilizes ALJ’s) and the forum of federal district court – and provides citations to the statutes and rules authorizing enforcement. I find that five of the twenty agencies profiled (in addition to the SEC) have enforcement authority in both forums. I would also contend preliminarily that the public civil enforcement authority of the SEC is more high-profile and more inextricably bound with the mission of the agency than are the programs in the other five agencies. The data in this table emphasize that, given the
relatively uncommon organization of the SEC’s enforcement program, it is useful to recognize that it may be more difficult to generalize some of the lessons garnered in this research across all independent regulatory agencies – though some findings will doubtless be broadly applicable.

Table 2.1 List of Major Federal Independent Regulatory Agencies and Their Enforcement Authority

In Table 2.1, 1 = Yes and 0 = No

<table>
<thead>
<tr>
<th>Major Federal Independent Regulatory Agencies</th>
<th>Administrative Enforcement</th>
<th>Authority</th>
<th>Federal Court Enforcement</th>
<th>ALI</th>
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<tr>
<td>Board of Governors of Federal Reserve System (Fed)</td>
<td>1</td>
<td>12 U.S.C. §1818q</td>
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<td>Commodity Futures Trading Commission (CFTC)</td>
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<td>7 U.S.C. §13a-1</td>
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<td>1</td>
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<td>Environmental Protection Agency (EPA)*</td>
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<td>40 C.F.R. §22</td>
<td>1</td>
<td>1</td>
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<td>Equal Employment Opportunity Commission (EEOC)</td>
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<td>42 U.S.C. §2000 et seq.</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Federal Communications Commission (FCC)</td>
<td>0</td>
<td>47 U.S.C. §503</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Federal Deposit Insurance Corporation (FDIC)</td>
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<td>12 C.F.R. §308.103 (ALI)</td>
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<td>1</td>
</tr>
<tr>
<td>Federal Election Commission (FEC)</td>
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<td>2 U.S.C. §437g</td>
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<tr>
<td>Federal Energy Regulatory Commission (FERC)</td>
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<td>18 C.F.R. §385.102(b)</td>
<td>0</td>
<td>1</td>
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<td>12 U.S.C. §1422a&amp;b</td>
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<td>Federal Maritime Commission</td>
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<td>Federal Trade Commission (FTC)</td>
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<td>Nuclear Regulatory Commission (NRC)</td>
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<td>Occupational Safety and Health Review Commission (OSHRC)</td>
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<td>United States International Trade Commission (USITC)</td>
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<td>19 U.S.C. §1337</td>
<td>0</td>
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</tr>
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</table>

* The EPA is technically independent, though its cabinet-level status distinguishes it from the other independent agencies and renders it a hybrid agency.

Further, I compare the two SEC civil enforcement paths and conclude that both the SEC and a defendant in securities litigation have far more riding on a case in the forum of district court than in the forum of administrative proceedings. I also present
original data showing that the agency fares better, however, in the administrative setting. This sets up the SEC’s trade-off of the potential for more severe sanctions in court versus a higher probability of success before an ALJ.

Finally, in this chapter I explain the importance of the legal structuring of the SEC as an independent agency and describe how both Congress and the agency itself helped create and encourage this independence. The independence feature is key because it should, in theory, work to insulate the agency at least partially from political pressure from both Congress and the White House. I analyze below whether the insulation is effective or if – and to what extent – politics enters the civil enforcement process to influence the decision making and behavior of the agency in an area (the prosecution of individuals and entities) that, normatively, should be relatively free from politics.

Why the SEC?

The SEC decision making process regarding the forum for filing a civil enforcement action comprises a combination of factors that makes it well-suited for this analysis. First, this SEC decision making process involves an activity that largely helps define the mission of this federal independent agency. The process includes review and input from all levels of the bureaucracy, including the Commissioners who oversee this independent agency. This decision making process is inextricably bound with the raison d’être of the SEC.

Next, the SEC process includes a binary choice of options that can be operationalized, built into a data base and tested using statistical analysis designed for a dichotomous dependent variable.
Further, because the enforcement process is so critical to the SEC and regularly involves senior principals who are political appointees, there are various points through which politics may possibly enter the decision making process – through political principals in the agency itself, Congress, the White House, and the federal courts. So, it presents a potentially rich framework to test for the influence of political ideology on the decision making of an independent regulatory agency involving a function that should, normatively, be free from politics – its role as civil prosecutor.

Moreover, the SEC plays a crucial role in the effective functioning of the U.S.’s and the world’s market-based economic system, by providing the underlying credibility necessary to maintain the confidence of market participants. As evident recently in both the U.S. and the E.U., when this confidence falters there are severe adverse consequences. Therefore, the SEC is at times subject to intense political pressure. This dissertation attempts to identify whether that pressure affects the decision making of the agency and, if so, under what circumstances (e.g. where and when) such political factors enter the agency’s decision making process.

Finally, SEC civil enforcement is distinct from the processes of most other federal agencies, because the SEC is designed and empowered, in theory, to exercise its status as an independence agency partially through control over its own litigation docket. In general, Congress has authorized the DOJ to conduct litigation on behalf of the U.S. government and most of its agencies through the Office of Solicitor General. Congress has exempted the SEC from this requirement.

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This independence encourages the development within the agency of competent and experienced civil enforcement litigators. They believe their decisions will not be second-guessed by a subsequent team of DOJ attorneys and, along with the SEC’s commissioners, control the agency’s own litigation strategy up to the Supreme Court. This represents a significant distinction between the SEC and the enforcement programs in most other agencies.26 The dissertation analyzes whether this independence mechanism insulates the agency from, or at least mitigates the effects of, politics and ideology on its bureaucratic decision making and function as civil prosecutor.

**Enforcement Actions Help Define Agency Mission**

Enforcement actions have traditionally defined the mission of the SEC.27 The stated mission of the SEC throughout the last decade has been to protect investors, to maintain fair, orderly and efficient markets, and to facilitate capital formation (SEC 2009).28 The first goal listed in both the SEC *Strategic Plan for Fiscal 2004-2009* and the *Strategic Plan for 2010-2015* is to “…enforce compliance with the federal securities laws.”

Congress created the SEC in 1934 following hearings of the Senate Banking and Currency Committee into stock exchange practices that led to the market crash in October 1929 (Seligman 2003). The Committee uncovered rampant stock market manipulation, insider trading and breaches of fiduciary duty by directors and officers who

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28 This represents a minor expansion of the SEC mission since its establishment, which was to protect investors and maintain fair and orderly markets (GAO 2009a).
controlled publicly traded corporations (Karmel 1982). Prior to the crash, U.S. securities markets were governed by state “blue sky” laws, which varied across states and were a potpourri of antifraud and licensing laws (Keller and Gehlmann 1988). States enforced these laws unevenly, and as the Senate hearings revealed, the laws were fundamentally ineffective deterrents to fraud (Khademian 1992).

The hearings prompted Congress to devise a regulatory regime to try to reduce the likelihood of a future market crash. The related legislation included the two primary acts administered by the SEC, the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act), which established the SEC and transferred to it from the Federal Trade Commission (FTC) the power to enforce the new federal securities laws (the FTC had this power for a brief time, Congress having delegated it to the FTC in the 1933 Act since no other agency yet existed that could enforce its new mandates).

Dating to the time of these earliest grants of authority from Congress, the SEC has focused many of its efforts and resources on its prosecutorial role. Prior to 1950, however, the SEC’s enforcement efforts were conducted out of its regional offices with no central management authority. During the 1950’s, each of the SEC’s operating Divisions developed its own enforcement branch, typically known as an Office of Special Investigation. As financial markets became increasingly complex, as more people began to participate in the markets, and as financial fraud evolved beyond boiler room operations, penny stock scams and dishonest stock brokers (though all of these bread-and-butter forms of fraud still thrive today), the SEC eventually realized it needed to specialize the enforcement function. Specialization would enable the agency to develop the nuanced skills it needed to confront sophisticated new forms of financial fraud and
manage its investigations and enforcement docket more efficiently. In addition, a new Division established solely for enforcement would help with the agency’s “branding” of its enforcement efforts to become a highly visible representative of the SEC.\textsuperscript{29}

Thus, in 1972 the SEC undertook a major review of its disparate enforcement operations (Karmel 1982) and decided to create a separate Division of Enforcement to “provide a more complete picture of (its) nationwide enforcement activities.” A specialized, focused Division with its own mandate, staff, and budget would empower the SEC to identify and implement better those national priorities without being distracted by other responsibilities emanating from the tensions inherent in the agency’s structure, such as rulemaking and financial oversight.\textsuperscript{30}

Under the SEC’s modern structure, Enforcement has consistently been the largest of the SEC’s operating Divisions. Over time, the reputation of the SEC has become tied even more closely to its highly visible enforcement activities (Pitt and Shapiro 1990), and this enforcement role continues to help define the SEC’s mission as an agency (Karmel 1998).

This is evident as the agency chooses every year to begin its Annual Report with a review of its enforcement activities and results prior to discussing its other areas of responsibility. This placement signals Congress about the priorities of the SEC, which reflects what the agency believes Congress focuses on during its annual budget review. Also, scholars theorize that the enforcement role of the SEC legitimizes the agency’s existence and its federal budget allocation to Congress (Bealing 1994). As a Director of

\textsuperscript{29} Ethiopis Tafara, Director, SEC Office of International Affairs. September 5, 2006. “The Benefits of an Enforcement Division.” \textit{Speech before the Brazilian Securities Commission, 30\textsuperscript{th} Anniversary International Seminar}, Rio de Janeiro, Brazil (discussion in this paragraph derived from speech).

\textsuperscript{30} \textit{Id.}
Enforcement stated publicly, “While Congress, not the SEC, sets our budget…enforcement gets top billing in the SEC budget.” Moreover, SEC chairs and commissioners use the occasion of public speeches before professional associations to remind the practitioners present – as a signal for deterrence – that the SEC is “(f)irst and foremost…a law enforcement agency,” which is “central” to the agency’s mission.

**Division of Enforcement Initiates Process**

The Division of Enforcement initiates the public civil prosecution process within the SEC. The Division is involved in virtually all of the enforcement activities of the SEC (SEC 2003a). It vets and investigates leads about violations of securities laws, interviews witnesses, develops evidence in support of enforcement filings, and negotiates settlements or litigates cases as necessary to complete the civil enforcement cycle. The Division is based in SEC headquarters in Washington, D.C. and maintains offices in the five regional and six local SEC offices.

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What Triggers Investigations

The SEC conducts all parts of its investigations privately (Larsen, Buckberg, and Lev 2008), primarily to mitigate materially harmful financial or career effects to an entity or individual in the common instance where the agency ultimately drops an investigation without filing charges. For this reason, there is a dearth of available statistical data regarding negotiations and outcomes. Nevertheless, from various public sources I describe the process in detail and I have extracted and cite data as they are relevant to the theory and background of the model of my dissertation.

The SEC’s Division of Corporation Finance is a major source of investigatory leads to the Division of Enforcement, because it monitors the filings of the Fortune 500 and other public companies and searches for red-flag issues and unusual disclosures that may be signs of ongoing financial fraud. As part of a more recent trend, the agency also will occasionally pursue issues raised by private shareholder plaintiffs in civil actions against companies.

The SEC receives information that triggers investigations from a panoply of other sources as well, including:


• Anonymous tips from customers or shareholders/investors of companies.

• Form 8-K’s filed by a company notifying SEC that it is changing its independent auditor may signal that the company is shopping its audit opinion or has a financial reporting problem that the outgoing accounting firm has identified.

• Former or current employees of a company alleging it is committing fraud.

• Newspaper and Internet stories about a company’s performance or unusual practices (Enforcement regularly reviews open-media sources for such leads).

• Random or scheduled compliance inspection of a broker-dealer’s files by SEC staff.

• Referrals from other federal and state government agencies.

The Division of Enforcement manages thousands of leads annually that involve different categories of actors and disparate areas of the economy. The diversity of sources at the front end of the process tends to be the first cut at diluting the potential for an SEC bias – political, ideological, or focused on a particular type of malfeasance – in the selection of cases, because there really is no way for the agency at this stage to control the universe of potential civil prosecutions.

Public Civil Enforcement Action Process

Since it is part of the “tradition” of the SEC that its public civil enforcement decision making process is designed to include substantive input from all levels of the agency, including the five SEC commissioners – its highest level – the process can take

a while (Davis 2001). The arduous process has evolved into a norm that the SEC reveres. The agency sees its role and the decisions it ultimately makes in the “powerful” process as critical to both the individual defendants and the nation’s system of civil justice and, therefore, they merit sufficient due process. “(The SEC’s) actions are the product of more due process than any government prosecutor anywhere in the world gives to putative defendants…” Whether or not this statement by a Director of the Division of Enforcement is accurate, it embodies how profoundly the process is inextricably bound with the core mission of the agency. It also reveals the degree to which the agency respects its profound responsibilities as civil prosecutor.

**Enforcement Inquiries and Investigations**

Depending on the geographic origins of a lead about a securities violation, a member of the enforcement staff in one of the SEC’s eleven branch offices will attempt to vet informally the merits of the lead by opening a Matter Under Inquiry (MUI). Staff can commit only limited time to this preliminary step, having to decide efficiently by examining extant public information whether the tip washes out of the process early on – as the vast majority do – or whether the case warrants a deeper look and the MUI gets converted into an investigation (GAO 2007). At this early second stage, the process remains driven completely by facts and staff research that determine if the fact pattern emerging from a tip has any potential worthy of an investigation.

39 In general, the duration of some SEC investigations – from a few months to many years – has been a source of criticism for the agency during the period of my dissertation’s primary data set.


41 See n. 35, *supra*. 
A Division of Enforcement staff attorney can open an informal investigation of those cases that emerge from the MUI phase with the approval of a branch chief (Mahoney, Walker, Schwartz, and Greenstein 2004). The distinguishing feature of this step is that the SEC does not have subpoena authority and relies on the cooperation of potential witnesses and defendants to voluntarily submit the testimony and proprietary information it seeks (Larsen, Buckberg, and Lev 2008). Once SEC staff completes this process, it has three avenues: (i) if its investigation has produced significant evidence of wrongdoing, it may progress directly to requesting approval from the Commission for a civil enforcement filing (this is a rare outcome); (ii) if the investigation does not get traction, it may simply drop the matter; or (iii) if it concludes that further investigation is necessary, it can seek approval from the Commission for a formal investigation. The agency may also respond to a defendant’s overtures to negotiate a settlement (settlements are addressed separately below).

In the absence of an early settlement, the matter may evolve into a formal investigation. The timing of when the SEC initiates this step, however, varies across branch offices since some enforcement staff members will wait until a key witness refuses to cooperate any further prior to taking this advanced action. The SEC in-take process at this stage remains focused on available evidence and is heavily fact-specific – staff have to be able to support empirically a recommendation in favor of one of the three avenues, or to respond to settlement proposals.

In order to initiate a formal investigation, a member of the local enforcement staff (from the region where the tip emerged) submits a written recommendation to the SEC Office of General Counsel (OGC). The staff recommendations often incorporate local

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42 SEC Informal and Other Procedures, Rule 5(a), 17 C.F.R. § 202.5(a).
agency biases and knowledge (cf. Canes-Wrone 2003). When the draft is approved by the General Counsel, the recommendation for a formal investigation is forwarded to the offices of the SEC chair and each of the four other commissioners for review.

An order authorizing a formal investigation may be issued in one of three ways. First, a commissioner who has been assigned as a duty officer for a particular time period may issue the order. Second, a majority of the commissioners acting independently may authorize the formal order. And third, the SEC can issue a formal order through the agreement of a majority of the commissioners in a closed-door meeting (Mahoney, Walker, Schwartz, and Greenstein 2004, A-15-16).

It is noteworthy that at this early stage a formal investigation will not proceed without the approval of the commissioners representing the highest level of the agency. Commissioners generally only approve these requests when they conclude that it is likely a securities law violation has occurred and the agency needs to develop evidence more aggressively in its role as civil prosecutor (Larsen, Buckberg, and Lev 2008).

Figure 2.1 shows how many investigations (informal and formal) the agency initiated annually for SEC FY 1992 through FY 2007. It also illustrates that the SEC has many more pending investigations that carry over from prior fiscal years. In fact, for SEC FY 1992 through FY 2004, the agency on average worked on 3.4 times the number of pending investigations as it did on new investigations. The SEC stopped reporting the number of pending investigations in FY 2005, presumably because it revealed how large the backlog was growing, even as the SEC significantly increased the number of new investigations it was pursuing. This would have exposed the agency to public criticism and questions from Congress for inefficient management of its resources.
Figure 2.1 Annual Investigations Initiated by SEC, and Investigations Pending from Prior Years
Managing Investigative Priorities

The SEC utilizes its finite resources to manage its role as civil prosecutor and attempt to establish priorities when considering whether to pursue formal investigations and ultimately file public civil enforcement actions. Annually, the agency vets thousands of leads, institutes hundreds of investigations, and must try to clear a backlog of thousands of pending investigations. Like any other enforcement agency or prosecutor on the federal or state level, it needs to have a strategy for identifying cases to prioritize and this stage of managing caseloads can insert a modicum of case selection bias by the agency into the process.

For the period of my primary data set, however, the potential for selection bias is mitigated for various reasons. Until 2007, although the Division of Enforcement set annual case priorities for its civil prosecution planning process, it “used a largely decentralized approach for reviewing and approving individual new investigations, which may have limited the (D)ivision’s operational effectiveness…” (GAO 2007, 15-16). This approach, far from bureaucratic lock-step, was designed on a policy level to “foster…creativity in the investigative process” and incentivize local staff to be aggressive in developing investigations (Id. at 16). On the practical side, the SEC used a decentralized approach, because the agency had not yet developed the information technology necessary to coordinate its investigative process across eleven branch offices.

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43 In 2007, the Division of Enforcement began to use a more centralized approach for reviewing and approving the opening of investigations. This process now requires one of two deputies who report directly to the director of the Division to review and approve all new investigations. The SEC did this under the auspices of directing resources more efficiently. Skeptics note that this gives the commissioners, through senior staff, more power to guide the determination of the targets of investigations. (GAO 2007)
Supporters argue that the changes eliminate a layer of management and streamline the procedures for opening investigations so the agency can respond more quickly to crises. They also believe the modifications show confidence in senior staff and help morale in the Division. Mary L. Schapiro, SEC Chair. February 5, 2010. “Looking Ahead and Moving Forward.” Speech at SEC Speaks. Washington, D.C.
(GAO 2004). Consequently, this was a major factor in causing the agency to use its resources inefficiently on a macro level.\textsuperscript{44}

These shortcomings, perhaps, were an underlying cause of the SEC’s significant underperformance leading up to the U.S. financial crash that surfaced with a bang in September 2007. The agency was simply incapable of shifting its resources effectively to proactively address some of its most pressing priorities. The SEC finally consolidated its procedures and published its first \textit{Enforcement Manual} in October 2008 (after the date of the last case in my primary data set), in unstated response to these mounting criticisms.\textsuperscript{45}

Most relevant to this dissertation, however, is the uneven identification and implementation of the SEC’s prosecutorial priorities during SEC FY 1992 through FY 2007.

This inconsistency is also reflected in the agency’s occasional focus on specific types of financial fraud in those fiscal years, typically in response to trends in malfeasance or innovations in parts of the economy the SEC regulated. For example, civil prosecution of Internet-based fraud is reflected in the primary data set beginning in the late 1990’s. Also, during those fiscal years the agency focused intermittently on cases

\textsuperscript{44} The decentralized approach was also a vestige of the earlier history of the SEC’s enforcement efforts, developed during the 1940’s and 1950’s (see discussion in “Enforcement Actions Help Define Agency Mission” supra).

\textsuperscript{45} “The Manual memorializes in one place staff policies that have developed over decades(,) but which were applied principally on the basis of oral tradition or internal, unpublished memoranda…Historically, the decision whether to open an investigation has been left to the discretion of the staff, often at a junior level. Once begun, investigations can remain open indefinitely…” Gibson, Dunn & Crutcher (law firm). October 10, 2008. “SEC Adopts Enforcement Manual.” \textit{Gibson Dunn Publications}. New York, N.Y.
of insider trading, aggressive “boiler room” penny stock sales schemes, illicit backdating of stock options, prime bank fraud\textsuperscript{46} and affiliation fraud.\textsuperscript{47}

These areas of investigatory emphasis varied across SEC FY 1992 through FY 2007. I did not identify an overarching strategic theme in the sixteen years of data that comprise the primary data set. Moreover, although the SEC intermittently emphasized certain substantive areas, it also took a “‘cover the waterfront’” approach to civil prosecution by maintaining an enforcement presence – and filing cases – across all areas of financial fraud. This tactic was designed to leverage the agency’s finite resources to project a deterrence effect (GAO 2007, 15). It was a way for the agency to respond consistently to the bread-and-butter-type fraud cases that would emerge unpredictably and without any pattern across geographic areas and industries.

Further, as the data in Figure 2.1 make evident, although an investigation enters the civil enforcement cycle in a particular fiscal year, it is impossible to determine when that case will exit the cycle. The thousands of pending investigations that carry over across years speak to a pool of prosecutions with origins rooted in different (i) investigative emphases, (ii) geographic areas, and (iii) SEC Division of Enforcement staff teams. These sources of diversity for the set of cases that make it into the process and that are intermingled without a discernible trend across fiscal years, also tend to mitigate selection bias by the agency.

\textsuperscript{46} Prime bank fraud generally tries to exploit investors’ greed and lack of due diligence. This form of financial fraud originates with claims by the perpetrator that investors’ funds will buy ”prime bank” financial instruments – from very successful banks and other institutions – on clandestine overseas markets that will produce big returns. The financial instruments and the markets on which they allegedly trade, however, do not exist – and the perpetrator steals the investment funds. \textit{See, e.g.}, SEC v. Philip J. Yoder, June 10, 2003, LR-18184.

\textsuperscript{47} Affiliation fraud is financial fraud perpetrated upon members of a particular ethnic or religious group by a fellow member of the group who is in a position of trust. \textit{See, e.g.}, SEC v. W.L. Ware Enterprises, Inc., January 27, 2004, LR-18557 (“targeted African-Americans and Christians”).
Beyond the Investigation

Once an investigation is complete, SEC staff have a choice of closing out the case without bringing charges or recommending the next step in the enforcement path—filing a civil enforcement action in federal district court or before an ALJ, or negotiating a settlement with a defendant. SEC staff may close an informal investigation relatively simply and quickly, but they must get Commission approval to close a formal investigation without bringing charges by submitting a memorandum through the General Counsel, laying out the evidence (or lack thereof) and the relevant legal analysis and justification for not pursuing the matter. Given the non-public nature of the SEC’s investigatory process, there is no data available that quantifies this outcome. It is reasonable to presume, though, that this is an uncommon bureaucratic result.

In-depth analysis of the case by both SEC staff and commissioners occurs at the stage when the application for approval to initiate a formal investigation is submitted to the commissioners (Marshall 2002) – to minimize an avoidable waste of resources. Alternatively, when SEC staff concludes it has developed through its investigations evidence sufficient for the agency to justify a proceeding to charge defendants with violating securities laws, it will prepare a recommendation for the Commission to submit a public civil enforcement action in district court or before an ALJ (McLucas, Taylor, and Mathews 1997). Once the SEC decides to bring a civil enforcement action, it is

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48 Remarkably, the SEC is not legally required to inform targets of, or witnesses in, an investigation that it has closed the investigation. The agency’s issuance of an appropriate “closing letter” is optional (McLucas, Taylor, and Mathews 1997, 111), although in recent years its policy is to strongly encourage staff to send such notices (see SEC Division of Enforcement. March 9, 2012. Enforcement Manual 2012, 34-35, Washington, D.C.).
empowered through federal statutes and its own *Rules of Practice* to file the civil complaint in either forum – district court or administrative proceedings before an ALJ.

On the micro level, part of the staff’s focus when justifying its recommendation of forum to the commissioners includes case characteristics such as: (i) the seriousness of the alleged offense, (ii) whether the violation was technical (*e.g.* involved non-conformance with regulatory filing provisions), and (iii) what form(s) of sanction would be warranted (Johnson 2007, 642). Importantly, the dissertation tests on a macro level whether the staff strategically factor in the nature of the available forums, including the ideological reputation of the district court that most likely would have jurisdiction over the case, in addition to potential case characteristics.

**Wells Process**

After the investigation is complete but before SEC staff submits the memorandum to the commissioners, it typically provides a “Wells notice” to counsel for the potential defendant, describing its findings and the probable causes of action it will recommend bringing against the defendant.\(^4\)

The recipient of the notice may respond via a “Wells submission,” a legal brief explaining the potential defendant’s view of the facts and making arguments why the case should not be submitted as a civil enforcement action. SEC staff may reconsider its position after examining the submission or, in the more common scenario, proceed with its enforcement recommendation. This step provides

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\(^4\) The SEC appointed an advisory committee headed by former SEC chair John A. Wells (also founder of the law firm Rogers & Wells) and comprising two other former SEC chairs, Manuel F. Cohen and Ralph H. Demmler. More than 40 recommendations from the Wells Committee to the SEC for improving the efficiency and fairness of the agency’s enforcement program, including this discretionary notification process, were included in the “Report of the Advisory Committee on Enforcement Policies and Practices,” June 29, 1972. See Securities Act Release No. 5310, September 27, 1972. (Herr 2003, 56; Mahoney, Walker, Schwartz, and Greenstein 2004, A-65).
both another source of information and one more self-check for the staff during the process of its investigation and finalization of its recommendation. The Wells submission, and staff responses addressing the potential defendant’s arguments, are included as part of the package for the full Commission.50 (Johnson 2007; Larsen, Buckberg, and Lev 2008; and Mahoney, Walker, Schwartz, and Greenstein 2004)

Commissioners Consider Public Civil Enforcement Filing

On a macro level, SEC commissioners review the memorandum in the context of the universe of cases they have been compelled to evaluate through diverse submissions originating from various regional and local SEC branch offices. An SEC commissioner recently opened a window on the agency’s strategic ruminations, describing in some detail the factors that are appropriate for a commissioner to consider when deciding whether to approve a filing51:

- How and to what extent did the alleged violation harm investors.
- Did the defendant commit the act(s) intentionally or were they the result of negligence.
- Do better alternatives exist for addressing the conduct rather than through an enforcement action.
- What will be the deterrent effect of bringing a case of this type – will there be diminishing returns on deterrence.

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50 SEC staff is not required to issue a Wells notice to the subject of an investigation – particularly when the agency decides it must act quickly to protect the public interest from ongoing fraud (17 C.F.R. § 202.5; and McLucas, Taylor, and Mathews 1997).

51 In addition to this detailed list, I was able to find one other – more general – description of such strategic considerations provided by an SEC commissioner. See Ethiopis Tafara, Director, SEC Office of International Affairs. April 15, 2004. “Remarks Before the Panamanian Securities Regulatory Community and Industry,” 3, Panama.
• What will be the marginal effect of bringing a certain case or advancing a legal theory – will the agency be able to get the relief it seeks without expending significant resources to bring a civil action.

• Will the alleged violator likely be sanctioned by another government entity or through private securities litigation – if so, the agency may be able to conserve resources and pursue cases that are not being addressed by others.  

Although this list was provided publicly well after the date of the last case in my primary data set, it is fair to presume that it is a compilation of factors commissioners considered as part of their decision making for at least some of the SEC fiscal years prior to 2009 (when the commissioner delivered this speech) dating back to FY 1992 (the start of the data set). It also is not a formal list, but a reflection of informal guidance that provides a useful glimpse of commissioners’ priorities. This large number of informal considerations (and the absence of official guidelines for commissioners to evaluate cases), in addition to the diverse perspectives on decision making from the twenty different commissioners who served on the SEC during the period of the primary data set, again mitigate against a systematic bias over sixteen years in the type of case the SEC pursued through its civil enforcement program.

According to some accounts, weekly debates over the enforcement recommendations from staff among the commissioners typically take place in one or two closed-door three-hour sessions. Though I could find no transcripts of such proceedings, it is again reasonable to conclude that the Commission debates the staff’s recommendations regarding forum in the memoranda they are presented and their

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strategic implications for potential success in the respective cases. It remains unclear whether the Commission discusses the specifics of venue as well, or whether – once forum is agreed upon – the narrower venue decision is made by the litigation team factoring in such information as the political ideology and reputation of the relevant district court. Ultimately, the Commission decides publicly whether to bring a civil enforcement action, and the forum for the filing, at a formal meeting. This decision lists the causes of action, defendants, specific charges, and the type of relief the agency seeks (Johnson 2007, 644). The process represents a substantial time commitment of the Commission as a group – again demonstrating how important the civil enforcement process and its outcomes are to the SEC.

**Option to Appeal Trial Outcome**

A defendant in a civil enforcement proceeding has the usual option of appealing a decision by a federal district court to the federal circuit court of appeals with jurisdiction for that district. The *SEC Rules of Practice* governing administrative proceedings, however, provide that the decision of an ALJ can be appealed first to the full Commission. The Commission considers such appeals, *de novo*, or in their legal entirety. That is, it will use the facts and testimony assembled during the administrative proceeding, but does not review the decision of the ALJ in an appellate mode. Rather, the Commission renders its own ‘new’ decision, and it may provide distinct legal reasoning for agreeing with or rejecting an ALJ’s Initial Decision. The decision of the

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54 *SEC Rules of Practice*, Rule 411(a) (“The Commission may reverse, modify, set aside in whole or in part, an initial decision by a hearing officer”).
full SEC, in turn, can be appealed to the D.C. Circuit or to the circuit court of appeals where the defendant resides or has its principal place of business.\(^{55}\)

**Binary Choice of Forum for Public Civil Enforcement Actions (Informing Operationalization of Dependent Variable)**

As the description of the SEC’s public civil enforcement process states above, when the agency decides to file a civil enforcement action it is empowered through federal statutes and its own *Rules of Practice* to file the complaint either in the forum of district court or in the forum of administrative proceedings before an ALJ.

The material differences between the enforcement options available to the SEC in federal court compared to those in administrative proceedings compel the agency to make a series of substantive decisions before initiating a public civil enforcement action against a defendant. SEC bureaucrats and commissioners must determine, for example, whether the evidence warrants the enhanced expenditure of agency resources in pursuit of a more severe penalty against a defendant in federal district court. They decide in each matter whether the marginal benefits of filing a suit in the forum of federal court outweigh the increased risk of going to court over the more agency-friendly forum of administrative proceedings.

**Civil (Not Criminal) Enforcement Actions Only**

Prior to deciding whether to pursue a civil enforcement action, the SEC – if it identifies a possible additional criminal violation of securities laws – has the discretion to refer that part of the case to the DOJ or directly to a regional U.S. Attorney’s Office for

investigation (Mahoney, Walker, Schwartz, and Greenstein 2004). The SEC is not itself empowered to pursue a criminal investigation. There is no standard procedure for these referrals, the process remains informal, and often the SEC does not adequately document the criminal referrals (GAO 2007). As a result, cooperation between the SEC and DOJ during the period of my primary data set was inconsistent.

Skeptics of this informal approach argue that it raises the issue of the moral hazard of expecting bureaucrats from an agency like the SEC to voluntarily pass on cases – which are more likely to have policy gravitas (involving a criminal component), to be high-profile and to attract positive attention from political principals like members of congressional budget and oversight committees, and to provide intellectual challenges – to another set of bureaucrats for nothing in return. This quandary “may also lead to the expansion and application of civil enforcement authority (by the SEC maintaining jurisdiction and filing a parallel civil action) to cases where a(n absolute) criminal referral would better suit the offense, the violator, and the needs of the public and markets” (Davis 2001, 83). In addition, at least one SEC commissioner has viewed the transmission of cases to DOJ prosecutors as the agency “abdicate(ng)...its responsibility for shaping securities laws... Restrictive court interpretations of the securities laws, especially in criminal cases (handled by DOJ, not SEC enforcement attorneys), threatened” SEC enforcement initiatives (Karmel 1998, 43-44).

On the other hand, criminal prosecutors in the DOJ had traditionally deemphasized referrals from the SEC involving issues like securities fraud because those cases are often complex, document-intensive, and would return relatively little to a prosecutor’s office for the large expenditure of resources. For example, during 1998-
1999 SEC Chair Arthur Levitt traveled to U.S. Attorneys’ Offices across the nation in an effort to encourage them to accept more financial fraud cases – to little avail. Apart from the SDNY, few offices took on SEC-sourced cases. After the onset of high-profile corporate fraud cases like Enron in 2001, however, the DOJ made securities fraud one of its top priorities. As a result, criminal referrals to other agencies, including the DOJ and U.S. Attorneys’ Offices, became much easier for the SEC. In 2003 for instance, 48 separate districts brought securities fraud cases.

The SEC can proceed with its own parallel civil case against a defendant who is subject separately to a criminal prosecution. The agency is even authorized to use evidence developed by DOJ prosecutors in a criminal proceeding for its own civil proceeding. Also, the lower federal courts have consistently rejected Constitutional challenges (based on Fifth Amendment right against self-incrimination, or the doctrine of double jeopardy) to these parallel civil and criminal proceedings (Mahoney, Walker, Schwartz, and Greenstein 2004).

About 12% of the civil cases comprising the original data set developed for this dissertation are part of parallel proceedings. Table 2.2 provides a summary of the fundamental distinctions between civil and criminal enforcement of U.S. securities laws.

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58 SEC v. HealthSouth Corp., 261 F.Supp.2d 1298 (N.D. Alabama 2003). Also, the section entitled “Indirect – Private Fruits of SEC Public Enforcement Litigation” in the Addendum chapter of my dissertation describes how a large percentage of SEC public civil enforcement cases, in turn, spawn parallel private securities litigation cases.
### Table 2.2 Summary of Distinctions: Civil vs. Criminal Enforcement of U.S. Securities Laws


<table>
<thead>
<tr>
<th>Civil Enforcement</th>
<th>Criminal Enforcement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General:</strong> remedial purpose – individual brings suit to be made whole from injuries caused by defendant. Or government agency brings action in “interest of society,” but defendant’s action does not rise to level of “crime” as defined by legislative body</td>
<td><strong>General:</strong> government prosecutes defendant to punish for crime. Rationale underlying statute defining crime often includes “moral” dimension</td>
</tr>
<tr>
<td><strong>Conceptual:</strong> focus on objective liability, protecting legal rights, and getting plaintiffs restitution for losses</td>
<td><strong>Conceptual:</strong> focus on mens rea, scienter, and the intent of the defendant (“guilty mind”)</td>
</tr>
<tr>
<td><strong>Conceptual:</strong> compensatory, business-like, and concerned with damages incurred by individuals</td>
<td><strong>Conceptual:</strong> retributive and non-utilitarian; concerned with a threat to society</td>
</tr>
<tr>
<td><strong>Practical:</strong> civil authorities – like SEC – have more limited powers of investigation; restrained by Privacy Act of 1974 to identify up front purpose of inquiry</td>
<td><strong>Practical:</strong> criminal authorities have broader powers, many tools to investigate – including undercover operations, intercepts, paying informants, conferring immunity to compel testimony – that civil authorities do not have</td>
</tr>
<tr>
<td><strong>Practical:</strong> once case is filed, however, civil party like SEC or defendant has more latitude to get at facts and prove case under Federal Rules of Civil Procedure – broad discovery rights. Jury can draw adverse inference from invocation of 5th Amendment</td>
<td><strong>Practical:</strong> Federal Rules of Criminal Procedure limit both the prosecutor’s and defendant’s rights to pre-trial discovery. Cannot draw any conclusion from silence under 5th Amendment</td>
</tr>
<tr>
<td><strong>Threshold:</strong> Preponderance of evidence</td>
<td><strong>Threshold:</strong> beyond a reasonable doubt</td>
</tr>
<tr>
<td><strong>Remedial penalties:</strong> injunction – i.e. mandate from court for defendant to cease wrongdoing; restitution to plaintiff/victim; disgorgement – i.e. give up ill-gotten gains; deny privileges, like working in certain jobs or holding licenses</td>
<td><strong>Retributive penalties:</strong> imprisonment, severe monetary fines, and capital punishment</td>
</tr>
<tr>
<td>Commission must approve bringing case.</td>
<td>Grand jury must hand down indictment in order for case to go to court.</td>
</tr>
</tbody>
</table>
Evolution of Binary Choice of Public Civil Enforcement Forum

The binary choice the SEC has for filing a public civil enforcement action – federal district court or administrative proceedings – has its roots in both the general evolution of the administrative process in the U.S. and the agency’s enabling legislation. The establishment of the Interstate Commerce Commission (ICC) (predecessor to scaled-down Surface Transportation Board) in 1887 is considered the starting point of administrative law and process in the U.S. (Attorney General’s Committee 1941). The first federal independent commission, however, was actually created in 1822. Table 2.3 summarizes the evolution of the administrative state in the U.S. prior to World War II.

Table 2.3 Evolution of the Administrative State in the U.S., Pre-World War II

<table>
<thead>
<tr>
<th>Period Established</th>
<th>Number of Agencies Established</th>
<th>Examples of New Agencies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior to End of Civil War</td>
<td>11</td>
<td>Patent Office, Bureau of Internal Revenue</td>
</tr>
<tr>
<td>1865-1900</td>
<td>6</td>
<td>ICC</td>
</tr>
<tr>
<td>Prior to End of World War I</td>
<td>9</td>
<td>FDA, The Fed, FTC</td>
</tr>
<tr>
<td>1918-1929</td>
<td>9</td>
<td>(Predecessor to) FCC</td>
</tr>
<tr>
<td>1930’s (New Deal)</td>
<td>17</td>
<td>SEC, NLRB, Social Security Board</td>
</tr>
</tbody>
</table>

Source of Data: Kuehnle (2004-05) (citing Attorney General’s Committee 1941)

The U.S. Supreme Court recognized as early as 1810 that a bureaucrat – a collector of customs duties – under a system of administrative powers that had been delegated by the First Congress, served legitimately as a “quasi judge.” Further, the Court in 1884 acknowledged the legality of “quasi-judicial functions” performed by

59 The Florida Land Commission. Another of the earliest federal independent agencies, the California Land Commission, was established in 1851.
administrative bodies. Thus, the Court accepted the delegation and combination of separate powers – regulatory/legislative and judicial – by Congress in the administrative function in some of its earliest precedent (Schwartz 1976). These are the roots of the judicial function that the SEC performs as an independent agency in the modern era.

The ICC provided a key precedent for the modern administrative state in the U.S. because it was the first agency whose primary mandate was the oversight and well-being of a particular industry (Landis 1938). As a result, it was the structural model for many subsequent administrative agencies. Congress delegated to the ICC powers of rulemaking and adjudication, thereby combining legislative and judicial functions with executive authority in the agency. Through the creation of this administrative structure (and in future acts) Congress recognized that the Industrial Revolution and, eventually, the New Deal, had spawned the need to address economic disputes in a much more complex policy environment. The modern administrative model, therefore, emerged largely from the demands of a modernizing economy (Rich 1983).

It was in this context, and still quite early in the overall development of administrative agencies, that the enabling legislation for the SEC was drafted.\(^{60}\) The drafters had the ICC as a precedent for structuring the agency. They also drew much of their inspiration for defining the approach of this new agency in its regulation of the financial markets from the English Companies Act (Companies Act).\(^ {61}\) The core concept

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\(^{61}\) *English Companies Act*, 1929, 19 & 20 George 5.
embodied in the Companies Act was disclosure. Modern regulation of securities markets actually began in England in 1844 under the first version of the Companies Act, which mandated financial disclosure through the registration of a company prospectus. Hence, the goal of the new U.S. regulatory body was to enforce the provision by participants in U.S. financial markets of full and accurate information to investors.

The Directors’ Liability Act was promulgated in England in 1900 and was used to enforce the Companies Act by penalizing corporate directors and promoters for untrue statements in their prospectuses. The Companies Act also contained civil liability provisions that the drafters of the SEC enabling legislation were able to draw upon while modeling the statute (Landis 1959). These provisions were designed to enforce the disclosure requirements of the new regulatory regime. Nonetheless, the enabling legislation delegated modest powers to the agency and was more remarkable for the powers it initially withheld from the SEC than for those it explicitly granted (Seligman 2003). The legislation did grant residual powers to the agency, however, to allow it to evolve over time to meet the increasingly complex challenges of the developing economy.

The SEC, like any federal independent agency, is a creature of statute – it has those powers that Congress delegates to it (Schwartz 1976). The source of SEC administrative adjudicatory power, for instance, is Congress and not the agency itself – though the SEC exercises these powers and provides due process protections to its defendants (cf. Rosenberg 1981). A commonly cited rationale for the delegation of power to the SEC and other independent agencies is that it relieves Congress of the

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burden of legislating in rapidly evolving, technically complex issue areas like securities regulation. This can also have the unintended consequence of fostering information asymmetry between the agency and its political principals.

Some scholars remain unconvinced by the reasoning of relieving Congress of a technical burden (e.g. Ting 2002), arguing that Congress could have instead delegated the regulatory function to the judiciary “whose traditional role is precisely to formulate and apply rules regulating activities that are often complex…” (Posner 1986, 571). Instead of technical efficiency, this argument goes, Congress delegates powers to independent agencies to promote a more sympathetic enforcement of policy goals than would be found in Article III courts. I examine the concept of case complexity in Chapter 4 through the use of separate independent variables that serve respectively as proxies for the technical complexity and cost of a civil enforcement action by the SEC. I also argue later in this chapter that the SEC does, indeed, offer a more sympathetic setting for policy goals through administrative proceedings in the section, “SEC Fares Better in Civil Enforcement Proceedings before ALJ’s.”

The scope of the SEC’s administrative reach is therefore defined by statute and refined via regulation. It has grown as Congress has tapped the residual powers granted in its enabling legislation and provided the SEC with more administrative enforcement power. Congress has delegated an expanding coterie of powers to the independent agency since 1933 because the need for the SEC to effectively address its mandate requires it to administer civil – that is, remedial – penalties in an ever-more complex

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economic system. The primary purpose underlying this civil form of penalty is to prevent (through injunction) or rectify a wrongdoing (Swenson 1952).

Given the administrative structure and broad enforcement mandate of the SEC, it confronts various forms of transgression in the financial markets. To enforce its mandate in the face of such a dastardly variety, the SEC needs access to multiple adjudicatory approaches. As a natural result of these demands, SEC enforcement tools are provided not only via civil proceedings in federal court, but also through administrative proceedings. In this way, the SEC has the flexibility to use two types of forum for public civil enforcement actions in order to meet its mandate. Congress determines, subject to the review of the federal courts, those transgressions that may be handled in an administrative setting and those that are more appropriate for federal court. As a result, the SEC utilizes a bifurcated civil enforcement system and has a binary choice once it has decided to file a civil enforcement action.

**Forum: Why Compare SEC Filings in Federal District Court to Administrative Proceedings**

The stakes for both the SEC and defendants are higher in federal district court than they are in administrative proceedings, but the SEC tends to fare better against civil defendants in its in-house administrative proceedings. As the SEC acknowledges publicly (SEC 2009, 15), it employs strategic decision making to determine how to pursue civil enforcement actions. It is within this decision making process that the SEC would be influenced, if at all, by the ideology of the lower federal courts or its political principals.
Scope of Authority: District Court Compared to Administrative Proceedings

The SEC has a more potent array of sanctions to levy on defendants in federal court than it does in administrative proceedings.\(^{64}\) Table 2.4 summarizes the sanctions available to the SEC when filing a civil enforcement action in the forum of federal district court as compared to the forum of an administrative proceeding. It is worth noting, as I describe in Chapter 3, that the Sarbanes-Oxley Act (Sarbox) enhanced the sanctions available to the SEC through administrative proceedings beginning in the fourth quarter of 2002.

Also, because a defendant is exposed to greater risk and a more severe outcome in federal district court, the *Federal Rules of Civil Procedure*, which govern discovery practice in federal court, provide protections to a defendant that exceed those offered through the *SEC Rules of Practice*, which govern discovery in SEC administrative proceedings.\(^{65}\) The relatively relaxed evidence standard in administrative proceedings, like those conducted by ALJ’s located in the SEC, is designed to encourage broad admission of evidence – including hearsay\(^{66}\) (Kuehnle 2004-05). In general, traditional concepts of introducing evidence against a defendant are applied more flexibly in the administrative setting to provide ALJ’s the discretion to develop facts supporting a

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\(^{64}\) See Mary L. Schapiro, SEC Commissioner. January 20, 1993. “New Enforcement Remedies.” *Remarks at the Twentieth Annual Securities Regulation Institute*, Coronado, California, 9 (though SEC forum decision is fact-sensitive to each case, one generalization is that more serious violations should be filed in federal district court because (at time of speech) court-issued injunctions have more consequences for defendants than other forms of penalty that can be meted out through administrative proceedings).

\(^{65}\) 17 CFR §§201.01-201.29 (specialized *Rules of Practice* for the SEC; not every agency has specialized rules that govern its ALJ proceedings). The provisions of the SEC’s *Rules* for admitting evidence – like those of a substantial majority of federal agencies (Pierce 1987, 3 n.7) – track closely those of the Administrative Procedure Act of 1946 (APA), establishing the baseline requirements for the adjudicative function of the administrative process for all federal agencies (Kuehnle 2004-05).

\(^{66}\) *Richardson v. Perales*, 402 U.S. 389 (1971) (hearsay admissible in administrative proceedings and as a valid basis for the actual decision by an ALJ).
resolution for both the individual dispute before the judge as well as the broader (and often more important to the agency) policy issue at hand (Koch 2005).67

Table 2.4 Civil Enforcement Sanctions Available to SEC in Federal District Court vs. those Available in Administrative Proceedings for Period of Primary Data Set, SEC FY1992-2007

<table>
<thead>
<tr>
<th>Federal District Court</th>
<th>Administrative Proceedings</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEC must meet lower “reasonable likelihood” standard of proof to obtain temporary or permanent injunction.</td>
<td>SEC must meet higher “irreparable injury” or “inadequate legal remedy” standard to obtain temporary or permanent injunction.</td>
</tr>
<tr>
<td>SEC can seek either temporary or permanent injunction against any person or entity</td>
<td>SEC has authority to seek temporary injunction against only a limited number of categories of participants in the securities industry.</td>
</tr>
<tr>
<td>No statute of limitations for injunctive actions</td>
<td>Statute of limitations exists, varies depending on sanction SEC seeks.</td>
</tr>
<tr>
<td>SEC has broad authority to seek civil monetary penalties against any violator of federal securities laws (for example, agency can seek civil monetary penalties against issuers of public stock only in federal court)</td>
<td>Authority of SEC to impose administrative fines limited to actions against categories of securities professionals specified in federal statutes.</td>
</tr>
<tr>
<td>SEC may seek punitive monetary penalties up to 3 times the amount of money gained or loss avoided, depending on level of scienter of defendant</td>
<td>SEC must meet 2 additional burdens prior to imposing monetary penalties on defendant: (i) must find it in “public interest” (as defined by statute) and (ii) must prove defendant “willfully” violated law.</td>
</tr>
<tr>
<td>Courts can use general equitable powers to allow SEC to pursue remedies beyond injunctive and monetary relief against entities, such as (i) requiring the appointment of an independent majority to board of directors of public company, (ii) appointment of a receiver to a public company, (iii) appointment of independent counsel to conduct investigations, (iv) asset freezes and (v) requiring creation of audit committees composed of independent directors.</td>
<td>SEC has no comparable general powers of equity. Federal statutes, however, expressly provide SEC with limited range of additional sanctions (12-month suspension, revocation or bar) to impose against certain securities professionals (registered brokers and dealers and persons associated with them) who violate law.</td>
</tr>
<tr>
<td>Court can permanently bar a defendant from serving as officer or director of publicly traded company</td>
<td>After passage of Sarbox in 2002, SEC can also permanently bar a defendant from serving as officer or director of publicly traded company.</td>
</tr>
</tbody>
</table>

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67 The emphasis on flexibility can lead to a lack of standardization. One scholar has noted that in 1987, 1,121 ALJ’s utilized 280 different sets of rules of evidence in administrative proceedings (Pierce 1987).
Its own *Rules of Practice* restrict the scope of the information that the SEC has to provide to a defendant through discovery prior to the onset of proceedings before an ALJ and do not automatically provide for standard techniques of developing potentially exculpatory facts such as depositions. As a consequence, a defendant in a civil enforcement action in federal court – where pre-trial discovery is compelled to a greater degree – may have a better idea of the evidence that the SEC has developed early in the process.

Further, a defendant in an SEC civil prosecution in federal district court has access to three additional protections that are absent in administrative proceedings. First, the defendant may bring claims against third parties for indemnification and contribution, thereby attempting to reduce the pain of civil monetary penalties by spreading it to others not named by the SEC. Next, a defendant may bring a counterclaim against the SEC, causing the agency to expend limited resources and time on its own defense and possibly absorb adverse press coverage – which could draw the attention of members of Congress on its oversight and appropriation committees, as well as unwanted attention from the White House. Finally, defendants in federal district court have a right to a jury trial, which is in stark contrast to pleading one’s case solely to an ALJ. (Rakoff Opinion and Order 2011, 6)

Complying with stricter discovery requirements and preparing a case for trial in federal court, where it may face unexpected third parties or a hostile jury, consume the time and resources of the SEC – as well as the defendant. The SEC also opens itself to the potential consequences of counterclaims in this forum. For its part, the bureaucracy must weigh those costs against the far greater potential upside of prosecuting a civil
enforcement action in court, as well as against the benefits of the friendlier administrative forum.

**Fares Better in Civil Enforcement Proceedings before ALJ Corps**

Concerns over the fairness of the administrative process to defendants at the SEC emerged intermittently during (and prior to) the time period covering the data set. Moreover, it is generally accepted among the community of securities litigators – those most consistently affected by the decision making of ALJ’s at the SEC – that the agency maintains a home field advantage in administrative proceedings. One way the advantage manifests itself, according to adherents of this position, is through an inordinate number of successful outcomes for the agency in these proceedings. This perception generally holds up to empirical scrutiny, but it is necessary to drill down into the data to provide a useful context to the rate of ‘successful outcomes’ for the SEC before ALJ’s.

Nearly twenty years ago, a task force of the American Bar Association (ABA) evaluated the “fairness” of the SEC’s administrative process. This study was triggered in part by The Securities Law Enforcement Remedies Act of 1990 (Remedies Act), which provided the SEC with new administrative civil enforcement remedies and expanded the universe of potential defendants against whom the SEC could bring administrative proceedings. According to the report, while the Remedies Act gave the SEC

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68 Committee on Federal Regulation of Securities, ABA. 1991-1992. “Report of Task Force on the SEC Administrative Law Judge Process.” *Business Lawyer* 47(4):1731-38. This was the third ABA task force to address the ‘fairness’ issue (the prior two were established in 1979 and 1986); the SEC largely ignored the recommendations of the earlier task forces.

69 Note that the primary data set for the dissertation begins in SEC FY 1992 (SEC Fiscal Year ends September 30th) because this new securities law enforcement regime expanded the SEC’s administrative jurisdiction and powers, making them for the first time comparable in many respects to the agency’s
significantly expanded powers, it also provided the agency “complete discretion” to choose whether to bring a civil action in district court or before an ALJ. “No standards for choosing one forum or the other (were) provided” through the legislation. This remains the case today.

The task force recommended “structural” reforms to the administrative process at the SEC in order to “eliminate the risk of perceived and actual unfairness inherent in the (agency’s) dual prosecutorial and judicial roles.” These proposed reforms included: (1) the SEC voluntarily choosing federal court as a forum when it has the binary option of bringing a civil enforcement action in court or administrative proceedings; (2) Congress providing defendants in SEC administrative proceedings the unilateral right to shift forum to federal court; and (3) Congress vesting the authority of the SEC to bring a civil enforcement action before an ALJ in an office of independent general counsel.

Also, the task force found that the SEC “prevailed” in 58 of 62 administrative proceedings that the agency litigated from 1983 through 1988. It argued, “Even if the inference of bias (in favor of the SEC)…is not warranted in fact, the public perception to this effect may be every bit as damaging to the public confidence in the integrity and fairness of the process.” This perception is sometimes hard to balance, particularly when litigants realize that one of the parties – the prosecuting agency – actually supplies enforcement jurisdiction and powers in federal court. I address this in more detail in the “Data” section in Chapter 4.

70 Committee on Federal Regulation of Securities (1991-92, 1732).

71 Id. at 1733.

72 Id.

73 Id. at 1734.

74 Id. at 1735
the ALJ with office space, staff and equipment. Maintaining a reputation of fairness and absence of political influence in prosecutorial entities is critical to their ability to perform effectively. Specifically with regard to the Division of Enforcement, this reputation is essential to the perception of integrity of the U.S. free market system that it has been authorized by Congress to police.

The task force’s conclusions demonstrated clearly the legitimate jurisprudential concern that the SEC has an unfair advantage over a defendant in the administrative setting (particularly when compared to proceedings in federal court). Neither the SEC nor Congress ultimately enacted any of the task force’s proposals for structural reform. Hence, the fairness issue has remained stubbornly unsettled for more than two decades.

One legal practitioner (a former chief litigation counsel in the SEC’s Division of Enforcement) has observed that a defendant in an administrative proceeding before the SEC “is likely…to wonder if the SEC’s administrative system permits a respondent to win (its) case” (Mixter 2001, 214). Mixter’s study cites data suggesting it is rare for a defendant to gain a full dismissal – and ‘win’ outright – in these proceedings. But a study published around the same time argued that although the SEC won most cases before ALJ’s on the merits during the period from September 1998 through May 2000 (covering that study’s data set), the agency was not as successful in obtaining all of the sanctions it sought against defendants (Goldman and Edelschick 2000). As a result, the notion of ‘success’ in SEC administrative proceedings contains nuances beyond straight sanctions (agency wins) and dismissals (losses). It can be qualified further in terms of the extent to

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75 In the litigation I featured in the case study in the Introduction, Judge Rakoff still referred to SEC administrative proceedings as the agency’s “home turf” and stated that it was a forum “favorable” to the SEC when compared to the federal courts (Rakoff Opinion and Order, July 11, 2011, 1 and 4).
which the punishment meted out by an ALJ against a defendant corresponds to the full array of sanctions originally sought by the agency.

**Original Data Set of ALJ Initial Decisions, SEC FY 1992 – 2007**

In this context, to examine the extent to which the SEC fares better in civil enforcement proceedings before ALJ’s for the period covered by my primary data set – SEC FY 1992 through SEC FY 2007 – I created a separate, original data set by coding the 296 Initial Decisions published by SEC ALJ’s during that time period. The data identify: (i) the ALJ rendering each decision; (ii) whether the case was dismissed or the defendant was sanctioned; (iii) for decisions where there were sanctions, whether the ALJ granted all of the sanctions sought by the SEC; (iv) whether the full Commission reviewed the ALJ’s decision – and the outcome of any such review; and (v) where the full Commission rendered a decision, whether that decision was reviewed by a federal Circuit Court of Appeals – and the outcome of such review.

This original data set substantially expands the research beyond the data utilized in the Mixter (2001) and Goldman and Edelschick (2000) works to determine how consistently their findings apply over the period of my study.

**Findings**

The data in Figure 2.2 reveal that 39 of the 296 Initial Decisions resulted in ALJ dismissals for the defendants, while ALJs decided in favor of the agency in 257 cases. The Initial Decisions, however, are the first stage of administrative proceedings and tell

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Footnote 76: The Initial Decisions of SEC ALJ’s from the present through SEC FY 1960 are online at [www.sec.gov](http://www.sec.gov).
only part of the story since they are subject to the appeals process described earlier in this chapter.

**Figure 2.2 SEC Success Rates in Administrative Process**

**Source:** Original Data Set

**Notes:** *Filings of 122 petitions for review: (i) 78.7% filed by defendants, (ii) 9% by Division of Enforcement, and (iii) 12.3% by parties jointly.

**Outcomes of 122 petitions: (i) reversed ALJ in 6 cases; (ii) upheld ALJ in 93; (iii) increased penalties on defendants in 12; and (iv) decreased penalties in 11 cases.*
In summary, only 23 of the original 39 ALJ dismissals survived through the last stage of the administrative appeals process – the SEC ultimately prevailed over defendants in the other 16. As for the 257 cases where the SEC initially won, defendants had nine cases fully reversed, two cases partially reversed, and achieved reduced penalties in 11 appeals. The tally of the data demonstrates that the SEC ultimately won in administrative proceedings against defendants in 262 of 296 of cases – or about 89% of the time – for SEC FY 1992 through SEC FY 2007.

Two additional measures provide context to the success rate by the agency in the administrative process.

Sanctions

First, as explained above, when the SEC prevails in administrative proceedings it does not necessarily obtain all of the sanctions it seeks against defendants. For this original data set, the SEC achieved all of the sanctions it sought against defendants in 154 of the 257 cases where it initially prevailed before an ALJ – a rate of about 60%. This rate rises to 68.3% when the outcomes of full Commission reviews on appeal are factored into the numerator.\footnote{The numerator includes 154 cases where ALJ’s granted all of the sanctions the SEC originally thought, and 25 additional cases where sanctions were added by the full Commission on review.}

Though some have interpreted Goldman and Edelschick’s (2000) original article on the disparity between the percentage of cases where the SEC wins and the percentage where it attains all of the sanctions it seeks as a reason to criticize the agency’s performance, there is another side to the issue. It is a common strategy for a litigant to ask a court for more than it can realistically expect to attain. As long as a civil
prosecutor, for instance, can make a reasonable argument that the evidence would allow a particular claim, there is little incentive for the prosecutor to exclude it from the original filing. Reaching to add a claim serves at least two purposes: the prosecutor can add the claim to see what ultimately sticks against the defendant, and the claims give the agency added leverage in settlement negotiations against the defendant as the case plays out.

Moreover, as even Goldman and Edelschick (2000, 15) recognize, SEC administrative proceedings “pose() substantial risks” to those defendants “who value their unblemished reputations.” To many targets of SEC civil prosecution, any sanction levied by the SEC can cause serious damage to their professional reputations (i.e. their career currency) and result in the end of their source of income. The agency thus does not have to win on the whole gamut of charges in order to succeed. So, for many defendants, the sanction disparity provides little solace.

**District Court Outcomes**

In order to compare how defendants fare in administrative proceedings to their fate in public civil enforcement litigation in federal district court, I developed another original data set by coding a sample of district court outcomes in civil enforcement cases. The Mixter (2001) and Goldman and Edelschick (2000) research did not compare outcomes in cases before ALJ’s to those in district court. For these data, I chose district court cases from a random selection of SEC fiscal years spanning the period of the primary data set. Because district court cases more often than administrative proceedings

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include multiple defendants, I identified the litigation result for each individual defendant (not the case as a whole) and coded accordingly.\textsuperscript{79}

The SEC fully litigated civil enforcement actions against 170 defendants in 69 cases during the sample fiscal years from the primary data set. Federal judges dismissed all charges against 41 of the defendants, while 129 – or about 76\% of the defendants – were sanctioned. This result compared closely with data presented by Mixter (2008), who found that during SEC FY 2007 the agency prevailed in civil enforcement litigation against 37 defendants in 25 cases, while charges were dismissed against 12 – for a success rate of roughly 75\%.

This demonstrates that, while litigating fully against the SEC in federal court risks a difficult path, the agency actually increases its chances of prevailing over defendants by more than 17\% when it brings civil enforcement actions through administrative proceedings. This represents a substantial improvement in the odds for the agency. It is large enough, surely, to factor into the SEC’s decision making when negotiating settlements with defendants or deciding what forum would be appropriate for a particular case. These findings also tend to verify the longstanding perception that the SEC maintains a home field advantage in administrative proceedings.

The section below entitled “SEC ALJ’s” reveals, however, that this strategic advantage on a macro level varies for the agency on a micro level. That is, different ALJs produce different rates of success for the SEC over time. As shown in Table 2.5, these micro-level differences are complicated further by the fact that different ALJs have significantly different rates of productivity (so their rates of sanctioning and dismissing

\textsuperscript{79} This followed the method used in Mixter (2008).
defendants must be weighted differently) and by the lack of a fully transparent and predictable process for assigning cases to ALJs.

Table 2.5 Initial Decision Outcomes for SEC ALJ’s, SEC FY 1992 through FY 2007
Source: Original Data Set derived from initial decision opinions available on www.sec.gov

<table>
<thead>
<tr>
<th>ALJ Name</th>
<th>Cases-Sanctions</th>
<th>Requested Sanctions</th>
<th>Cases-Discards</th>
<th>Reversed by Full Commission</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warren E. Blair</td>
<td>6</td>
<td>4</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>G. Marvin Bober</td>
<td>6</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>William J. Cowan</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Cameron Elliot</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Carol Fox Foelak</td>
<td>40</td>
<td>27</td>
<td>10</td>
<td>6</td>
</tr>
<tr>
<td>Herbert Grossman</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Stephen Grossman</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>James T. Kelly</td>
<td>33</td>
<td>20</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Burton S. Kolko</td>
<td>5</td>
<td>3</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Edward Kuhlmann</td>
<td>11</td>
<td>9</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Glenn Lawrence</td>
<td>19</td>
<td>5</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Robert G. Mahony</td>
<td>36</td>
<td>25</td>
<td>9</td>
<td>2</td>
</tr>
<tr>
<td>Lillian McEwen</td>
<td>27</td>
<td>14</td>
<td>13</td>
<td>8</td>
</tr>
<tr>
<td>Brenda P. Murray</td>
<td>62</td>
<td>42</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>Max Regensteiner</td>
<td>5</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Jerome Soffer</td>
<td>3</td>
<td>2</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>H. Peter Young</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>257</strong></td>
<td><strong>154</strong></td>
<td><strong>39</strong></td>
<td><strong>18</strong></td>
</tr>
</tbody>
</table>

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80 ALJ’s Cowan, H. Grossman, S. Grossman, and Young did not serve as SEC ALJ’s, but their services were loaned from their respective agencies briefly to the SEC to clear case backlogs.
81 ALJ Elliot’s term began in 2011.
**Success Rates in Broader Context**

To put the SEC success rates in broader perspective, I conducted an analysis of the success rates of all U.S. Attorneys’ offices in two distinct litigation practice areas for the same time period. First, I calculated the combined average success rate for those offices in federal criminal prosecutions, and found that it was about 90.4%. The variation within this average rate ranged from a high of 93.5% in FY 2007 to a low of 86.5% in FY 1992. I also examined the combined average success rate in “affirmative civil enforcement” cases, or those civil cases where U.S. Attorneys’ offices represent executive agencies of the U.S. government in a variety of litigation. U.S. Attorneys’ offices prevailed in an average of about 84.6% of cases annually for this period. The variation within this category was a bit wider, with a range from a high of 90.2% in FY 2003 to a low of 76.9% in FY 1993. These success rates in prosecutorial settings analogous to the SEC’s public civil enforcement program are generally comparable to the agency’s overall performance.

**SEC Strategically Utilizes Both Forums**

Since the SEC maintains a relative advantage, though nuanced, in outcomes produced through administrative proceedings over those in federal district court, why does the agency not always forego the potential for higher penalties against defendants it

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83 *Id.* (FY 1993) at 40 (“Affirmative civil enforcement is important as a powerful legal tool to help ensure that federal funds are recovered, that federal laws are obeyed, and that violators provide compensation to the government for losses and damages they cause as a result of fraud, waste, and abuse of government funds and resources”).
can seek in federal court and conserve staff time and agency resources and minimize risk by bringing all of its civil enforcement cases before its ALJ corps?

First, the reality is that the SEC’s enforcement program has numerous political audiences it must satisfy through its public performance and results. So, there are occasions when such trade-offs simply do not comport with the practical needs for political support by the agency. In Chapter 4, I test for the existence of political influence by some of these principals on the behavior of the agency.

Congress, for instance, drives the agency’s budget and has a critical oversight role pertaining to its enforcement mission. It is unlikely that members of congressional committees with responsibility for the agency would regularly accept qualitatively watered down enforcement outcomes processed through an ‘easy route’ of administrative proceedings. The members’ reputations with their own political constituencies would be at risk to different degrees depending on the nature of the defendants in a proceedings, the level of damage alleged in a case, and the electorate’s more general level of emphasis on issues of financial fraud in a particular year. All of these factors may be magnified in an election year – which falls every other year for a member of the House.

A similar argument applies to the SEC’s audience in the White House, and through the President’s extended political reach as embodied by the agency’s politically appointed commissioners. The commissioners, who must sign off on the enforcement playbook – in terms of both litigation strategy and/or settlement negotiations – for each case the SEC brings, will not simply eschew the panoply of penalties available to the agency in every instance. The commissioners, like the professionals on the staff of the Division of Enforcement, weigh the appropriateness of expending resources against
seeking harsher penalties for certain defendants. The SEC – to its political principals in Congress, the White House, and within the agency itself – cannot be perceived as letting financial offenders off easily on a regular basis and must, therefore, reach a reasonable balance of leveraging its resources and the laws at its disposal to pursue remedies against securities law violators.

The SEC’s regulated community is another audience whom the enforcement staff and commissioners must consider when developing strategy and deciding on the forum for a case. As discussed above in “Enforcement Actions Help Define Agency Mission,” the agency will use public civil enforcement cases to attempt to deter future fraud or discourage certain forms of dubious financial activity. If this latent audience perceives the agency as being weak and unwilling to use its resources to pursue the full range of penalties against securities violators, the agency’s traditional deterrence function, pursuant to which it actually leverages its limited resources, will lose credibility.

In this context, it is reasonable to conclude, and I test the notion in Chapter 4, that not all civil enforcement cases may be alike in substance. The agency may have more flexibility to conserve resources and utilize its ALJ corps when the evidence supporting a case is not particularly compelling or points toward one of the agency’s ‘bread-and-butter’ matters, that is, those routine cases of fraud or negligent behavior that the SEC must prosecute on a regular basis. These cases typically do not pose an original fact pattern and fall under areas of the law in which precedent is well-settled. In contrast, some new fact patterns present opportunities for the agency to use the federal district courts to forge new common law and legal precepts to utilize as precedent in the future. Administrative proceedings do not produce such legal precedent – ALJ’s do not
necessarily follow each others’ precedents, and their opinions do not have substantive legal standing in district court.

Therefore, as intended by the development of the bifurcated enforcement path described earlier in this chapter, both political reality and sound legal process compel the SEC to make regular strategic use of its two forum options for filing public civil enforcement actions.

**Independent Agency**

I provide an original classification of the sources of the SEC’s independence as a federal agency into two distinct categories: the agency’s structural design and legal independence, and its rhetorical independence.\(^{84}\)

**Structural/Legal Independence**

**Institutional Design**

Creating independence through institutional design most directly affects the highest level of the bureaucracy.

In general, Congress may designate independent agencies – those outside the power rubric of the Executive Office of the President and the agencies comprising the cabinet – by statute.\(^ {85}\) As for the SEC, under the 1934 Act there are five commissioners, not more than three of whom can be members of the same political party. The President

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\(^{84}\) See Table 2.1 for a list of Major Federal Independent Regulatory Agencies and their enforcement-related legal authorities.

\(^{85}\) The Supreme Court held Congress can create independent agencies under certain conditions with commissioners who can only be removed for cause in *Humphrey’s Executor v. United States*, 295 U.S. 602 (1935) (removal of FTC Commissioner by President Franklin Delano Roosevelt for not supporting the President’s New Deal policies deemed illegitimate).
appoints SEC commissioners, with the advice and consent of the Senate, and must select commissioners alternately by party whenever practicable. The staggered terms are five years long – designed not to coincide with presidential terms – and end on June 6th or until a successor is confirmed. A commissioner may be removed only for cause.

This structure follows the typical format that Congress utilizes to design independent agencies. Its purpose is to constrain a President who may attempt to exercise control over an agency. The main structural provisions include the partisan-balance requirement, staggered terms for commissioners and the provision that a commissioner may be removed only for cause. They are intended to create the potential for a newly elected President to inherit a commission that comprises a majority of members who disagree with the President’s policy preferences (Devins and Lewis 2008, 462). “The requirement that commission membership be at least nominally bipartisan does not prevent the appointment of political friends but doubtless lowers the political temperature” (Strauss 1984, 589).

In practice, the structure has mixed results as applied to the SEC. On one hand, only those SEC commissioners nominated during the Nixon Administration had an average length of stay in office that met or exceeded the full five-year term. The average term for an SEC commissioner nominated by President Nixon was 9.3 years, by President

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86 Congress delegated this SEC appointment power to the President because, in general, Congress cannot appoint members of an agency or commission – like the SEC – with administrative powers such as rulemaking or issuing advisory opinions through letters from staff (see Buckley v. Valeo, 424 U.S. 1 (1976)).


88 I address separately the potential for political influence by Congress on independent agencies (i) in the ‘Congressional Dominance’ discussion in the Introduction in Chapter 1, and (ii) in the Data and Methodology section in Chapter 4 by operationalizing and testing a series of independent variables measuring the political ideology of the House and Senate floors, and both the committees and subcommittees with oversight and appropriations responsibility for the SEC (I tested multiple potential sources of congressional influence as a robustness check).
Ford was 1.5 years, by President Carter was 2.6 years, by President Reagan – even though he served two terms – was 4.1 years, by President Bush 41 was 3.1 years, by President Clinton (two terms) was 4.8 years – as weighted heavily by the 7.5-year term of his Chair Arthur Levitt, and by President Bush 43 was 3.4 years.

On the other hand, 19 of 28 commissioners appointed during these Administrations\(^{89}\) ended their term in a Presidential Administration different from the one in which the Commissioner had begun, confirming somewhat the notion that staggered five-year terms have the potential for a newly elected President to inherit a commission that comprises a majority of members who disagree with the President’s policy preferences.

Table 2.6 illustrates that it takes time, and the consent of the Senate, for a new President to change the make-up of the SEC and attempt to project policy preferences through new nominees.

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\(^{89}\) This is adjusted to eliminate the data from the outlier Bush 43 Administration, where only 1 of 10 SEC commissioners nominated by President Bush served for terms that crossed over to the Obama Administration.
Table 2.6 Days to Turnover of Majority Party of SEC Commissioners

<table>
<thead>
<tr>
<th>President</th>
<th>Days from Start of First Term of President to Turnover of Majority Party of SEC Commissioners</th>
<th>Date of Turnover of Majority Party</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jimmy Carter</td>
<td>253</td>
<td>September 30, 1977</td>
</tr>
<tr>
<td>Ronald Reagan</td>
<td>105</td>
<td>May 6, 1981</td>
</tr>
<tr>
<td>George H.W. Bush</td>
<td>0</td>
<td>January 20, 1989&lt;sup&gt;90&lt;/sup&gt;</td>
</tr>
<tr>
<td>Bill Clinton</td>
<td>531</td>
<td>July 5, 1994</td>
</tr>
<tr>
<td>George W. Bush</td>
<td>565</td>
<td>August 8, 2002</td>
</tr>
<tr>
<td>Barack Obama</td>
<td>__</td>
<td>Has not yet occurred</td>
</tr>
</tbody>
</table>


Despite the low rate of full terms and service across administrations by SEC commissioners, the mean time for the composition of the Commission to turn over party majority (after removing the Bush 41 and Obama outliers) is 363.5 days, almost exactly one year. This indicates that the institutional design components, as a whole, do have a mitigating effect as applied to the SEC. The politics of the Commission are one step removed from the electoral cycle, thereby ‘lowering the political temperature.’

Another potential point of influence through which the President may project political preferences is the chair of an independent agency. The chair often exercises substantial influence over a commission (Strauss 1984, 590) and, in the case of the SEC, serves at the pleasure of the President.<sup>91</sup> While it would be politically unpalatable and

<sup>90</sup> Republican majority carried over from Reagan Administration.

perhaps violate federal law for a President to put direct pressure on the SEC chair to encourage certain outcomes,\textsuperscript{92} the President can still influence the agency by selecting a chair that is ideologically in sync with the administration.

Table 2.7 shows, however, absent extreme circumstances newly elected Presidents in the modern era have not immediately begun the transformation of SEC policy preferences through the agency’s chair. The mean number of days it took a President to successfully get a nominee for SEC chair confirmed (excluding the Obama Administration outlier) is 161. Also, because of this potentially unique role, the SEC chair has been subject to political pressure by opponents of the President.\textsuperscript{93}

\textsuperscript{92} Thankfully, the only example I could find of a specific attempt at direct interference in the modern era was by the Nixon Administration trying to intervene in the SEC investigation of Robert Vesco (Seligman 2003, 447-48). This effort was made despite protestations (real or posturing) of Counsel to the President, John Ehrlichman, to Al Haig (soon-to-be Chief of Staff) that the SEC is an independent agency and apparent inquiries made by the Ambassador from Costa Rica to the White House on behalf of Vesco should be answered by “discretely informing” him “that whether or not (the SEC) intends to take action against Vesco should be the subject of inquiry directly from the Ambassador to (then-SEC) Chairman (William) Casey rather than through…the Executive Branch” (Ehrlichman Memorandum to Haig, August 26, 1972, SEC Historical Commission web site, http://c0403731.cdn.cloudfiles.rackspacecloud.com/collection/papers/1970/1972_0826_EhrlichmanHaigT.pdf).

\textsuperscript{93} See, e.g., Harvey L. Pitt, SEC Chair. November 8, 2002. “Remarks at the Securities Industry Association Annual Meeting,” Boca Raton, Florida (“I hope my successor isn’t greeted with the same climate of attack and partisanship (as I was)…” (parenthetical added)).
Table 2.7 Days to Confirmation of SEC Chair Nominated by Newly Elected President

<table>
<thead>
<tr>
<th>President</th>
<th>Days from Start of First Term of President to Confirmation of SEC Chair</th>
<th>Date of Confirmation of SEC Chair</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jimmy Carter</td>
<td>87</td>
<td>April 18, 1977</td>
</tr>
<tr>
<td>Ronald Reagan</td>
<td>105</td>
<td>May 6, 1981</td>
</tr>
<tr>
<td>George H.W. Bush</td>
<td>232</td>
<td>October 11, 1989</td>
</tr>
<tr>
<td>Bill Clinton</td>
<td>187 *</td>
<td>July 27, 1993</td>
</tr>
<tr>
<td>George W. Bush</td>
<td>194 **</td>
<td>August 3, 2001</td>
</tr>
<tr>
<td>Barack Obama</td>
<td>7 ***</td>
<td>January 27, 2009</td>
</tr>
</tbody>
</table>


Notes: * SEC chair was vacant from May 7 to July 27, 1993

** Clinton holdover and longest-ever serving SEC chair, Arthur Levitt, Jr., remained until February 9, 2001

*** Brief confirmation process attributable largely to “extreme circumstances,” i.e. U.S. economy was in midst of rapidly evolving financial crisis

Control over Litigation

The SEC is also empowered to exercise independence through control over its own litigation docket. In general, Congress has authorized the DOJ to conduct litigation on behalf of the United States and most of its agencies.\textsuperscript{94} This is intended to provide administrations the ability to speak as one voice before the lower federal courts while

\textsuperscript{94} 28 U.S.C. §516.
enabling the President, through a cabinet member (the Attorney General), to guide that voice. Congress has exempted the SEC from this requirement.

The SEC is authorized to conduct its own litigation on all matters before every court except the Supreme Court,\(^9\) where it is represented by the Office of the Solicitor General.\(^9\) The federal courts have recognized as legitimate this delegation of power to the SEC since its first year of existence.\(^9\) Not surprisingly, since 1935 the SEC and DOJ have struggled periodically over the SEC’s continued authority to represent itself in federal court (Karmel 1982).

In practice, Congress grants exceptions to decentralize the DOJ’s litigation authority in the lower federal courts, thereby expanding the power of independent agencies and, some argue, giving more leverage to congressional oversight committees (and subcommittees) to influence agency policy (Devins 1994). In the case of the SEC, this independence encourages the development within the agency of a competent and experienced corps of civil enforcement litigators. SEC Enforcement litigators believe their decisions will not be second-guessed by a subsequent team of DOJ attorneys and, along with the SEC’s commissioners, control the agency’s litigation strategy up to the Supreme Court.\(^9\) This structure can also empower the agency – for better or worse – to

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\(^9\) 15 U.S.C. §§77t(b)-(c), §§78u(c)-(e).

\(^9\) 28 C.F.R. §0.20 (the Office of the Solicitor General is charged with (c)onducting, or assigning and supervising, all Supreme Court cases for the federal government, except where explicitly provided otherwise by statute).


\(^9\) This distinguishes the SEC and its enforcement program from most other agencies. Contrast the SEC structure with the EPA, for instance. EPA litigation in the lower federal courts (but not in its administrative proceedings – where EPA attorneys handle its cases) is conducted by DOJ litigators who represent the views of the federal government on a macro level and consider the competing views of other federal agencies when developing the EPA’s approach to a case. The positions the DOJ attorneys take in court, or
promulgate policy through litigation (see Karmel 1982) and concentrate its efforts on
different forms of financial fraud (or those acts it alleges constitute fraud) to stay ahead
of the curve on emerging forms of malfeasance and deter potential bad actors.

If the SEC were compelled to hand key litigation decisions over to the DOJ, the agency would lose much control and predictability surrounding its public civil enforce
program. And since civil enforcement has traditionally defined the mission of the SEC, the SEC’s independent litigation authority goes to the core of its mission as an agency.

Although the Supreme Court is not part of the focus of this dissertation, it is worth noting that for SEC litigation at the Court – where the Solicitor General represents the agency 99 – the SEC has historically worked well with its litigation partner (Lochner 1993). In fact, Congress in 1973 had originally proposed amendments to the 1933 and
1934 Acts that would have provided the SEC with fully independent litigating authority before the Supreme Court, but withdrew the language after the SEC did not pursue the issue hard in committee. The agency was apparently content with the relationship that it maintained with the Solicitor General and believed its views were being appropriately represented by that Office (Devins 1994, 272-73).

There has not been a subsequent push for SEC independence at the Supreme
Court level, perhaps since – relative to other federal agencies – it already has significant independence because of its litigation authority in the lower federal courts. In addition, the agency’s relationship with the Solicitor General cuts two ways. The SEC cedes the

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99 The Solicitor General is appointed by the President. The Office of Solicitor General has been within the DOJ since the Department’s establishment in 1870, is subject to supervision of the Attorney General and removal by the President (Lochner 1993; McCree 1981). In practice, the Office is considered to have significant independence from the direction of the Attorney General and DOJ (Devins 1994). So, though the Office of Solicitor General is of the DOJ, it is reasonable to consider it a distinct entity.
independence that it has to manage its own litigation in the lower federal courts, and the agency must sometimes work hard to convince the Solicitor General to petition the Court for certiorari. Nonetheless, such a petition from the Solicitor General carries gravitas with the Court that the SEC simply could not replicate on its own. The Solicitor General traditionally petitions the Court on those cases that it believes the Court wants to hear and selects only those cases it believes it can win on the merits (Lochner 1993, 558). No other litigator has a more comprehensive perspective on this issue since the Solicitor General conducts virtually all of the federal government’s Supreme Court litigation. This improves the SEC’s chances of succeeding on a petition for certiorari over what its prospects would be if the agency submitted a petition on its own – and the agency surely does not have the range and depth of perspective of the Solicitor General regarding the preferences of the Supreme Court.

**Exempt from Executive Orders**

Presidents in the modern era have also attempted to exert control over agencies and their processes by issuing executive orders intended to impose procedural constraints and resource-intensive reporting requirements on those agencies when they take actions such as issuing regulations (see Mayer and Weko 2000). Table 2.8 summarizes the scope and substance of executive orders from the modern era that were designed to control agency behavior.
### Table 2.8. Executive Orders of the Modern Era and Their Application to Independent Agencies

<table>
<thead>
<tr>
<th>President</th>
<th>Executive Order (EO)</th>
<th>Primary Purpose of EO</th>
<th>Whether Applied to Independent Agencies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Richard Nixon</td>
<td>“Quality of Life” review Memoranda from Office of Management and Budget (OMB) Director, (not EO)</td>
<td>OMB “interagency” review of proposed regulations involving environment, consumer protection and occupational safety and health to determine impact on other agencies</td>
<td>Did not apply</td>
</tr>
<tr>
<td>Gerald Ford</td>
<td>EO 11821</td>
<td>Agencies must produce “inflationary impact” statement when proposing rules and regulations</td>
<td>Did not apply</td>
</tr>
<tr>
<td>Jimmy Carter</td>
<td>(1) EO 12044, (2) EO 12174</td>
<td>(1) Promote economic analysis of agency actions, (2) Paperwork reduction</td>
<td>Neither applied</td>
</tr>
<tr>
<td>Ronald Reagan</td>
<td>(1) EO 12291 revoked EOs 12044 and 12174, (2) EO 12498</td>
<td>(1) Expanded OMB review authority; OIRA* empowered to examine all new regulations; (2) agencies submit regulatory agenda to Reagan Admin and explain how advances President’s agenda</td>
<td>Neither applied</td>
</tr>
<tr>
<td>George H.W. Bush</td>
<td>Continued implementation of EOs 12291 and 12498</td>
<td>Broadened OMB review authority beyond scope defined by Reagan Admin; maintained much of Reagan Admin process as well – still governs process for promulgating regulations</td>
<td>Did not apply**</td>
</tr>
<tr>
<td>Bill Clinton</td>
<td>EO 12866 (revoked EOs 12291 and 12498)</td>
<td></td>
<td>Did not apply</td>
</tr>
<tr>
<td>George W. Bush</td>
<td>EO 13422 (amended 12866)***</td>
<td>Intensified regulatory review provisions of prior EOs, cost-benefit</td>
<td>Did not apply</td>
</tr>
<tr>
<td>Barack Obama</td>
<td>EO 13563****</td>
<td>Supplements/reeffirms EO 12866, requires flexible use of online posting of regulations and public comments</td>
<td>Does not apply**</td>
</tr>
</tbody>
</table>
Notes to Table 2.8:

* Office of Information and Regulatory Affairs, an entity within OMB;

** Administration followed up with non-binding request that independent agencies voluntarily attempt to abide by provisions of EO that applied directly to executive agencies;

*** Revoked on January 30, 2009 by President Obama EO 13497, 74 Fed. Reg. 6113 (February 4, 2009);

**** Supplemented by EO 13579, 76 Fed Reg. 41587 (July 14, 2011) encouraging independent agencies to follow its provisions

Sources of Data Used in Table 2.8:

Nixon:

Ford:

Carter:
Executive Order 12174, 44 Fed. Reg. 69609 (December 4, 1979)

Reagan:
Executive Order 12291, 46 C.F.R. 13193 (February 17, 1981)

Clinton:
Executive Order 12866, 58 Fed. Reg. 51735 (October 4, 1993)

Bush 43:
Executive Order 13422, 72 C.F.R. 2763 (January 23, 2007)

Obama:

In general:

Also helpful:
Table 2.8 reveals that one of the relatively more onerous requirements imposed through executive order – and continued across administrations – is for agencies to produce a cost-benefit analysis of each regulation it intends to promulgate. This requirement applies only to executive agencies, however, because Presidents specifically and repeatedly have exempted independent agencies like the SEC from the jurisdiction of executive orders that levied this constraint.

Although both Presidents Jimmy Carter and Ronald Reagan, who imposed this requirement through executive order, were provided a legal opinion by the DOJ that concluded that they had legal authority to apply the requirement to independent regulatory agencies, including the SEC, they chose to exempt those agencies from the mandate (Strauss 1984). Presidents Carter and Reagan, as well as every other President in the modern era, apparently decided the political price of imposing the President’s will on an independent agency in this manner would be unacceptably steep. Nevertheless, these administrations have understood that exempting independent agencies from these regimes designed to control bureaucratic behavior would dilute their impact.100 So, they occasionally took a more subtle tact to projecting influence.

In 1981 for example, Vice-President Bush issued a public plea on behalf of the Reagan Administration to encourage – but not demand – independent agencies to comply with the cost analysis and regulatory review requirements for executive agencies, as mandated by Executive Order 12991 (see Table 2.8): “To the extent you can comply

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100 For example, during the Obama Administration OMB estimates that independent agencies have a $230 billion impact on the U.S. economy, yet the rules and regulations that independent agencies promulgate are accompanied by a minimal amount of financial impact analysis (Subcommittee on Oversight and Investigations Staff. July 5, 2011. “Hearing on ‘The Views of Independent Regulatory Agencies on Regulatory Reform.’” Internal Memorandum for Members of Subcommittee on Oversight and Investigations. House Committee on Energy and Commerce, Washington, D.C.).
with the spirit of the order, this will help demonstrate to the American people the willingness of all components of the federal government to respond to their concerns about unnecessary intrusion of government into their daily lives.”

Thirty years later, the Obama Administration engaged in a more aggressive approach to encourage independent agencies to produce cost-benefit analyses and utilize more flexible approaches in developing regulations as required of executive agencies under its Executive Order 13563. The Administration issued an unprecedented second Executive Order – Number 13579 – pertaining explicitly to independent agencies stating (in Section 1(a)), “To the extent permitted by law, (regulatory) decisions should be made only after consideration of their costs and benefits…” The OMB followed with accompanying guidance emphasizing “independent regulatory agencies (like their executive agency counterparts) should follow the key principles of Executive Order 13563…,” but clarifying that “…this guidance is issued with full respect for the independence of the agencies to which it is addressed, and hence nothing said here is meant to be binding.” Both Presidents thus resorted to soft power to influence the behavior of independent agencies rather than harsh mandates that would bring a strong political response from Congress – the source of the agencies’ independence.

In addition to avoiding anticipated political consequences, Presidents in the modern era still tread lightly when exercising power through executive order, very likely because the constitutionality of mandating behavior for independent agencies through this

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vehicle remains unclear and has yet to be fully litigated. The primary constitutional issue involves the separation of powers. That is, could the President essentially circumvent the explicit will of Congress – that originally chose to create an independent agency through statute – and exert control over the agency through a unilateral act of executive lawmaking without a basis in statutory or constitutional authority? In the absence of such a legal foundation, an executive order would have no effect.  

Moreover, opponents could reasonably claim that a President in these circumstances would be effectively rewriting the provisions that define and establish independent agencies as well as those of the APA governing agency procedures and due process (Rosenberg 1981) by adding exceptions – such as cost-effectiveness requirements – that were not contemplated by Congress and contravene the statutes establishing independent agencies like the SEC. In light of this unclear legal landscape, the specter of a political battle to assert direct authority over independent agencies through executive order – rather than trying to influence decision making through suggestion – has thus far dissuaded Presidents from testing the constitutional limits of their authority.

The SEC is therefore free from the oversight and onerous reporting requirements, managed through the OMB and the White House, that executive agencies are subject to by executive order. This removes an entry point of leverage for the President over the agency. It also helps the SEC to retain some independence in setting policy and bureaucratic priorities and to maintain an arm’s length from the political tensions within an administration. This is not to say that the President, through soft power or other

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104 Rosenberg (1981), 1205 (citing Youngstown Sheet & Tube Co. v. Sawyer, 343 U.S. 579 (1952)).

105 OMB is “a source of presidential institutional memory.” It has “historically sought to increase presidential influence and control” over agencies as the “locus of administrative management” in the executive branch (Lewis 2003, 71).
means, does not attempt to influence the SEC or other independent agencies. But the direct conduit of executive order authority to control behavior has not been available to an administration over the last forty years.  

Rhetorical Independence

The SEC, more than any other agency in the modern era, uses public rhetoric to emphasize its independence. Both SEC commissioners and senior staff argue, accurately or not, that the extent of the agency’s independence differentiates it from its cohorts. One strategy underlying this tactic of ‘independence rhetoric’ may be to enhance the legitimacy of the SEC’s mission-critical enforcement function to financial markets and the federal courts. Another may be to discourage the executive branch from trying to use political pressure to influence the well-publicized independent – and therefore credible – enforcement and regulatory processes of the agency.

Over the last thirty years, as if in response to skeptics arising in the wake of the Vesco fiasco, SEC leadership has utilized a variety of forums to sustain this brand. “It was once remarked to me that the SEC has a tradition of greater independence than the other independent agencies. I would have to agree,” wrote a former commissioner in her book (Karmel 1982, 86). Another commissioner over two decades later differentiated the

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106 The SEC has sought public comment and is conducting a voluntary review and retrospective analysis of its significant existing regulations in response to Executive Order 13579. The SEC, however, did not seek comment on specific troublesome regulations, but only on the process it should use to conduct the review (SEC Press Release, September 6, 2011, “SEC to Seek Comment on Review of Existing Regulations,” Washington, D.C.). Also, pursuant to the Executive Order, the voluntary SEC process will “reflect… (the agency’s) resources and regulatory priorities and processes” – so it will not compel a shift in priorities or resources at the SEC, in contrast to the effect executive orders have had on its counterpart executive agencies.

107 See note 92 supra.
agency in a speech targeted to an industry the SEC regulates: "The SEC is…the crown jewel among (independent) regulatory agencies."\(^{108}\)

A recent SEC chair felt compelled to issue a statement to the media in response to suggestions that some SEC civil enforcement decision making may have been influenced by politics:

> The SEC is an independent law enforcement agency…I am disappointed by the rhetoric. In all my years as a (c)ommissioner and (c)hair at the SEC and the CFTC – having been nominated to these posts by Presidents of both political parties dating back to Ronald Reagan – I cannot think of an instance where politics was a consideration in bringing an enforcement action.\(^{109}\)

The SEC’s independence rhetoric has focused consistently on the theme of the legitimacy of decision making surrounding civil enforcement. This is analogous to the legitimacy of the federal courts: for parties consistently to accept and enforce the decisions of the courts, they must view the federal litigation process as fair and relatively free of politically driven outcomes. The SEC, like the federal courts, relies heavily on its reputation as both a fair enforcer and arbiter in order to be credible with litigants, with regulated parties and with the federal courts. Were this reputation to slip, the SEC would not be able to fulfill its mission.

A future SEC chair who had served on the senior staff of the agency addressed this in an academic journal: “…(A)n enforcement program must be seen as free from political influence…The SEC has been remarkably free from such controversy, and is


widely respected for an enforcement program that will not yield to political pressures…” (Pitt and Shapiro 1990, 170). A director of the Division of Enforcement made the same point in a speech six years later, “…(T)he SEC traditionally has defined the word ‘independent’ in the phrase ‘independent regulatory agency.’ This is not done out of arrogance…It is simply a discipline in the Commission’s management of its law enforcement role which has…lent integrity to the agency’s law enforcement process.”

It is worth noting, however, that some of these commentators have been less confident regarding the SEC’s independent streak when it comes to the agency’s relationship with Congress. “The Commission is not as good at resisting interference from Congress, even if that interference is clearly political” (Karmel 1982, 87). “The Congress…exercises active oversight of the Commission through its appropriation of funds…and through a more informal process of requiring the Chairman to come before the Congress to testify…”

Conclusion

This chapter has presented findings and original data to provide a foundation supporting the theory that I present next in Chapter 3 and the methodology and analysis provided in Chapter 4. This chapter has described the uncommon civil enforcement process of the agency, establishes it as a sound vehicle for analyzing the decision making and behavior of a federal bureaucracy, and cites entry points where politics may


112 See Table 2.1 supra.
influence that process. This process mitigates the potential for selection bias in the primary data set. The chapter also makes clear that the civil enforcement process is inextricably linked to the mission of the SEC and involves all levels of the agency.

I have established here the origins and importance of the agency’s options for civil enforcement and compare them in detail, before concluding that securities litigants have potentially more at stake in district court. Yet I also demonstrate, through use of an original data set, that the SEC has a higher success rate before ALJ’s than in court. As a result, the agency faces a trade-off of the potential for more severe sanctions in district court versus the relative safety of a higher success rate before ALJ’s.

Last, this chapter provides an original classification of the sources of the SEC’s independence as a federal agency, first through the agency’s structural design and legal independence and second, through its rhetorical independence. Agency independence is important in this context because it has the potential to partially insulate the agency from political pressure. This provides the foundation to analyze whether the insulation works or whether – and where – politics enters the civil enforcement process to influence the decision making of the SEC. The agency’s civil enforcement process should be relatively free from politics in order for the agency to maintain a reputation as a fair arbiter and to remain credible with litigants and regulated parties fulfilling its mission.
Chapter 3
Framework of Theory and Hypotheses

Introduction

This chapter presents the framework of the theory that I utilize to structure my analysis of the SEC’s decision making regarding choice of forum and other material elements comprising its public civil enforcement process. The chapter provides a construct of the factors that, at times, affect its behavior. I not only draw on the foundational information and original data provided in Chapter 2, but I also present and utilize additional original data to support the discussion underlying my theory.

This chapter first presents original research to support the main theory. I explain the rationale of key assumptions underlying the theory, including a discussion of how the attitudinal model applies to the lower federal courts, why conservative and liberal lower federal courts view SEC enforcement differently, and how the SEC is aware of the effects of ideology on the behavior of lower federal courts and couches its strategic enforcement decision making in this context.

Next, I illustrate my main theory by showing estimated strategic preferences of the SEC relative to the lower federal courts and its ALJ corps. My theory presumes through this presentation that the SEC functions as an independent regulatory agency and that the politics of its principals in Congress and the executive branch neither influence how it is perceived by the lower federal courts nor how the SEC views those courts.

The chapter then illustrates separately how an exogenous shock to the SEC-regulated financial community – in this case, the Enron scandal in October 2001 – may have temporarily shifted the political preferences of some conservative courts relating to
SEC enforcement. In this context I discuss how such a change could affect the decision making of the SEC. I also discuss potential alternative explanations of how the exogenous shock may have affected the preferences of the players relative to each other.

I then illustrate an alternative view of the SEC that I eventually test in Chapter 4 for comparative theoretical purposes. In this different portrayal, the decision making and behavior of the agency are affected by the ideology of political principals. The lower federal courts respond differently to the enforcement agenda of the SEC depending on whether the agency’s principals in Congress (and/or the executive branch) are ideologically conservative or liberal. In this portrayal, the agency becomes aware of this shift and responds accordingly.

Importantly, I present original data and research on the SEC ALJ corps which has not been presented previously in any other scholarly work to my knowledge. I explain why using ALJ ideology as an independent variable in the dissertation is not practicable or necessary. My discussion highlights how the role and function of federal ALJ’s differ across agencies, and I argue that political science literature often fails to take these differences into account.

The chapter then addresses two key methodical issues that arise in the context of the theory. The first issue is how I mitigated selection bias when creating the primary data set. The second is why I treat SEC settlements of civil enforcement cases as the observational equivalent of litigation in district court or before its ALJ Corps.

In the last section of this chapter I present in descriptive fashion the primary hypothesis and a set of seven secondary hypotheses that emerge naturally from the data and research model underlying my dissertation. I test these hypotheses in Chapter 4 to
determine whether my theory presents a reasonable picture of the causes of SEC enforcement decision making and behavior. The theory provides context and an explanation for the hypotheses. I intend for the secondary hypotheses, in particular, to help provide a richer explanation of why the SEC acts as it does with regard to its uncommon, bifurcated public program of enforcing U.S. federal securities laws.

Framework of Theory

Key Assumptions Supporting Theory about SEC Decision Making Process

I have incorporated certain key assumptions into my theoretical framework. First, I assume as valid the attitudinal model, a dominant paradigm from political science literature. The attitudinal model portrays U.S. Supreme Court justices as basing their decision making in large part on their own political preferences – that is, political ideology – and applying the law to the facts of a case in a way that reflects those ideological preferences. I assume further that the attitudinal model, developed originally to explain behavior among U.S. Supreme Court justices, validly applies to the lower federal courts, such as the federal district court where the SEC can file a civil enforcement action or the federal circuit courts of appeal. I explain, however, that the effects the model predicts are likely mitigated because of different circumstances prevalent in the lower courts. I describe the attitudinal model and literature supporting it, and discuss its application to the civil enforcement process of the SEC in the section of the Appendix titled, “Discussion: Attitudinal Model Applied to SEC Civil Enforcement Actions.”
Next, within the context that political ideology plays a role in the decision making of judges on the federal district and circuit courts, I incorporate the assumption that lower federal courts with a conservative political ideology are less likely than politically liberal courts to favor the prosecutorial program of an independent agency like the SEC. This is supported by the argument that the conservative political attitude favors reducing bureaucracy and taking a more laissez-faire approach to financial market control with an emphasis on self-regulation by capital markets. Similarly, I assume a liberal court would be more likely to view SEC civil enforcement actions favorably because of the liberal political attitude that government plays a key role in preventing fraud by corporate entities and their agents on investors in the securities markets. I recognize, however, that an exogenous shock – triggered by an extreme scandal such as the financial fraud involving Enron – may mitigate or reverse at least temporarily some of these political preferences.

Last, I connect these two strands of logic to SEC decision making and behavior by assuming further that SEC bureaucrats or commissioners participating in the intricate enforcement decision making process described in Chapter 2 above possess information – at least an informed opinion – about the ideological reputations of the federal courts (i.e. the aggregation of the preferences of the individual judges sitting on the respective courts) they are considering in their strategic deliberations about type of case to file and forum selection. Also, implicit in this assumption is the notion that these participants in the SEC process have the inclination and ability to take advantage of this information if it serves their strategic goals.
Therefore, under this theoretical model, not only does the political ideology of federal judges affect their decision making, but much of the time ideologically conservative and liberal judges inherently view SEC civil enforcement actions differently. SEC bureaucrats and commissioners take these differences into consideration through their perceptions of the ideological reputations of respective courts, and will often use this information when making decisions about where to file an action.

**How Conservative and Liberal Lower Federal Courts View SEC Enforcement**

In the context of the attitudinal-model framework, I incorporate the assumption that lower federal courts with a conservative political ideology are less likely than politically liberal courts to favor an independent regulatory agency like the SEC (see Howard 2007; Kagan and VanSickle-Ward 2006; Karmel 1982). Johnson and Songer (2002, 662 (citing Carp and Rowland 1983)) defined “liberal” judicial ideology, for use in their empirical analysis of lower federal courts, as “…those decisions that support the government in a challenge to regulation of the economy…”

This concept, as applied to the SEC, contends that the conservative political attitude favors reducing bureaucracy and taking a relatively more laissez-faire approach to financial market regulation with an emphasis on self-regulation by capital markets. “Over-regulation is a threat to entrepreneurship and the bundle of rights that in (the ‘conservative view’) legimitely attaches to economic success” (Langevoort 2003, 1141). The liberal perspective, in contrast, “chafes at the artificial distinction long drawn between federal and state spheres of authority, wishing to extend the federal

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presence to a full range of matters touching on managerial accountability and corporate governance’’ (Id. at 1142). It is reasonable to assume, following this line of thought, that a liberal court would be more likely to view SEC public civil enforcement actions more favorably because of the liberal political attitude that government plays an appropriate material role in preventing fraud by corporate entities and their agents on the public.

As Figure 3.1 illustrates, this approach would imply that, when confronting an ideologically conservative federal court, the SEC may prefer to trade off the potential enhanced benefits of bringing a civil enforcement action in the forum of federal district court for the opportunity to bring the proceeding before an ALJ in a forum that is more favorable to the agency.\textsuperscript{114}

\textbf{Figure 3.1 How Conservative and Liberal Lower Federal Courts Affect SEC Choice of Forum}

<table>
<thead>
<tr>
<th>Liberal Lower Federal Court</th>
<th>Forum - Court</th>
<th>Forum - ALJ Corps</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>SEC files: agency perceives chances of success \textit{up}, and potential real penalties against defendants \textit{up}</td>
<td>SEC tries to avoid filing</td>
</tr>
<tr>
<td>Conservative Lower Federal Court</td>
<td>SEC tries to avoid filing</td>
<td>SEC files: agency perceives chances of success \textit{up}, but potential real penalties against defendants \textit{down}</td>
</tr>
</tbody>
</table>

The concept is deeply rooted in the history of the SEC, dating back to its establishment as an agency. The regulatory-reform ideology that emerged with the New Deal in the aftermath of the Great Depression was promulgated by the more liberal administration of President Franklin Delano Roosevelt starting in 1933 with support from the new Democratic majority in Congress (1933 was the first year the Democrats had a

\textsuperscript{114} \textit{See} discussion, “SEC Fares Better in Civil Enforcement Proceedings before ALJ’s,” in \textit{Chapter 2}. 
majority in the House since 1917 and in the Senate since 1919). Leaders in the pre-reform environment, characterized as based on a laissez-faire ideology associated with the more conservative administrations of Presidents Calvin Coolidge and Herbert Hoover, questioned whether the federal regulation of securities was even constitutional. (Seligman 2003)

This dichotomy in attitudes from opposing ideologies permeated successive decades. The Eisenhower Administration, for example, continuously fought new legislative initiatives to expand the authority of the SEC on the grounds that increasing the authority of the agency would harm small business. The more liberal Kennedy Administration, in contrast, successfully promoted its campaign promise to increase the authority of the SEC to regulate stock and bond markets – the first material change in SEC authority in over a decade (the first SEC chair was the President’s father, Joseph P. Kennedy, who had served from 1934 to 1935). And the more conservative Nixon Administration continually discouraged proposals to further increase the power and reach of the SEC. (Kemp 1984)

The broader notion tying ideology to attitudes towards the role of regulatory power is consistent with an empirical study that found, from 1984 through 2004, federal lower court judges who were appointed by Republican presidents were less likely than those appointed by Democrats to defer to the U.S. Environmental Protection Agency (EPA) when private industry challenged EPA policy in federal court (Sunstein, Schkade, Ellman, and Sawicki 2006). The study used Republican politics as a proxy for conservative ideology and Democratic politics as a proxy for liberal ideology. This dissertation utilizes the same categories of proxies in its analysis below.
The Sunstein (2006) study, like research by Revesz (1997, 1999), found also that federal judges who were nominated by Democratic presidents were, in turn, less likely to defer to industry groups when those groups challenged EPA policy in federal court. In general, the federal judges appointed by Democratic presidents in those studies took an ideologically liberal stance on the cases.115

Caution: Potential for ‘Partisan Reversal’…

A note of caution, however, is appropriate here. In their study demonstrating that IRS audit policy is responsive to political controls, Scholz and Wood (1999, 1174) identified a national “partisan reversal” over time in the relative emphasis by the parties on tax audit equity compared to audit efficiency. They explained that the standard assumption is that Republican political principals would promote efficient tax collection for lower- and middle-income returns, and Democrats, in contrast, would emphasize equity in tax collections between individuals and corporations. This assumption held prior to 1981. During the Reagan Administration, though, Republicans criticized the negative elements of tax collection as part of their political criticism of big government and promoted legislation that would establish a taxpayers’ bill of rights. And Democrats, trying to link budget shortfalls to Reagan Administration tax cuts, began to exhort the need for efficient IRS enforcement practices to increase revenues from taxes in order to reduce the deficit. This role reversal changed the direction of partisan policy effects on the IRS after 1981, and according to the authors, it continued for nearly two decades.

115 See also Farhang (2006, 90) (supporting the concept of the conservative/liberal dichotomy: it is “certainly a plausible assumption over the course of the twentieth century” that, “on the whole, more liberal and more Democratic congresses have been more likely to favor regulatory legislation than more conservative and more Republican ones”).
Also, Moe (1982) has argued that the dominant ideologies of the two political parties may result in nuanced behavior that occasionally contradicts the views that form the bases of the assumptions. For example, while Republican emphasis on free enterprise may compel the party to favor business interests in policy making relative to other groups, the same emphasis may also cause it to favor rigorous enforcement of securities laws to prevent fraud that adversely affects the functioning of the free market. Similarly, Democratic emphasis on regulation of business does not necessarily lead to an adversarial relationship with business interests. Moe points out that Democratic Administrations have in the past emphasized cooperation between business and government in the regulation of the private sector.

It is therefore worthwhile to keep in mind that partisan reversal effects could confound some results drawn from the data for some of the fiscal years in my analysis and mitigate the magnitude of the ideological effects measured in various contexts. To address this possibility in part, I use a dummy independent variable in my models – “shock” – both as a stand-alone variable and as part of an interaction term. The application of the partisan-reversal concept to SEC enforcement, and a rationale for the ‘shock’ independent variable, is explained below.

SEC Has Information about Ideology of Lower Federal Courts and Utilizes It to Serve Strategic Enforcement Goals

I connect the prior two underlying components of my theory to SEC decision making behavior by assuming that SEC bureaucrats or commissioners participating in the civil enforcement decision making process described above have information, or an informed opinion, about the ideological reputation of the federal courts that they consider
during their deliberations over forum selection and other elements of their cases. Implicit in this assumption is the notion that these participants in the SEC process have the inclination and ability to take advantage of this information if it serves their strategic goals. As Shipan (1997, 559) has stated in an analogous setting, “If a policy has been in effect for several years, an interest group should have a good sense of the likely actions and biases of agencies (administratively) and courts. Therefore…a group examines its past experiences with the courts and agencies and tries to predict what they will do in the future.” The SEC is characterized as a culture that is dominated by lawyers, rather than by economists or social scientists, with one consequence being that it is very focused on process and moves slowly and deliberately in its decision making (Macey 2010). It is fair to presume that if interest groups can use past experiences to try to predict judicial behavior, some of the many lawyers participating in the enforcement decision making process at the SEC can also consider the reputation— including ideology— of relevant federal district courts when contemplating the forum for filing.

When the SEC makes strategic decisions about forum and other case-specific matters in its public civil enforcement process, the agency possesses information about the ideology of the federal courts. In this context, the SEC also incorporates its perception of how the agency fares before a particular court. For example, one scholar recently reported that an SEC bureaucrat— in response to a research survey question— explained the agency prefers to litigate in the Second Circuit because, among other things, that appellate court has expertise in financial cases, whereas it regards the Fourth Circuit— a court with a reputation for being ideologically conservative— as “institutionally hostile” to the agency (Hume 2009, 95). My primary data set bears this
out. Figure 3.2 shows that the SEC brought about 22% of the actions in the data set in districts that feed the Second Circuit – the most of any circuit. In contrast, the SEC brought about 3% of the cases in the data set in those districts feeding the Fourth Circuit – the second fewest in any circuit.

Figure 3.2 Public Civil Enforcement Actions by Federal Circuit Court, CY 1992 through CY 2007

In addition, scholars have identified other federal agencies where bureaucrats have demonstrated knowledge of the ideology of the lower federal courts. Canes-Wrone (2003, 207), for instance, found through interviews with members of the Army Corps that bureaucrats who make decisions regarding the granting of permits to develop federal wetlands not only “revealed knowledge of the ideological composition of” the district
courts that would hear their cases should their decisions be litigated, but “expressed belief that the composition would influence rulings.”

Howard and Nixon (2002) showed the IRS changes its tax-audit strategy based on the median ideology of federal circuit courts. The authors demonstrated the IRS shifts the focus of its audits between wealthier and less affluent taxpayers in response to judicial ideology. As the circuit court becomes more liberal, the IRS shifts its audit strategy in that circuit to emphasize “equity” in tax collection by increasing its audits on wealthier taxpayers while reducing them on the less affluent. And as the circuit court grows more conservative, the IRS shifts to emphasize “efficiency” in that circuit by increasing the number of audits of the less affluent (Id. at 919). According to this study, the IRS changes its behavior because it is aware of, and acts on, the ideology of the circuit to carry out its strategy of litigation success.

Federal agencies also demonstrate they possess information about the lower federal courts and will act on that knowledge if it serves their strategic interests when they “forum shop”116 in order to practice “nonacquiescence.” ‘Nonacquiescence’ is essentially the refusal of an agency to follow judicial precedent when it is adjudicating or filing a case based on issues similar to those already ruled on by the lower federal courts (Rooney 1992, 1111). Federal agencies reveal they are aware of the reputations of lower federal courts and show they are willing to strategically seek an “agreeable verdict in an

116 Forum shopping “occurs when a(n agency) attempts to have (its) action tried in a particular court or jurisdiction where (it) feels (it) will receive the most favorable judgment or verdict” (Black’s Law Dictionary, 5th Edition. 1979. St. Paul, Minnesota: West Publishing Company).
ideologically sympathetic” court when they use this practice to ward off the precedential effects of an adverse judgment.

A large legal literature – that radiated some influence on political science literature – was spawned by Estreicher and Revezs’s (1989) article discussing the costs and benefits of the longstanding practice of nonacquiescence with particular focus on its utilization by the National Labor Relations Board (NLRB) and the Social Security Administration (SSA). Scholars have subsequently identified the practice among various federal agencies, including the SEC (Rooney 1992).

One factor that constrains the SEC’s use of nonacquiescence, however, is its binary option for filing civil enforcement actions. To explain, the NLRB is a serial user of the tactic. Its enforcement authority regarding unfair labor practices (adversarial, under §8 of the National Labor Relations Act (NLRA) since its passage in 1935) resides solely with its board and its adjudication is purely administrative because it is not authorized to use the lower federal courts (Brudney 2004-05). In contrast, the SEC’s founding legislation provides the binary enforcement option. As a result, the SEC cannot consistently ignore circuit court precedent because many of its civil enforcement filings are with federal district courts, and those courts would rule adversely to the agency. The NLRB, to the contrary, can – and does – choose to ignore lower court precedent in its board opinions.118 Moreover, parties aggrieved by administrative decisions in the SEC have an option to appeal to the federal circuit court, whereas parties before the NLRB do not.

117 Canes-Wrone (2003), 206.

118 One of the highest-profile instances of the NLRB ignoring a lower court ruling occurred when it chose to ignore the opinion of the D.C. Circuit Court of Appeals that President Obama’s recess appointments of three of its members was unconstitutional. It responded, “The Board respectfully disagrees with (the) decision…In the meantime…we will continue to perform our statutory duties and issue decisions.” “Courts? Who Listens to Courts?” Wall Street Journal, Review & Outlook, January 28, 2013, http://online.wsj.com/article/SB10001424127887323375204578269941859266174.html.
not. Although the SEC is far more selective in using nonacquiescence than some other federal agencies, the existence of this tactic supports the notion that the agency possesses knowledge of the ideological and legal reputations of the lower federal courts and will incorporate that information into its decision making and civil enforcement action process.

Again, however, this knowledge is likely stronger with regards to the federal circuit courts than it is the district courts. It is unlikely that an agency like the SEC can determine in advance the specific judge who will be assigned to an action in district court, so it relies on its knowledge of the general reputation of the court during its decision making process. Also, agencies are likely more aware of the ideology of particular circuits than of individual trial-level district courts. Federal circuit courts are bound to follow fewer precedents than are district courts and produce a higher volume of written opinions. Thus, circuit courts have more flexibility to develop their ideological position on legal issues as well as a means for communicating those positions to litigants like the SEC. Therefore, the connection may be more attenuated for the district courts, and the dissertation models for and empirically tests this concept below.

**Big Picture: Illustrations of Theoretical Construct**

**Primary Version of Theory**

Figure 3.3a illustrates the core mechanics of my theory. It provides for reference a picture of the primary version of the SEC decision making process regarding choice of forum and its incorporation of information about both the ideology of the lower federal courts as well as its own perceived likelihood of success in various forums. The figure
portrays the SEC’s strategic preferences relative to the theorized political preferences of the lower federal courts and the theorized static position of the SEC ALJ corps. The courts are positioned along a single-dimension ideological continuum.

The SEC’s ALJ corps, and the agency itself, are not located on the continuum because their preference positions do not necessarily reflect ideological positions in this portrayal, but reflect the relative positioning of SEC preferences in light of the agency’s perception of the likelihood of favorable outcomes when strategizing choice of forum between different district courts and its ALJ corps. I discuss the background and function of the SEC’s ALJ Corps in detail below, and explain why it is impracticable to identify an ideological predisposition of the corps.

**Figure 3.3a  SEC Decision Making Process (Primary Version of Theory)**

Note 1: SEC prefers liberal federal district court to conservative district court for forum: (i) agency perception of likelihood of favorable outcome higher, and (ii) same real penalty potential against defendants in public civil enforcement actions.

Note 2: SEC prefers liberal district court to ALJ corps: (i) agency perception of likelihood of favorable outcome relatively equal, and (ii) higher real penalty potential against defendants tip preference to district court.

Note 3: SEC prefers ALJ corps to conservative court: (i) agency perception of likelihood of favorable outcome far higher, thereby (ii) outweighing higher real penalty potential of federal district court.
Shock Effect as Independent Variable – Rationale

Figure 3.3a illustrates the relative preferences of the players in the absence of potential influence from the shock independent variable. By comparison, Figure 3.3b illustrates a theoretical influence of the shock independent variable which, if significant in the model, may impart a temporary, partial partisan reversal that affects the attitude of conservatives toward the SEC’s civil enforcement agenda – via the courts and, perhaps, the agency itself.

As included in model 3 in Chapter 4, the dissertation uses a dummy variable to test for the effects of an exogenous shock to the financial sector and to determine whether it influenced the decision making of the SEC during the period of the primary data set. In this presentation, the exogenous shock embedded in the data set is triggered by the date of the historic financial scandal involving Enron\textsuperscript{119} that was discovered initially during an earnings call by the company on October 16, 2001\textsuperscript{120} and investigated by Congress in 2002.\textsuperscript{121} Within a year, both the company and its eighty-eight year-old public auditing firm, Arthur Andersen, were dissolved along with thousands of private-sector jobs. Moreover, Congress had commenced the bi-partisan legislative effort that resulted in the Sarbox law that upgraded the SEC’s enforcement powers.

Pursuant to the theory, an exogenous shock to the day-to-day operations of the U.S. financial sector as profound as Enron would make SEC civil enforcement cases generally more attractive to the personal policy preferences of conservatives, particularly

\textsuperscript{119} For a comprehensive timeline of the Enron scandal and ultimate consequences, see http://www.nytimes.com/ref/business/20060201_ENRON_GRAPHIC.html (in New York Times online Archive).


\textsuperscript{121} NYU Center for Law and Business (2005, 5) (the SEC Enforcement “universe” can be divided “fairly” into pre- and post-Enron segments).
on the lower federal courts – and the SEC enforcement bureaucracy would rapidly become aware of, or anticipate, this shift. As a consequence, the position of those conservative courts would move within the spectrum of SEC strategic preferences in relation to the agency’s ALJ corps and even relative to liberal and moderate district courts.

The agency’s normal preference for liberal over conservative district courts would thereby become less distinguishable for a finite period as its perception of the likelihood of a favorable outcome would now be similar for both ideological categories of courts – and there still would be the same real penalty potential in either setting against defendants. So, the attitudes of the courts toward enforcement in this context would shift towards temporarily converging. Moreover, the position of the SEC itself relative to the federal courts and its ALJ corps might also shift temporarily towards the liberal end of the ideological continuum as a response to the Enron scandal and the accompanying passage of Sarbox, for the reasons described below.122

In Figure 3.3b, I illustrate the mechanics of these potential shifts, which I generally refer to as a ‘partial partisan reversal’ after the partisan political effects explicated in Scholz and Wood (1999) discussed above. The material impact of financial scandals throughout history, however, is thought to dissipate after lingering for relatively brief periods (Kemp 1984). Thus, the shock variable is designed, as I describe in Chapter 4 below, so that the duration of its effect is finite and its magnitude phases down over time.

122 I thank Professor Michael Ting here for raising this as a possible scenario.
I took the opportunity to apply the concept of exogenous shock\textsuperscript{123} to test for the presence of partisan reversal in the primary data set because the Enron scandal was historic in its economic and political impact through 2007 (prior to the market crash of 2008). It has been compared to the financial scandals and market crash that led originally to the founding of the SEC (Khademian 2002). In light of this shock falling during the period of the primary data set (and covering the final 35\% of the data), I decided it was essential to test for its possible effects.

\textsuperscript{123} The concept of shock is used in various scholarly fields. For example, economics literature has used the concept to study whether “exogenous local shocks” to income caused physicians to render unnecessary, excessive care to patients to make up for lost revenue. Specifically, income ‘shock’ resulted from decreased fertility rates, leading ob-gyn doctors to utilize the more costly option of caesarian sections at a significantly higher rate than they had pre-shock to make up for the lost income (Gruber and Owings 1996, 109).
Figure 3.3b SEC Decision Making Process (Including Possible ‘Shock’ Effects)

Note 1: Initially, possible shock effect makes SEC public civil enforcement cases more attractive to policy preferences of conservatives, including district court judges – and agency becomes aware of temporary shift. As consequence, the position of some conservative courts would move within the spectrum of SEC strategic preferences in relation to the agency’s ALJ corps and even relative to moderate and liberal district courts, which do not shift materially.

Note 2: SEC preference for liberal over conservative district courts now less distinguishable for finite period because: (i) agency perception of likelihood of favorable outcome now more similar for both ideological categories of courts, and (ii) same real penalty potential against defendants in both courts. This reflects a partial partisan reversal affecting the trend of the SEC/conservative court relationship.

Note 3: SEC may become temporarily more aggressive in enforcement decision making in response to scandal as well as its new enforcement powers under Sarbox. This possible effect is built into illustration. It is represented with broken line because neither its magnitude nor duration necessarily align with those of the shift of conservative federal courts.

Note 4: Liberal (and moderate) courts remain essentially in same position relative to SEC preferences (even when agency’s preferences shift), as does ALJ corps. During this period, SEC may opt for forum of ALJ for reasons other than relative ideological preferences (e.g. case facts, available evidence).

Note 5: Over time, shock effect diminishes and conservative courts shift back toward their original relative position on ideological continuum. SEC becomes aware of this ‘correction’ and its preferences trend towards their original posture vis-à-vis the conservative district courts. The position of the ALJ corps within the SEC band of preferences remains relatively static.

Possible increase in aggressiveness of the SEC’s enforcement decision also subsides, shifting agency back to its original relative position.
In this primary framework, the SEC does not make strategic decisions about forum for civil enforcement because of its own ideological preferences (e.g. it is a politically liberal agency). Instead, as an independent agency whose enforcement mandate is inextricably bound with its raison d'être, as explained in Chapter 2, the SEC’s strategic goal is to maximize its public civil enforcement success. The agency succeeds mainly by winning cases and secondarily by achieving the maximum penalties it seeks against defendants. It may also temporarily assume a more aggressive enforcement posture to signal its political principals and public constituency that it is responding to a scandal and, to a lesser extent, exploring the use of its new powers under Sarbox. As an independent, competent civil prosecutor, the agency possesses information about the ideological reputations of lower federal courts and is willing to strategically seek successful outcomes in sympathetic courts (or before its ALJ corps) that it perceives are more inclined to support its mission.

The SEC develops this strategy from its experience before lower federal courts – both at trial and in settlement negotiations – and its institutional notions about the attitudes of liberal versus conservative judges toward the agency. Under this primary theoretical framework of agency ‘independence,’ neither the strategy of the SEC nor its image to federal judges changes significantly when its political principals (i.e. the President, SEC Commissioners, or congressional subcommittee and/or committees) change. One potential explanation for this is the SEC functions mainly as a bottom-up bureaucracy, that is, one where enforcement policy changes often percolate up from career prosecutors in the independent agency’s Division of Enforcement who base their decision making on practical considerations of pursuing their agency’s critical mission.
with minimal political interference. This would tend to insulate the agency’s enforcement efforts from politics and its incentives would not change on political whims, but rather on practical prosecutorial considerations. Similarly, federal lower court judges do not necessarily view the SEC as a liberal agency. As this chapter explained above, these judges have ideological preferences regarding the appropriate role of federal agencies in the regulation of financial markets.

**Evidence of Shifting Attitudes of Federal Judges**

To my knowledge, as of yet there is no published comprehensive study of shifting attitudes of federal court judges specifically toward the enforcement program of the SEC. There is, however, on a macro level a set of studies tracking over time the change of attitudes of federal judges toward the public accounting profession – which is subject to regulation by the SEC and was a main focus of Sarbox\(^{124}\) – from the mid-1990’s through 2010.\(^{125}\) The studies encompassed, in particular, changes in judicial attitudes reflected in the near-term and long-term wake of Enron.

The studies of federal judicial attitudes toward the accounting profession may provide insight into the views of federal judges toward their primary public regulator – the SEC – over the same time period. It is reasonable to presume that a sudden negative

\(^{124}\) The “real structural change” to securities law imposed by Sarbox was “to the field of accounting and auditing” (Langevoort 2003, 1151; see also Romano 2005).

\(^{125}\) In addition, there is anecdotal evidence on a micro level of changes in attitudes of some conservative judges toward the SEC role in the regulation of the financial industry (e.g. Kenneth Durr, Interviewer, January 25, 2011. “Securities and Exchange Commission Historical Society Oral History Project Interview with Richard Posner,” p. 18) (long-time thought-leader for conservative judges, originally in favor of deregulating financial markets, stating, “I don’t know whether the SEC can deal with bubbles, but their existence underscores the need for regulation, since the bubble phenomenon is apparently not self-correcting”). The change in attitude among leading conservative judges post-Enron is not, however, universal (e.g. Frank H. Easterbrook, Chief Judge, 7th Circuit Court of Appeals. 2009. “The Race for the Bottom in Corporate Governance.” *University of Virginia Law Review* 95(4):685-706 (critical of philosophy underlying Sarbox and SEC’s role)).
turn in the attitudes of federal judges toward the performance and trustworthiness of public accountants could accompany a shift in judicial attitude toward the SEC that would be sympathetic to the agency and, as a result, more positive toward enforcement as implementing the agency’s mission. Furthering this line of thought, the marginal effect of such a shift would presumably be larger for a change in the attitudes of conservative judges who may have originally been more skeptical than their liberal (or moderate) colleagues about the role of the SEC in regulating U.S. financial markets.

Scholars comparing federal judicial attitudes toward the public accounting profession expected to find modest, if any, change over time unless a “substantial stimulus” or “major disruptive event” was introduced to compel a significant shift in attitudes (Reckers, Jennings, Lowe, and Pany 2007, 630; Iyer and Jennings 2010, 25). The scholars surveyed samples of sitting federal judges on their attitudes toward the public accounting profession in 1993 (Anderson, Jennings, and Reckers 1993), 1997 (Anderson, Jennings, Lowe, and Reckers 1997), 2003 (Reckers, Jennings, Lowe, and Pany 2007), and 2009 (Iyer and Jennings 2010) as part of a continuing education program spanning two decades run by the National Judicial College in partnership with the ABA. They found that judicial attitudes were generally positive, and stable, throughout the decade of the 1990’s, but had become significantly more negative by 2003. The researchers “attributed the erosion (in judicial attitudes) to extensive negative publicity related to major auditing failures of (the Enron) era, protracted congressional inquiries

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126 The National Judicial College is a non-profit entity designed to provide educational programs to U.S. judges that originated from a report issued by the Joint Committee for the Effective Administration of Justice (comprising, in part, representatives of the ABA) fifty years ago. It is funded by the ABA and the DOJ, as well as the University of Nevada, where it is based. See [http://www.judges.org/](http://www.judges.org/).
leading to reform legislation, and the demise of Arthur Andersen (because of the Enron audit)” (Id. at 26).

These researchers found that by 2009, however, judicial attitudes toward the public accounting profession had rebounded virtually back to their pre-Enron levels, as the “memory of the earlier accounting abuses may have faded away or lessened in contrast” (Id.). These findings are consistent with my theory of the potential for an exogenous shock. As these attitudes of federal judges slowly returned to their prior equilibrium over the six-to-eight years following Enron, it would be fair to conclude also that other related attitudes may have shifted back to their original equilibria as well, including those pertaining to the appropriate role for SEC enforcement and a reduction in sympathy for the agency’s implementation of its mission.

Big Picture, Part Two: Illustrations of Comparative Theoretical Construct

An important element of the portrayal of the SEC in the theoretical framework of my dissertation is its independence as an agency, as explained in depth in Chapter 2. Being an independent agency enables the SEC, in theory, to mitigate much political influence and maintain consistent incentives when making defining decisions about its civil enforcement strategy.

The SEC’s independence does not necessarily rule out all political interference by either Congress or the executive branch, but political influence and its sources may be difficult to discern when analyzing agency outcomes. In Chapter 4 I control for the possibility of political influence from various sources in Congress. I also use independent variables to control for political influence from the executive branch,
identifying the most likely sources of that influence to be either the President or presidential appointees, that is, SEC Commissioners. My primary theory underlying the analysis presumes an independent SEC, but these controls for political influence are essential to test the reasonableness of this presumption.

Mainly to provide this alternative theoretical context, the dissertation presents modifications to Figures 3.3a and 3.3b that illustrate the comparative effects of political influence were it to affect the preferences and, thereby, the decision making of the agency regarding its public civil enforcement strategy.
Figure 3.4a Modified Version of SEC Decision Making Process – Reflecting Influence by Conservative Political Principal(s)

Note 1: SEC’s preferences shift – agency may now prefer some conservative courts to liberal courts: (i) SEC perceives its likelihood of favorable outcome to be higher in some conservative courts, perhaps because its enforcement strategy has changed to move more in line with conservative principles and/or it believes it is now viewed more favorably by some conservative judges, and (ii) Same real penalty potential against public civil enforcement defendants in both types of courts.

I use “some” here to qualify conservative judges because shifts among those judges toward the enforcement role of the agency may not be universal, as note 125 illustrates in a slightly different context.

Note 2: SEC generally prefers ALJ corps to some liberal courts as agency drifts ideologically away from those courts, but this preference varies and is a case-by-case balance of: (i) agency perceives its likelihood of favorable outcome higher before ALJ corps, but (ii) lower real penalty potential against defendants before ALJ’s.

Note 3: SEC prefers some conservative courts to ALJ corps: (i) agency perceives its likelihood of favorable outcome in some conservative courts closer to ALJ corps now that it is ideologically more in line with them, and (ii) higher real penalty potential against defendants in court.
Figure 3.4b Modified Version of SEC Decision Making Process – Reflecting Influence by Liberal Political Principal(s)

Note 1: SEC continues to prefer liberal courts to conservative courts and, to a lesser degree, moderate courts, but preferences shift to a stronger position: SEC perceives its likelihood of favorable outcome to be even higher in liberal courts, perhaps because its enforcement strategy has changed to move more consistently in line with liberal principles.

Note 2: SEC prefers liberal courts to ALJ corps as agency drifts ideologically further toward liberal courts: (i) agency perceives its likelihood of favorable outcome even higher before liberal courts, and (ii) higher real penalty potential against defendants in federal court.

As Figures 3.4a and 3.4b illustrate, the SEC under this alternative might change the strategy of its civil enforcement decision making, particularly regarding choice of forum, when the ideology of those political principals who can actually influence the agency changes. I test for these potential political effects by operationalizing the political ideology of (i) the floor of Congress, (ii) members of congressional oversight and budget committees with responsibility for the SEC (iii) the President, and (iv) presidential appointees – SEC Commissioners, and incorporating those independent variables into the analytical models.

Pursuant to this portrayal, the SEC’s perception of the effect of the ideology of the lower federal courts would change – and the way those courts perceive the SEC
would change – when the ideology of the agency’s political principals changes. The enforcement process of this SEC would be less politically independent. Its policy preferences, and political reputation, would be affected by a shift in political leadership. The SEC would prefer a court that is more ideologically in line with its new principals – and principles. As a result, in contrast to Figures 3.3a and 3.3b, the SEC’s preferences in Figures 3.4a and 3.4b do not remain static.

So, for example, this SEC under Republican (proxy for conservative) political principals (Figure 3.4a) would not try as much to avoid conservative lower federal courts. The agency may trend towards avoiding more liberal courts by opting for ALJ proceedings, though the preference to avoid a liberal court would be somewhat muted because of liberal judges’ general pro-regulatory-agency leaning. In contrast, the dynamics of SEC decision making under Democratic (proxy for liberal) political principals (see Figure 3.4b) would resemble those illustrated (but slightly more extreme) in the primary version of the theory in Figure 3.3a. The SEC with Democratic political principals, however, would have a more pronounced preference to try to avoid conservative courts since the contrast in ideologies would intensify the general anti-agency, pro-market attitudes of conservative judges towards the SEC. An SEC with shifting preferences would be not be substantially insulated from politics in the enforcement setting because it would function more as a top-down bureaucracy, where the ideology of political principals would materially influence its decision making from above regarding choice of forum and other civil enforcement issues.
A Word about Sarbox and the SEC

The enactment of Sarbox “was not a one-off event(, but) was a fairly standard example of the boom-bust-regulate pattern that characterizes U.S. federal regulation of corporate governance” (Bainbridge 2010-2011, 1782). Scholars find that this responsive pattern can be traced at least to the period just prior to the New Deal, and some claim to be able to identify it extending back into the nineteenth century (Id.). Thus, in this context, a change in the laws regulating the financial markets brought about by Sarbox did not present an unknown challenge to the agency. Moreover, “many of the provisions of (Sarbox) reflect long-held positions of the (SEC) about corporate governance and accountability” (Gorman and Stewart 2004, 138). Thus, Sarbox did not necessarily cause the agency to update its beliefs about appropriate regulatory reach and enforcement, but it did require the agency to respond, at least in the short-term, in a way that signaled its political principals that it was taking their mandate seriously. Although Sarbox enhanced public accounting and auditing controls as discussed above, some commentators consider its overall substantive impact to be “fairly moderate” (e.g. Langevoort 2003, 1143). The SEC responded to its new enforcement powers and additional funding – as it had to statutory and budgetary changes in the past – within its extant bureaucratic framework.

Sarbox includes two provisions that potentially increase the scope of proceedings the SEC can bring before an ALJ. First, as Table 2.4 lists, it authorizes the SEC to use administrative proceedings to seek bars against violators of securities laws from ever again serving as officers and directors of publicly traded companies (Baker and Campbell


2003). Many participants in the securities industry view this sanction as one of the harshest because it effectively ends the defendant’s career and current livelihood.\(^{129}\) Previously, the SEC was empowered to bring such actions only in federal court.

Second, Sarbox lowers the legal standard of proof for instituting such bars (Mahoney, Walker, Schwartz, and Greenstein 2004). In 2001, prior to the implementation by the SEC of its new powers, the agency sought orders barring 51 defendants from serving as officers or directors of public companies. In 2002, this number rose to 126 with partial implementation of Sarbox and in 2003, the first year of full implementation, the SEC sought 170 officer and director bars.\(^{130}\) The SEC had argued that its record of success in those proceedings was mixed largely because the prior legal standard of proof was too high. Congress apparently listened to the arguments of the SEC bureaucrats when drafting Sarbox.

The data underlying Figure 3.5 demonstrates, however, that the ratio of cases the SEC brought in the forum of federal district court to those it brought in the forum of administrative proceedings remained virtually identical for the pre- and post-Sarbox years of the primary data set. The district-court-to-ALJ ratio was .75:1 before Sarbox, and .77:1 after the law.\(^{131}\) Also, post-Sarbox the annual pool of SEC enforcement cases has grown. The mean annual number of aggregate federal court and administrative

\(^{129}\) See, e.g., NYU Center for Law and Business (2005, 20) (discussion by present and former directors of SEC Division of Enforcement regarding how permanent bar of professional in his or her twenties for insider trading may be disproportionate in severity); Rinehart (1952, 146) (traditionally, SEC penalties affecting the professional reputation of brokers and dealers were considered of “far greater severity” than monetary penalties).


\(^{131}\) I excluded SEC FY 2002 from this calculation because it was a transitional year since Sarbox was passed in July 2002. The court-to-ALJ ratio for that year was .96:1 (i.e. the number of cases the SEC filed in each of the two forums was nearly identical).
enforcement filings by the SEC prior to Sarbox was 457. After the implementation of the law, the annual mean increased to 627. Yet, once the level of enforcement filings rose to 636 the year following Sarbox, its rate of growth was slightly negative. This signals, perhaps, that the SEC rapidly reached equilibrium between its new powers and resource level and the amount of enforcement activity it could muster annually as an agency.

Figure 3.5 Number of SEC Civil Enforcement Actions Brought in Federal District Court and in Administrative Proceedings, SEC FY 1990 through SEC FY 2007

X axis = SEC Fiscal Year (Note: SEC fiscal year ends September 30th)
Y axis = Number of Civil Enforcement Actions Filed

Another challenge for the SEC following Enron was the need to balance and control competing political and public pressures in the short-term – and the agency had mixed results.\(^\text{132}\) For example, a recent study of the SEC’s enforcement pattern in cases of alleged fraudulent financial reporting pre- and post-Sarbox (enhanced requirements for financial reporting, in the context of accounting and auditing were a focus of the law) identified few material changes implemented by the agency. The major shift was that the average size of a company that was the target of an SEC enforcement action for fraudulent reporting during that period was larger than the average target company during the five years preceding Sarbox. Scholars have speculated that this may be because larger targets in the short-term drew more private-sector attention and served as deterreants to similarly situated companies to clean up their regulatory acts. In terms of the types of fraud that the SEC pursued in this subset, though, the study identified little change. The SEC continued to focus heavily on certain industries, such as manufacturing, healthcare and technology, and many of its investigations stemmed from the more common forms of fraudulent revenue recognition. In general, “it is evident that the SEC continues to utilize the traditional procedures from the past even today.” (Lynch, Bryant, and Reck 2011, 116-118)

As for the political element, some scholars argue that in order to discourage the proliferation of federal government regulation in the financial sector over the long-term, one of the key provisions of Sarbox was the threat of sanctions – and even jail time - for individual business executives who knowingly certify false financial reports, “(r)egulators have brought only a handful of crisis-related civil allegations in that area”).

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\(^{132}\) Given the advantage of hindsight on the tenth anniversary of Sarbox, some commentators lamented the reticence of the SEC to utilize some of the potential enforcement tools the law provided. See, e.g., Francine McKenna. August 5, 2012. “More Sarbanes-Oxley Anniversary Thoughts.” Re: The Auditors (citing Michael Rapoport. July 29, 2012. “Law’s Big Weapon Sits Idle.” Wall Street Journal (although one of the key provisions of Sarbox was the threat of sanctions – and even jail time - for individual business executives who knowingly certify false financial reports, “(r)egulators have brought only a handful of crisis-related civil allegations in that area”)).
conservative political principals often respond strongly to significant frauds over the short-term, accentuating enforcement and using rhetoric to make their case. According to this account, when exogenous events, like Enron, are simply too large to ignore without political consequence, these political principals may approach them strategically by emphasizing a response to individual “bad apples,” while trying to keep control over the growth of the financial regulatory system more broadly (Langevoort 2003, 1141). As part of the response to Enron, Sarbox ended up being a bipartisan bill, as a split among business interests over its core components provided little reason for Republicans to perhaps alienate other elements of their constituencies who lost substantial sums in pension and stock portfolios (Romano 2005, 1565). The bi-partisan passage of Sarbox may have also reduced the significance of the Enron round of financial scandals for the 2002, and certainly by a larger magnitude for the 2004, congressional elections (cf. Id. at 1566).

The SEC had to manage the Enron fallout during this period, and struggled to keep its balance. The agency has been characterized as “naturally tilt(ing) slightly in the progressive direction” – with Republican chairs moderating this tilt – because of the regulatory element of its mission, but working hard to remain in the “middle ground” to balance the other part of its mission – maintaining broad investor confidence in U.S. financial markets (Langevoort 2003, 1144). This portrayal also attributes the SEC’s efforts at this difficult balance – beyond its structural and rhetorical independence – to its need to negotiate and sustain its annual appropriations with Congress. Moreover, SEC chairs “must satisfy both the congressional committees charged with oversight of the SEC and the (P)resident’s administration…Even the most earnest and capable of SEC
chair(s) have found the job’s political limitations to be formidable” (Smith and Walter 2006, 63).

In the wake of Enron, the Bush Administration replaced two supposedly business-friendly, and very experienced, SEC chairs well before their terms expired – possibly because they struggled to maintain this balance as well as the agency’s independence. The final Bush Administration chair, Christopher Cox, came under heavy criticism for his management of the agency, allegedly not building on the enhanced budget and growing the SEC’s mandate, but leaving its ranks somewhat demoralized (Langevoort 2009). So, the agency swam against the current in the wake of Enron to implement Sarbox and maintain its independence, particularly in its enforcement program, while managing its relationships with its disparate political principals under enhanced scrutiny. This context lends further support to the need to test for influence by political principals on the SEC’s decision making process through independent variables.

SEC ALJ Corps

It is noteworthy that I do not use a measure of the ideology of individual SEC ALJ’s in my analysis. In this section, I explain why it is not practicable, or necessary, to include ALJ ideology as an independent variable in the models. To support the explanation, I describe the position of ALJ, lay out the role of ALJ’s at the SEC and how it differs across agencies, discuss the performance of the ALJ corps at the SEC, and provide information on the SEC’s ALJ corps that has not to my knowledge been presented previously in any other scholarly format.
What is An ALJ? – The Fundamentals

The APA established the position of ALJ. The APA was enacted to promote badly needed due process reforms in administrative proceedings. The administrative state had grown exponentially over the decade-and-a-half prior to the APA, but the appropriate adjudicative apparatus and accompanying procedural protections had lagged behind in their development.

One crucial APA reform provides regulated individuals and entities the option of a formal adjudicatory hearing on the record before an ostensibly impartial hearing officer – the ALJ – when they are in dispute with a regulatory agency. The APA sought to reach a balance for this original and “unique” ALJ position by providing that ALJ’s “exercise…independent judgment on the evidence…free from pressures by the parties or other officials within (an) agency.” One way the legislation attempted to do this was by carving out general powers of appointment, compensation and tenure of ALJ’s and giving them to a distinct federal entity – the Office of Personnel Management (OPM) – rather than to the federal agencies. (GAO 1995)

APA statutory mandates have been implemented over time through regulations promulgated by both OPM and by the respective agencies that utilize ALJ’s. Generally, OPM regulations relating to ALJ’s apply to issues of protecting impartiality – appointment, compensation and tenure; agency regulations typically cover the

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133 The APA initially referred to ALJ’s as “hearing examiners”; the title was changed to Administrative Law Judges in 1978 pursuant to the Civil Service Reform Act, P.L. 95-251, 92 Stat. 183.


135 GAO 2010, 9.


137 The APA originally gave these powers to the U.S. Civil Service Commission.
adjudicatory process, and comprise their own rules of practice that govern their proceedings as derived from the APA. (GAO 2009b)\textsuperscript{138}

Specifically, the OPM is charged under the APA with determining ALJ qualification criteria, developing a list of individuals who meet those criteria, ranking the qualifying candidates and maintaining a register from which agencies with openings select new ALJ’s (GAO 1995). Although the selection process for ALJ’s is public, it is not political. OPM administers a merit-based selection process for ALJ’s pursuant to which it occasionally conducts competitive examinations of candidates to help it determine whether candidates are qualified and to rank those candidates on its register (CRS 2010). The OPM process closely reflects the standard civil service process.

Hence, the SEC, like other federal agencies, selects its ALJ corps from a register of candidates approved and rated by the OPM.\textsuperscript{139} Each agency is responsible for determining its own workload needs – by statute, it can appoint as many ALJ’s as it deems necessary to conduct the panoply of agency proceedings that must be on the record (\textit{Id.}). In reality, however, budget levels and personnel management responsibilities constrain this authority – particularly with regards to the SEC. As discussed below, the number of ALJ’s at the SEC has remained relatively consistent – and small – for decades, and the tenure of most of those ALJ’s has been long. There is little turnover and the ALJ corps – and the amount of its product – at the SEC is relatively static.

The OPM establishes salary levels for ALJ’s independent of ratings by or recommendations from any agency, including the SEC (Hoffman and Cihlar 1995).

\textsuperscript{138} See note 65, supra.

\textsuperscript{139} 5 U.S.C. §3105 (statute) and 5 C.F.R. §930.201 (regulations) (these federal laws establish the regime for the selection of ALJ’s).
Federal statutes specifically prohibit tying the compensation of ALJ’s to performance measures in order to encourage impartial decision making and discourage the application of inappropriate pressure on ALJ’s by agencies in litigation.\textsuperscript{140} Also, as to the relationship between ALJ’s and the SEC’s Division of Enforcement, the APA prohibits an ALJ from being “subject to…the supervision…of an employee or agent engaged in the performance of investigative or prosecuting functions” for the agency.\textsuperscript{141} In practice, ALJ’s at the SEC have regular professional interaction with members of the Division through administrative proceedings, but are not subject to oversight by those SEC employees. Moreover, on a broader level, according to SEC Chief ALJ Brenda Murray, SEC ALJ’s have “little, if any, interaction with the (SEC) Commissioners” and, though she was originally appointed by SEC Chair Arthur Levitt, Chief ALJ Murray has thereafter had “very little interaction” with SEC chairs.\textsuperscript{142}

In contrast to Article III federal judges who have lifetime tenure, ALJ’s can be removed by the OPM pursuant to federal reduction-in-force procedures (Verkuil, Koch, Griffin, Pierce, and Lubbers 1992). In addition, an agency like the SEC can remove an ALJ for good cause,\textsuperscript{143} but the definition of “good cause” remains somewhat vague. It has been found to include a consistently high rate of serious legal errors by an ALJ, but not general low productivity (and productivity rates vary significantly among ALJ’s, as discussed below) (CRS 2010, 8). Nonetheless, while perhaps not enjoying the level of

\begin{itemize}
\item \textsuperscript{140} 5 U.S.C. §§ 4301, 4302, and the 1978 Civil Service Reform Act.
\item \textsuperscript{141} CRS 2010, 7 (citing 5 U.S.C. §554(d)).
\item \textsuperscript{142} Chief ALJ Brenda Murray, \textit{Interview} (2011, 3).
\item \textsuperscript{143} 5 U.S.C. §7521.
\end{itemize}
job security of Article III judges, it is unusual for ALJ’s to be dislodged involuntarily from their positions.

Table 3.1 Division of Powers Relating to Management of ALJ Corps: Office of Personnel Management (OPM) vs. Federal Agencies

Source: Adapted from “Table 1: OPM and ALJ Agencies Share Responsibilities for Managing ALJ Hiring, Pay and Performance Management,” in GAO (2010) (GAO Table 1 based on its analysis of statutes and regulations pertaining to OPM and ALJ’s).

<table>
<thead>
<tr>
<th><strong>OPM</strong></th>
<th><strong>Federal Agencies</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Examination and selection of qualified ALJ candidates</td>
<td>Selection and appointment of ALJs at ALJ agency from list of certified candidates</td>
</tr>
<tr>
<td>Provide list of certified candidates to ALJ agencies upon request</td>
<td>Determining the number of ALJ positions at agency</td>
</tr>
<tr>
<td>Maintaining register of qualified ALJ candidates</td>
<td>Paying an ALJ applicant a higher rate of pay due to prior federal service</td>
</tr>
<tr>
<td>ALJ Tenure</td>
<td>Paying an ALJ applicant a higher rate of pay due to superior qualifications (Joint)</td>
</tr>
<tr>
<td>Establishing the three levels of pay for ALJs, and rates of pay within each level</td>
<td>Promoting ALJ to higher pay level (Joint)</td>
</tr>
<tr>
<td>Assigning each ALJ position at an agency to a pay level</td>
<td>Routine management of ALJs</td>
</tr>
<tr>
<td>Determining qualifications for appointment to each pay level</td>
<td>Assignment of cases to ALJ, in rotation</td>
</tr>
<tr>
<td>Paying an ALJ applicant a higher rate of pay due to superior qualifications (Joint)</td>
<td>Ensuring decisional independence (Joint)</td>
</tr>
<tr>
<td>Promoting ALJ to higher pay level (Joint)*</td>
<td>Defining permitted management activities</td>
</tr>
<tr>
<td>Ensuring decisional independence (Joint)</td>
<td></td>
</tr>
</tbody>
</table>

144 The ALJ position is “a creature of congressional enactment.” ALJ’s “have no vested right” to their positions, but hold them “by such tenure as Congress sees fit to give them.” Ramspeck v. Federal Trial Examiners Conference, 345 U.S. 128, 133 (1953).
Table 3.1 summarizes the material powers relating to ALJ’s that the OPM is empowered to exercise as compared to those that remain with their respective federal agencies.

So on paper at least, ALJ’s have a certain level of independence within their regulatory agencies. This statutory independence, though, does not necessarily translate into providing an environment for ALJ’s at the SEC to render decisions according to their political ideology. There are at least two main factors that significantly mitigate the effects of ALJ independence at the SEC and may help explain the apparent home field advantage for the agency in administrative proceedings – as well as render the use of ALJ ideology in my analysis impracticable.

**First Factor: ALJ’s “Quasi-Independent” In Certain Agencies**

This factor relates most directly to the issue of SEC ALJ independence. The structural relationship of ALJ’s to the agencies for which they adjudicate is not identical across federal agencies. Scholars, therefore, should use caution when comparing ALJ behavior across those agencies.

The SEC is considered among the “older enforcement agencies,” and Congress has not changed its organizational relationship with its ALJ corps over the years (Lubbers 1981, 273). It continues to manage its role as judge with its policy and regulatory role as an agency – without separation between the entities that serve these sometimes-conflicting responsibilities. This relationship reflects “a unique compromise…between adjudicatory independence and managerial responsibility born of the peculiar history of administrative governance in the United States” (Mashaw, Merrill and Shane 2003, 449).
In contrast, for instance, Congress amended the NLRA via the 1947 Taft-Hartley Act to delineate and divide out structurally the functions that the NLRB would fulfill in administering its mandate (Gifford 1997; and Lubbers 1981). As a result, the NLRB General Counsel’s Office is separate organizationally from the Board, its staff, and the ALJ’s who serve that agency. The NLRB General Counsel has “unreviewable authority” to initiate an investigation and file a complaint through an administrative proceeding (Estreicher and Revesz 1989, 705). The cases that are filed do not emerge from the same entity that adjudicates them – making the use of civil prosecution to achieve the agency’s policy goals more complicated because of a lack of complete coordination between the two functions. Thus, Congress created a separation of prosecuting and adjudicating powers within the NLRB, but not within the SEC.

Predictably, it has been common for members of Congress to introduce legislation seeking to remove ALJ’s from their line agencies – like the SEC – and place them organizationally into an independent corps of ALJ’s. Also, defendants in regulatory litigation against federal agencies often challenge the constitutionality of having ALJ’s who are located within the agencies who prosecute them civilly adjudicate their cases (Mashaw, Merrill, Shane 2003). Similarly, the Task Force on the SEC Administrative Law Judge Process (1991-92) recommended Congress provide the SEC General Counsel with independence from the agency and sole authority to file enforcement administrative proceedings, like the NLRB. None of these efforts has gained momentum politically.


146 Taking this a step further, Congress in 1975 created a separate agency, the National Transportation Safety Board, to adjudicate challenges brought by pilots against the Federal Aviation Administration when that agency denies, suspends or revokes pilots’ licenses (Lubbers 1981). This structure, dividing distinctly the adjudicatory from the regulatory components into two agencies, is deemed the “split-enforcement model” (GAO 2009b, 33).
over the last few decades, and ALJ’s within administrative structures like the SEC are considered by some scholars to be “quasi-independent” (Lubbers 1981, 272).

The ‘quasi-independent’ moniker is not intended to be critical of the performance of federal ALJ’s, but instead references the role of ALJ’s in agency structures, like that of the SEC, that derived originally from the APA-established position of ‘hearing examiner.’ While ALJ’s have independence within the agency to make impartial decisions in their administrative cases, their independence is not analogous to Article III federal district court judges. More recent legal literature has elaborated on this distinction and differentiated ALJ’s from their Article III judicial counterparts.

An analogy between Article III judges and ALJ’s is misleading. Article III judges are independent of the political branches so that they can perform their judicial role autonomously and act as a check on the other branches. Federal ALJ’s need only a limited degree of independence from their agencies so that their evidentiary factfinding can be done free from external pressure. Otherwise they are a component part of administration and are obligated to apply the policies of the agencies for which they work (Gifford 1997, 54 n.306 (emphasis added)).

This view holds that the powers Congress delegated to ALJ’s were never intended to replicate the authority that Article III judges derive from the Constitution. They do not comprise a separate – truly independent – branch, but instead exist “to preside impartially over fair hearings that implement and administer agency policy” and, thus, ALJ’s “must recognize that their role demands adherence to agency policy and goals” (Moliterno 2006, 1192).

In contrast to Article III judges, who may be reversed by a higher court, SEC ALJ’s are directly accountable to one of the parties in the proceedings before it – the agency for which they adjudicate – since the Commissioners on the SEC are authorized
to reverse a decision of an ALJ that goes contrary to the enforcement position of the SEC in an administrative proceeding. Some behavioral scholars argue that when decision makers know the policy positions of the parties to whom they are accountable, they often will anticipate those views – and this may influence an outcome accordingly. Therefore, the bias of an ALJ, ideologically or otherwise, can be mitigated through subsequent action – or pre-emptive influence – by the SEC Commissioners.

Viewing SEC ALJ’s through this prism, it is clear that there are potential constraints on the ability of an SEC ALJ to exercise decision making based on political ideology, as the attitudinal model would suggest were it applied to ALJ’s. While it is possible that this variable affects ALJ outcomes at the SEC, the notion of ALJ as agent participating in the fair administration of agency policy may narrow the spectrum of influence that the ideology of an individual ALJ can project on a case in that agency. The boundaries are narrower, so behavior indicative of the attitudinal model in SEC administrative hearings is commensurately more difficult to detect.

**Second Factor: SEC ALJ Corps is Static and Small**

The SEC ALJ’s do not turn over much – on average they have a long tenure as a group – and they comprise a very small number of the overall federal ALJ corps. The effect of this over time on the agency is that its enforcement decision makers – that is, those deciding whether and where to bring a particular case – can tend to view the SEC ALJ corps as an aggregate unit rather than as individual judges.

147 Committee on Federal Regulation of Securities (1991-92, 1732).

As for tenure, in 2008 all of the SEC ALJ’s were eligible to retire. This is consistent with a longstanding trend at the agency. In 1993, SEC ALJ’s had served an average of 20 years as ALJ’s and 29 years in all types of federal government service (GAO 1995, 14). So, when ALJ’s get their jobs – especially at the SEC – they hold them for a long time.

In terms of the size of the ALJ corps, the ratio of SEC ALJ’s to all ALJ’s has decreased significantly since the APA was enacted and has remained quite small for at least the last three decades. Initially, 63.8% of ALJ positions established under the APA were assigned to economic regulatory agencies in response to early demand based on perceived post-World War II regulatory needs (Lubbers 1981, 268). The SEC had 6 of the original 196 positions (3.06%) (Gifford 1997, 10 n. 39). By 1981, the SEC was down to 4 ALJ’s (0.36% of all ALJ’s). Since then, the number of ALJ’s at the SEC has remained steady at 4 (CRS 2010).

The SEC has somewhat different, albeit high, rates of success among its individual ALJ’s. The range of SEC success rates before the five ALJ’s who adjudicated the most SEC administrative proceedings during the period covering the primary data set, as well as the percentage of all cases for the period handled by each of those ALJ’s, is as follows:
Table 3.2 SEC Success Rate Before Individual ALJ’s and ALJ Adjudication Rates for SEC FY 1992 through FY 2007

<table>
<thead>
<tr>
<th>ALJ</th>
<th>SEC Success Rate before ALJ</th>
<th>Percentage of All SEC Administrative Proceedings Adjudicated by ALJ</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brenda P. Murray (Chief ALJ from FY 1994 to Present)</td>
<td>95%</td>
<td>22%</td>
</tr>
<tr>
<td>Carol Fox Foelak</td>
<td>80</td>
<td>16.9</td>
</tr>
<tr>
<td>James T. Kelly</td>
<td>91.7</td>
<td>12.2</td>
</tr>
<tr>
<td>Robert G. Mahony</td>
<td>80</td>
<td>15.2</td>
</tr>
<tr>
<td>Lillian McEwen</td>
<td>67.5</td>
<td>13.5</td>
</tr>
</tbody>
</table>

Source: Original Data Set derived from initial decision opinions on [www.sec.gov](http://www.sec.gov)

This handful of ALJ’s adjudicated 80% of all SEC administrative proceedings for the 16-year period of the data set. Figure 2.5 in Chapter 2 provides a detailed presentation of all of the SEC ALJ initial decision outcomes for the period of the primary data set, including the number of cases where each ALJ: (i) sanctioned a defendant, (ii) levied all of the sanctions sought by SEC civil prosecutors, (iii) dismissed a case, and (iv) was reversed on appeal to the full Commission.

Although the Chief ALJ “make(s) the case assignments (for administrative proceedings) in rotation as much as possible,”149 some ALJ’s – like Chief ALJ Murray – have a higher rate of production of initial decisions and, consequently, receive more cases to keep the docket flowing. The fact that certain ALJ’s adjudicate more cases because of their prolific writing ability weights the overall performance of the ALJ corps and factors into the likelihood that the SEC will succeed in administrative proceedings before them. The agency also knows on a macro level which administrative proceedings are active

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149 Chief ALJ Murray, Interview, p. 4.
(and to what extent) and which ALJ is likely too busy to take on another case at any one time. The same is not necessarily true for defendants in those proceedings.

This becomes important during settlement negotiations in administrative proceedings, which are frequently finalized during the SEC’s extensive review process for civil enforcement actions – when the parties know the forum for the case, but cannot yet determine the identity of the presiding ALJ. Despite a defendant playing the litigation odds hoping to appear before ALJ McEwen (prior to her retirement) rather than Chief ALJ Murray, “(B)oth sides can do little more than discount their respective settlement positions to reflect the uncertainty of the outcome at the ALJ level” (Mixter 2001, 15). The discounting is easier for the agency, given its deep knowledge of its ALJ unit. In practice, this translates into an advantage for SEC enforcement litigators.

**The SEC ALJ Corps – Difficult to Divine Political Party or Ideology**

The third, and perhaps most important, factor renders the use of ALJ ideology as an independent variable in my analysis impracticable – it is extremely difficult to divine the political party or ideology of the SEC ALJ corps.

In Table 3.3 below, I present for the first time to my knowledge information about the professional experience and employment backgrounds of the SEC ALJ’s for a period covering my primary data set, SEC FY 1992 through FY 2007. The table includes each ALJ’s term and whether each ALJ had: (i) been a prosecutor prior to becoming an ALJ, (ii) previous federal government work experience, and (iii) been a veteran.
Table 3.3 Professional Experience and Employment Background for SEC ALJ’s, SEC FY 1992 through FY 2007\textsuperscript{150}

\textsuperscript{*} = Could not be determined

<table>
<thead>
<tr>
<th>ALJ Name</th>
<th>Term</th>
<th>Prior Prosecutorial Experience</th>
<th>Former Federal Gov’t Employee</th>
<th>Veteran\textsuperscript{151}</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warren E. Blair</td>
<td>1964-1994</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>G. Marvin Bober</td>
<td>1996-1998</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>William J. Cowan</td>
<td>2000</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Cameron Elliot</td>
<td>2011-Present</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Carol Fox Foelak</td>
<td>1995-Present</td>
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<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Herbert Grossman</td>
<td>1999</td>
<td>1</td>
<td>1</td>
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</tr>
<tr>
<td>Stephen Grossman</td>
<td>1999</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>James T. Kelly</td>
<td>1999-2010</td>
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<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Burton S. Kolko</td>
<td>1995-1996</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Edward Kuhlmann</td>
<td>1993-1995</td>
<td>1</td>
<td>1</td>
<td>*</td>
</tr>
<tr>
<td>Glenn Lawrence</td>
<td>1993-1996</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Robert G. Mahony</td>
<td>1997-Present</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Lillian McEwen</td>
<td>1995-2007</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Brenda P. Murray</td>
<td>1987-Present</td>
<td>0</td>
<td>*</td>
<td>0</td>
</tr>
<tr>
<td>Max Regensteiner</td>
<td>1973-1993</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Jerome Soffer</td>
<td>1975-1992</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>H. Peter Young</td>
<td>2000</td>
<td>0</td>
<td>1</td>
<td>*</td>
</tr>
</tbody>
</table>

\textsuperscript{150} In Table 3.3, 1 = yes, and 0 = no

\textsuperscript{151} ALJ’s receive a veterans’ preference in federal hiring considerations pursuant to 5 C.F.R. §930.203(e).

\textsuperscript{152} Daughter of the late Annette Baker Fox, who established the William T.R. Fox Fellowship in Political Science at Columbia University in memory of her husband who was the first director of the Institute of War and Peace Studies. I was awarded the Fox Fellowship by Columbia and had the honor of spending an evening at Columbia’s Benefactor and Fellowship Dinner in the presence of Dr. Baker Fox.
I could determine the political party of only one of the sixteen ALJ’s who adjudicated a case for the SEC during this time period – and that information was available only because of an odd coincidence. ALJ Lillian McEwen happened to be the girlfriend of U.S. Supreme Court Justice Clarence Thomas when the Anita Hill scandal broke. McEwen went public with her story in 2010 after retiring as an ALJ and starting to shop a draft memoir. Her prior job as an aide to then-U.S. Senator Joe Biden (D-Delaware) was mentioned in accounts at the time.\textsuperscript{153}

It was difficult to find information that could serve as a proxy for the political ideology of SEC ALJ’s – like political party – because most of the ALJ’s had served many years in their current position and would not publicly identify with a party. In addition, most had previously served in other federal government employment, including prosecutorial roles, and therefore developed careers that reflected more traditional civil servants rather than politically active partisans. Political membership and/or activity did not turn up anywhere in their professional backgrounds – intentionally, and understandably, on the part of the ALJ’s who strictly protect their reputations as apolitical adjudicators. Further, because agencies select ALJ’s initially from the OPM register, there is no built-in means for identifying the possible political party of an ALJ – in contrast to Article III federal judges, who are appointed by the President and supported by at least one US Senator from their home state.

The picture of an SEC ALJ that emerges from Table 3.3 is of a politically inactive career federal employee, who has worked as a prosecutor in some form – and may therefore have some affinity towards the agency’s civil prosecutors, or at least understand prosecutorial behavior well, and has benefitted from the OPM’s veterans’ preference. This individual, though maintaining quasi-independence as an impartial adjudicator within his or her role, plays a key part in advancing the policy of the agency. The SEC often, but not always, prevails before the ALJ and it is very difficult for a researcher to accurately discern an ideological influence behind the ALJ’s’ decision making. Indeed, because of the small number of ALJ’s who handle administrative proceedings at the SEC, it is fair for the agency to view the ALJ corps as an aggregate unit rather than as individuals. Thus, I do not use the ideology of individual SEC ALJ’s as an independent variable in the analysis.

**Selection Bias Mitigated**

It is prudent, particularly when performing social science research in the context of legal case outcomes, to think through the potential for selection bias when formulating a data set. I addressed this issue through two means: first, by developing a research design based around available data that would minimize the probability of the presence of bias introduced by the SEC, and second by randomly selecting the data so that I would avoid introducing bias into the data set.

As to the first point, I do not attempt to draw conclusions that apply to all potential SEC public civil enforcement actions – that is, those prosecuted civilly by the SEC as well as those that are not (and are impossible to identify). Instead, I focus on the
strategy the SEC applies to those cases that have already traversed the agency’s multilayer process that I describe in detail earlier.\textsuperscript{154} The core issue turns on the agency’s strategic choice of forum and how judicial ideology, as well as case characteristics and potential political influences, affect that choice. The primary data set is built around a random selection of cases chosen from this narrower universe. And the universe includes all civil enforcement actions brought by the SEC in both forums – whether they are ultimately settled or litigated.

As the process I describe in Chapter 2 illustrates, there are numerous, diverse sources of SEC civil enforcement proceedings. The cases that progress to the settlement stage, or to litigation in district court or before an ALJ, wind their way through various vetting hurdles comprising distinct sets of judgments by rank-and-file enforcement staff in the field, senior enforcement staff in local offices as well as in Washington, D.C., and SEC Commissioners. Each of these steps, and chronologically divergent influences, mitigates bias in the set of cases the SEC selected over the sixteen-year period of my primary data set.

Moreover, the agency did not follow any overarching, formal set of guidelines or checklist over these years for selecting and approving cases for civil prosecution. Rather, as this section of my dissertation makes clear, the system was decentralized prior to 2007 which, on one hand, may have adversely affected the performance of the agency, but on the other inadvertently mitigated selection bias in the cases comprising the primary data set.

\textsuperscript{154} See Epstein and King (2002), 106-07 (explaining flaw of ascribing broad inferences about judicial behavior based on research covering only published – but not unpublished – opinions of federal circuit courts and noting that this may be remedied by explicitly narrowing the scope of the inferences to match the actual composition of the data set – which reflects how I structured the research models in this dissertation).
set. Not every participant in the enforcement process throughout the agency was on the same, narrow page at all times.

The process further reveals that the SEC did not select on the dependent variable I use in the analysis. There is no evidence the agency systematically selected cases based on their likely forum. Instead, I argue, the SEC loosely applied various other case-specific criteria to their determinations of whether to file a case for civil prosecution, and once a case made it to that point, a forum was selected. The dissertation tests whether, at this point, the agency made strategic decisions for filing accepted cases in a certain forum – and/or specific venues – based on political ideology and/or other factors that are discussed in the analysis.

Also, not all civil enforcement cases are alike. Many of the bread-and-butter cases have characteristics that are distinct from those cases where important legal precedents may be established for the SEC or from cases that are perhaps politically sensitive. The dissertation tests these characteristics as well to see if they are significant in the agency’s strategic decision making about forum and venue.

**Random Selection of Cases**

As to the second point, I selected the 1,617 cases comprising the primary data set using random selection of civil enforcement actions retrieved from SEC public releases. The sample was drawn from a potential population of about 7,900 cases the agency filed during this time period, representing slightly more than 20% of all SEC enforcement filings for the period. Time constraints from the extensive coding of each release, as well
as follow-up background research necessary on many of the cases, rendered creating a larger data set unfeasible.\textsuperscript{155}

The SEC published a description of the filing of each district-court litigation case and each administrative proceeding separately from SEC FY 1992 through FY 2007. Releases dated September 19, 1995 or later were accessible via the SEC web site, www.sec.gov. Earlier releases were available through paper or microfiche copies of the SEC Docket.\textsuperscript{156} In order to obtain a random sample, I performed a systematic random selection with a sampling interval width of eight, that is, I selected every eighth press release issued by the SEC and utilized the case it referenced.\textsuperscript{157} This systematic sampling technique would not mask any sort of pattern in these public releases, as they were generally homogeneous in nature and the agency issued them chronologically upon occurrence, not based on any other factor that I test through an independent variable. Also, because the press releases were chronological, the systematic selection provided a sort of stratified sample because it drew random samples of SEC enforcement actions for each SEC fiscal year of the study. For instance, this natural stratification guarantees a substantial number of observations over time, including for the periods pre- and post-Enron, in order to provide sufficient data to make an efficient causal inference about the

\textsuperscript{155} The 1,617 cases were coded to extract data I used to create the set of variables comprising the primary data set. The variables that I actually tested and used in my dissertation are summarized for reference in Table 4.A1 in the Appendix.

\textsuperscript{156} Published by a private business and tax-law information and software company, CCH. See www.cch.com.

\textsuperscript{157} In the rare circumstance a particular press release did not reference the filing of an enforcement action, I utilized the case referenced in the next release, but thereafter continued coding along the order of the original sampling interval.
shock variable while still ensuring the macro sample remains randomly generated.

**Dissertation Treats SEC Settlements of Civil Enforcement Cases as Observational Equivalent of Trials in District Court or Litigated Proceedings before ALJ Corps**

I view cases from the primary data set that settle, and those that progress to trial in federal district court or to proceedings before an ALJ, as observational equivalents. Therefore, any mention in this research of a case implicitly includes both categories of outcome. The reasoning is straightforward.

In general, most cases in the U.S. system of litigation settle – at various points along the dispute continuum – and very few matters actually reach trial (Clermont 2008-09). The U.S. civil justice system encourages settlements. On a micro level, the required commitment of resources (e.g. money, time, and opportunity cost) naturally incentivize parties to try to reach agreement. Macey (2010) asserts further that corporate defendants have greater incentive than individual defendants to settle with the SEC, for instance, because fines paid to the SEC do not come directly from individuals making the decision to settle, but come rather from the shareholders or insurance policies of a company.

On a macro level, the system cannot accommodate and process all of the civil cases filed annually through the complete cycle of adjudication. Nevertheless, scholars note that all litigation-related cases involve some level of strategizing over forum selection (e.g. at the most extreme, forum shopping) (Id.). The pre-trial positioning of the parties over forum (and venue) is a critical component of the system in part because it helps determine the relative leverage the parties have in settlement negotiations. The forum in most cases is just as important to parties who settle as it is to those who go to
trial. “When the dust settles, the case typically does too – but on terms that reflect the results of the (forum) shopping and skirmishing” (Id. at 1922).

Not surprisingly, these fundamental principles apply to the civil enforcement cycle of the SEC. “The SEC settles most enforcement actions by consent, pursuant to which the defendant(s) or respondent(s) neither admits nor denies the findings of fact and conclusions of law, but agrees to the entry of an injunction or order” (Johnson 2007, 647). From the perspective of a defendant in a public civil enforcement action, in addition to the resource conservation considerations mentioned above, it is often preferable to negotiate a settlement with the agency to avoid reputational harm from public, protracted litigation. In addition, each regulated defendant must manage its reputation vis-à-vis the SEC and avoid being perceived as an ongoing problem within the agency – with whom it will have recurring, material interactions over time (Committee on Federal Regulation of Securities 1992, 1093-94). This issue emerges from the tensions reflected in the dual role of the SEC under its founding legislation and the APA as regulator and adjudicator.

Further, as I discuss in more detail in the Addendum, some defendants have an incentive to settle with the SEC to pre-empt collateral estoppel. That is, “(c)ollateral estoppel will preclude a defendant from asserting arguments or defenses in a private action (by shareholders of a company, for instance)\(^\text{158}\) regarding the same issues that were litigated and decided by a federal court in a prior SEC action against the same defendant” (Mahoney, Walker, Schwartz, and Greenstein 2004, A-103).

\(^{158}\) “Nearly all” securities class action suits brought by private shareholders that survive motions to dismiss made by defendants eventually settle (Cox, Thomas and Bai 2009, 427).
The SEC prefers to settle civil enforcement matters (Johnson 2007, 628) because it is a relatively cheap means for the agency to fulfill a part of its primary mission – enforcement – while not precluding the Division of Enforcement from achieving its prioritized goals of protecting investors, deterring financial malfeasance, and improving conduct in the nation’s market economy (see Committee on Federal Regulation of Securities 1992, 1091). The underlying threat of the agency’s ability and willingness to litigate has a symbiotic relationship with the success of its settlement program. It provides the leverage necessary for the SEC to coerce defendants into line and work out settlement on terms beneficial to the agency.

Settlement negotiations can begin as early in the process as the informal investigation stage. It is more common, however, for the Wells Process to trigger settlement talks because both sides at that point have a more thorough understanding of the available evidence and the strategic intentions of the SEC toward the case. In addition, a large number of cases are either settled simultaneously with filing, or the parties complete settlement negotiations during pre-trial motions or during the trial itself. With regard in particular to the last two alternatives, the SEC’s intended forum plays a direct role in the strategic decision making of the respective parties.

In general, there is a dearth of data on settlements in the U.S. civil justice system because, in contrast to trial outcomes, it is more difficult to quantify specifics that are not readily observable – most settlement negotiations are conducted privately (Clermont 2008-09, 1953). In terms of the SEC, although the investigation process and settlement talks remain out of the public eye for much of the enforcement cycle, I have identified
one set of settlement statistics and developed another original set of data that shed some light on SEC settlement practice.

**Figure 3.6 Number of Annual Settlements in SEC Civil Enforcement Actions for Company and Individual Defendants, Respectively, for Calendar Years Post-Sarbox**

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
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<tbody>
<tr>
<td>Companies</td>
<td>74</td>
<td>222</td>
<td>250</td>
<td>195</td>
<td>194</td>
<td>213</td>
<td>160</td>
<td>188</td>
<td>159</td>
<td>196</td>
</tr>
<tr>
<td>Individuals</td>
<td>235</td>
<td>667</td>
<td>586</td>
<td>629</td>
<td>483</td>
<td>502</td>
<td>497</td>
<td>419</td>
<td>474</td>
<td>515</td>
</tr>
</tbody>
</table>

**Source:** Adapted from Data and Similar Charts in Larsen, Buckberg, and Lev (2008) and Overdahl and Buckberg (2012)

159 Note that because Sarbox was effective as of July 31, 2002, the data for calendar year 2002 is for August 1 through December 31, 2002.
Figure 3.6 shows the annual number of SEC settlements – broken out into agreements with companies and individuals, respectively – the agency has reached since the enactment of Sarbox on July 31, 2002. This date is significant because Sarbox includes a provision that permits the SEC to distribute penalty fees collected through settlements to shareholders of public companies identified by the agency to have been harmed by the company’s malfeasance. Prior to this option, SEC enforcement staff was cautious about pursuing large monetary penalties in the penalty phase of litigation against public companies because it sometimes viewed such tactics as compounding the harm suffered by already-aggrieved shareholders by possibly further driving down the value of their investments (Larsen, Buckberg, and Lev 2008). Also, the disparity in the larger number of cases settled against individual defendants as opposed to corporate entities may reflect the agency’s ongoing larger advantage in power and resources over individuals than it has over business entities.

My primary data set tracks the cases that the SEC announced via public media release that it had settled simultaneously upon the filing of a civil enforcement action for SEC FY 1992 through FY 2007. The overall rate of settlements-upon-filing for the sixteen fiscal years is over 57%. That is, in more than 57% of the cases the SEC announced publicly as being filed as civil enforcement actions in either district court or before an ALJ, the agency settled the matter as it was filed – post Wells Process, but prior to pre-trial motions. The rate of these settlements for administrative proceedings was 75% – far higher than the rate for cases filed in district court, which was 39%. Also, the settlement rate was higher for administrative cases than for district court cases for each of the respective fiscal years.
This disparity may reflect the perspective explained in the section of Chapter 2, “SEC Fares Better in Civil Enforcement Proceedings before ALJ’s,” that the agency maintains a home field advantage in administrative proceedings. Defendants may simply not have the requisite confidence to proceed to trial before an ALJ and, instead prefer to settle with the agency without having to describe specifically their bad acts. It may also reflect the discussion in Chapter 2, “SEC’s Scope of Authority: Federal District Court as Forum Compared to Administrative Proceedings,” and the data in Table 2.4, which demonstrates that the SEC has a more potent array of sanctions to levy on defendants in federal court than it does in administrative proceedings. It is likely that a defendant is more willing to expend significant resources to defend an action the agency brings in district court seeking relatively severe sanctions against the defendant. This is the case particularly if SEC staff has been inflexible in settlement negotiations, or if the agency is basing its claims on a new interpretation of securities law that has not yet been tried in federal court.

Hypotheses

In this section I present in descriptive fashion the primary hypothesis and a set of seven secondary hypotheses that emerge from the data and the models underlying my dissertation. Each hypothesis links back specifically to an independent variable or set of variables in one or all of the models. For example, the “primary hypothesis” relates specifically to the analysis of the independent variables in each model that measure the ideology of the lower federal courts, as described in Chapter 4. Moreover, the “case complexity hypothesis” applies to the analysis of a set of independent variables in each
model that is designed to measure the legal and investigatory complexity of cases in the data set.

I test each of these hypotheses in Chapter 4 to determine whether my theory overall presents an accurate portrayal of the causes of SEC enforcement decision making and behavior. The theory provides context and an explanation for the hypotheses and the independent variables they reflect. Along with the primary hypothesis, the secondary hypotheses help provide a richer explanation of why the SEC acts as it does with regard to its public civil enforcement program.

Primary Hypothesis

The primary hypothesis I test in this dissertation is:

H1 (Primary Hypothesis) – When the SEC decides to pursue a public civil enforcement action, the agency prefers to trade off the enhanced benefits of bringing the litigation in the forum of lower federal court and will instead file in the forum that is friendlier to the agency – an administrative proceeding before an ALJ – when the court with likely jurisdiction over the case is ideologically conservative.

Secondary Hypotheses

The secondary hypotheses are designed to set the stage for testing whether myriad influences, in addition to the ideology of the lower federal courts, affect the decision making and behavior of the SEC in the context of its public civil enforcement program. These secondary hypotheses are as follows:
H2 (Case Complexity Hypothesis) – The more legally complex and potentially costly to the SEC a civil enforcement action is, the more likely it is that the agency will file the case in federal district court.

H3 (Corporate Defendant Hypothesis) – When the proposed defendant in a civil enforcement action is a corporate entity, the SEC is more likely to file the case before an ALJ.

H4 (Harm Hypothesis) – When the alleged harm that is the subject of a civil enforcement action by the SEC was aimed primarily at a corporate entity or the functioning of the financial market system – rather than being intended for an individual (or set of individuals) – the agency is more likely to choose a more conservative federal district court for filing the action.

H5 (Favorite Court Hypothesis) – When a civil enforcement case emerges from the jurisdiction of the SDNY, the SEC is more likely to file the case in federal district court than before its ALJ corps because of a special relationship the agency maintains with that court, which is based on its perception of that district’s profound level of securities law expertise and familiarity with the mission of the agency.
H6 (Commissioners’ Political Influence Hypothesis) – Presuming the relative independence of the SEC’s public civil enforcement process, as the ideology of the politically appointed SEC commissioners grows either more conservative or more liberal, the likelihood of the SEC selecting federal district court over its ALJ corps as the forum for a civil enforcement action does not change.

H7 (Congressional Dominance Hypothesis) – Presuming the relative political independence of the SEC, as the ideology of the agency’s political principals in Congress – the congressional sub-committees and committees with oversight and appropriations responsibility over the SEC – grow significantly more conservative or more liberal, the likelihood of the SEC selecting federal district court over its ALJ corps as the forum for a civil enforcement action does not change.

H8 (Shock Hypothesis) – In the wake of the exogenous shock to the U.S. financial system caused by the Enron scandal in October 2001, the SEC became more likely – for a finite period – to choose more conservative federal district courts for filing civil enforcement actions.

Conclusion to Theoretical Framework and Hypotheses

This chapter establishes the primary theory of the SEC as an independent agency that takes into account the ideology of the lower federal courts in its strategic decision making regarding public civil enforcement. It presents the concept of shock to this study to demonstrate how an exogenous event may affect the interactions between a federal bureaucracy and the lower courts. The chapter also develops an alternative portrayal of
an SEC influenced by the ideology of its political principals to compare to the primary
theory, and to ultimately use to help explain the results of the statistical analysis I
perform below in Chapter 4.

In this chapter, I explain why political ideology may affect the interaction of the
SEC with the lower federal courts. I describe the SEC’s ALJ corps and explain why it is
impracticable, and unnecessary, to include a measure of its ideology in my statistical
analysis. Here I also discuss two methodological issues that arise in the construct of the
theory – the mitigation of potential selection bias in the data and why the dissertation
treats SEC settlements as the observational equivalent of actual litigation in the public
civil enforcement program.

Finally, in this chapter I present the primary, and seven additional secondary,
hypotheses that I test and analyze below in Chapter 4. These hypotheses structure the
subsequent analysis and foreshadow the independent variables that I operationalize and
use in my models.
Chapter 4
Primary Data, Models and Methodology

Introduction

In this chapter I describe the methodology and perform the empirical tests that support my primary empirical analysis. My findings, based on multivariate logit analysis that I perform on the primary data set, indicate that judicial ideology does, indeed, affect the SEC’s decision making, but that an exogenous shock can reverse the direction of this effect at least temporarily. While my findings do not identify political influence from the executive branch on the agency, strands of congressional dominance rear their head as the ideology of oversight and appropriations subcommittees are significant in the analytical models. Not surprisingly, the logit analysis reveals that case characteristics have a large effect on the practical side of the agency’s decision making and behavior when implementing its enforcement mission. Overall, my statistical analysis tends to confirm most of the hypotheses I lay out in Chapter 3.

I start this chapter by providing a detailed rationale for the boundaries of the primary data set. Next, I present the dependent variable and describe each independent variable. I explain the reasoning underlying each independent variable, provide support where appropriate for the individual variables through extant literature, and give the context for the variables in the six analytical models I use. I also provide detail about the operationalization of some independent variables – such as the ideology of the lower federal courts – that comprise multiple components drawn from previous research.

Here I tie each variable into a specific hypothesis from Chapter 3, present those hypotheses as equations I test statistically through multivariate logit, and provide
estimation equations for the models I created to analyze the primary data set. I also provide an annotated equation that explains the models in detail.

I next explain why I utilize a multivariate logit model in this section of the analysis, and discuss how complicated the interpretation of the results can be and the caution and discipline that is necessary when presenting them. In this chapter I present a detailed account of the results of the logit analysis, provided in Table 4.3, and discuss the findings mentioned above. As part of this discussion, I look at how well the models explain the political process behind the SEC’s strategic decision and behavior.

Primary Data

I utilize an original primary data set derived from a sample of 1,617 SEC public civil enforcement cases to test my hypotheses. These cases span nearly sixteen calendar years and, as I explain in Chapter 3, were selected through simple random sampling from the enforcement actions filed by the SEC in both the forum of federal district court and in administrative proceedings for the second quarter of SEC FY 1992 through FY 2007. Figure 3.5 shows the number of public civil enforcement actions the SEC filed each fiscal year during this period categorized by the amount filed in federal district court versus those filed before its ALJ corps.

Background on Primary Data Set

Data Set Begins in FY 1992

The data set starts in SEC FY 1992 because a new securities law enforcement regime had expanded the SEC’s administrative jurisdiction and powers, making them for
the first time comparable in many respects to the agency’s enforcement jurisdiction and powers in federal court – and making possible the comparative analysis underlying the dissertation. This regime “fundamentally changed” how the SEC would now confront violations of securities laws and its timing was critical as the agency faced a far more complex array of challenges because financial markets had changed dramatically in the late 1980s and early 1990s (NYU Center for Law and Business 2005, 4).

The Remedies Act provided the SEC with new administrative civil enforcement remedies and expanded the universe of potential defendants against whom the SEC could bring administrative proceedings (McLucas, DeTore, and Colachis 1991). As its legislative history describes, a main goal of the legislation was to “enable the Commission to maintain an aggressive and comprehensive program to enforce the federal securities laws.” It provided the SEC with flexibility to “achieve the appropriate level of deterrence in each case and thereby maximize the remedial effects of its enforcement actions.”

Prior to the Remedies Act, the SEC was authorized to file administrative enforcement proceedings against only narrow bands of industry participants such as investment advisors and broker-dealers. The Remedies Act empowered the SEC to bring

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160 At the time, it was “the most significant expansion” in history of the SEC’s authority to pursue penalties against violators of the federal securities laws. Stephen M. Cutler, Director, SEC Division of Enforcement. April 29, 2004. Speech at 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute. Chicago, Illinois. Prior to 1991, the SEC was relatively toothless. It was not empowered to impose monetary penalties in most cases. It had to rely solely on seeking injunctions, i.e. an order for the defendant to engage in no further violations of securities laws. Stephen M. Cutler, Director, SEC Division of Enforcement. March 18, 2005. “Staying the Course.” Remarks before the Directors’ Education Institute at Duke University. Durham, North Carolina.


162 Id. at 13.
a range of administrative enforcement remedies against all persons with respect to most provisions of major federal securities laws (Cox, Thomas, and Kiku 2003; Martin, Mirvis, and Herlihy 1991). Thus, it enabled the SEC for the first time to bring administrative proceedings in virtually all categories of cases falling within its civil enforcement jurisdiction (Orenstein and Dorfman 2000).

Shortly after enactment of the Remedies Act, scholars and legal practitioners predicted that the SEC would use its newly granted powers to bring administrative actions in significantly greater numbers, “especially when it wishe(d) to avoid initial (federal) judicial scrutiny of new enforcement positions” (Ferrara, Ferrigno, and Darland 1991; Martin, Mirvis, and Herlihy 1991, 20).

Although it took the SEC some time to incorporate these new powers into its enforcement arsenal after Congress passed the Remedies Act in 1990, Figure 3.5 shows that, for the first time, in FY 1992 the number of public civil enforcement actions the SEC filed in administrative proceedings surpassed the number filed in federal court – having grown an unprecedented 39% from the previous fiscal year. The SEC has since filed more civil enforcement actions through administrative proceedings than in federal court every fiscal year except one – SEC FY 2005. Nonetheless, although Congress materially enhanced the SEC’s administrative powers of enforcement through the Remedies Act, the agency’s “historic enforcement powers in the federal courts continue() to be an integral and numerically significant part of its arsenal…” (Cox, Thomas, and Kiku 2003, 742).
Data Set Continues Through FY 2007

The primary data set continues through FY 2007. As a consequence, it captures the effects of Sarbox, first implemented in late 2002, that I discuss in Chapter 3. It also reflects the influence of any pressure the agency had to absorb from its political principals in the wake of Enron.

Dependent Variable

The dependent variable I use to test the primary and secondary hypotheses is whether the SEC filed a civil enforcement proceeding in an individual case in the forum of federal district court or in the forum of an administrative proceeding before its ALJ corps. This variable has the value of 0 if filed in district court and 1 if initiated before an ALJ.

Primary Independent Variables – Ideology of Lower Federal Courts

I operationalize and use two primary continuous independent variables. The first represents the ideological composition of each of the relevant federal district courts and the second represents the ideology of the respective circuit courts with jurisdiction for those district courts. Figure 4.1 tracks the median ideology of the federal district and circuit courts, respectively, through the duration of my primary data set. One of the “Key Assumptions” of Chapter 3 is that the SEC is keenly aware of the ideological reputation of the lower federal courts and that those reputations are linked reasonably accurately to

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the actual ideological composition of the courts – as captured in the measurements comprising the primary independent variables.

**Figure 4.1 Annual Aggregate Median Ideology of Lower Federal Courts**

- **X axis = SEC Fiscal Year**
- **Y axis = Median Ideological Score of Lower Federal Courts**
- **Source:** Primary Data Set

**Selection of District Courts for Analysis**

For public civil enforcement actions in federal district court, I utilize the ideology of the court where the SEC brought the action on the date filed. I also use separately the ideology of the circuit court with jurisdiction for that district. For each civil enforcement action the SEC initiated in administrative proceedings, I estimate the ideology of the district court where the SEC *would have* filed the action had it decided to bring the action
in court on the date the administrative proceeding was filed, as well as the ideology of the corresponding circuit court (cf. Canes-Wrone 2003, 2006).

In order to identify the district court where the SEC would have filed an action, the analysis assumes that the relevant court for each administrative case is in the district that has jurisdiction over the location where an individual defendant resides or a corporate defendant has its principal place of business. The applicable federal venue statutes include these two categories in addition to a third, which is the district where an act or transaction (such as an offer or sale of securities) constituting the violation occurred.164

The relatively expansive statutory language of the third category would seem to permit some forum shopping165 by the SEC, which would complicate the prediction of where a case would have been filed. In practice, however, forum shopping is often constrained because many of the investigations leading to the filing of actions are generated by regional SEC offices that correspond to the residence of the individual or principal place of business of the entity under investigation. These offices typically pursue actions through their local federal district courts to conserve resources and have ready access to witnesses and evidence. As a check, I calculated that about 72% of the actions filed in district court that were coded for this analysis are in jurisdictions where the individual defendant resided or the corporate defendant had its principal place of

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165 See note 116 supra for definition of ‘forum shopping.’ In this instance, the term refers specifically to the SEC shopping for various venues, or different filing options within federal district court. The dissertation appropriately distinguishes venue from forum, which refers to the distinction between federal district court and administrative proceedings before the SEC’s ALJ corps.
business. This analysis presumes it is fair to ascribe a similar jurisdiccional rate to the cases filed in administrative proceedings.

As noted in the subsection “Option to Appeal Trial Outcome” in Chapter 2, the SEC Rules of Practice governing administrative proceedings provide that an ALJ’s decision can be appealed to the full SEC. The decision of the full SEC, in turn, can be appealed to the D.C. Circuit or to the circuit where the defendant resides or has its principal place of business. So, the federal statute governing the appeal of cases decided by the SEC eliminates much of the uncertainty inherent in other federal venue statutes and provides a firm basis for predicting the jurisdiction of the courts of appeals from ALJ decisions in administrative proceedings.

**Calculating the Ideology of the Federal Courts**

The ideological scores for the federal district and circuit courts I use in the analysis are calculated as follows.

I ascribe the median ideological score (based on DW-Nominate scores, as discussed below) of the full-time judges sitting in a district or a circuit on the date an

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166 See “Discussion: Footnote 166…” in Appendix for data and method of calculating this percentage.

167 This finding is not atypical. For example, relevant to federal agency enforcement, Estreicher and Revesz (1989, 766) explain that when the NLRB moves in federal court to enforce orders it has issued, its norm is not to forum shop. Instead, the agency typically files in the federal court “with jurisdiction over the geographic area where the unfair labor practice occurred.” The NLRB enforcement process is distinct from the SEC process in that it does not have a binary forum option. And its venue selection norm differs from the SEC norm. Importantly, though, the two agencies are similar in that they “do not take full advantage of the strategic benefits of” their available choices – though, perhaps, for different reasons. In the context of private securities fraud litigation discussed in the chapter comprising the Addendum, Cox, Thomas, and Bai (2009, 429) found that 85% of class action lawsuits for securities fraud filed by plaintiffs’ attorneys in federal district court are brought in the “home circuit of the defendant corporation.” In both examples, the respective venue statutes are as broad as the SEC venue statutes listed in note 164.

168 The analysis does not factor ideological scores for senior, part-time judges into the determination of the median. The Administrative Office of the U.S. Courts (AOC) (2006) published statistics showing that
action was filed by the SEC as the ideological score for that court. In this way, I consider each respective court a unitary actor and assume that, overall, the decisions of each court generally reflect the preferences of the pivotal median judge (Hall 2009).

The use of the median rather than the mean score for each court provides specific benefits to this research. First, it simplifies and enhances the accuracy of the coding process, without reducing the richness of the data, by rendering unnecessary additional calculations that could introduce bias from human error into the data thereby mitigating, but not eliminating, the possibility of human error in coding. Second, it eliminates the potential effects of ideological outliers that could bias the score of an entire federal district or circuit court if factored into a mean.

Also, as with most other scholarship at this stage that uses measures of the ideology of federal judges employing DW-Nominate scores in its analysis, the dissertation assumes that judges maintain essentially the same ideological positions throughout their tenures on the bench.

**Determination of Ideology of Individual Judges Comprising the Courts**

The analysis follows Giles, Hettinger, and Peppers (2001) in calculating the judicial ideology of individual federal judges. This method has been used in a variety

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169 I have on file for reference the written guidelines I developed for calculating and coding judicial ideology.
of contexts (Epstein, Martin, Segal, and Westerland 2007; and Johnson and Songer 2002).

The formula is expressed as follows: if, on the date of nomination of the judge, neither of the U.S. Senators from the judge’s home state were from the same political party as the President, the analysis uses the President’s DW-Nominate score as an estimate of that judge’s ideology. Next, if one of the home-state Senators was from the President’s political party, the ideology of the judge is estimated as the DW-Nominate score of that Senator. Finally, if both of the home-state Senators were from the President’s party on the date of nomination, the ideological score of the judge is set equal to the mean of the DW-Nominate scores of the two Senators. In Figure 4.2 I summarize the options comprising the formula.

**Figure 4.2 Summary of Formula to Estimate Ideology of Individual Federal Judges**

<table>
<thead>
<tr>
<th>Number of Home-State Senators from President’s Political Party on Date Judge was Nominated</th>
<th>Source of DW-Nominate Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>President</td>
</tr>
<tr>
<td>1</td>
<td>Senator</td>
</tr>
<tr>
<td>2</td>
<td>Mean of Two Senators</td>
</tr>
</tbody>
</table>

Earlier literature had theorized that Senators directly and actively implemented senatorial courtesy for district court nominations because each federal district includes only one state and the identification of ‘home-state’ Senators, according to that reasoning, is more natural because a judicial nominee resides within the single state where the district is located (Chase 1972; and Goldman 1967). The fact that the jurisdiction of a district court always falls within a single state is in contrast to the jurisdiction of each
circuit court, which always spans multiple states.\textsuperscript{170} As a result, Senators from various states could, in theory, become involved in the process for the nomination of a judge to a circuit court.

More recently, however, the literature has recognized that Senators exercise courtesy as actively with circuit court as with district court nominations and that the preferences of the home-state Senators of a circuit court judge are actually a better predictor of the voting behavior of the judge than is the ideological score of the appointing president (Giles 2008; and Giles, Hettinger, and Peppers 2001). Home-state Senators are typically recognized under this exercise of courtesy based on the home state of the nominee (and, often, circuit court vacancies are considered among Senators as ‘belonging to’ a particular state at a certain time) (Jacobi 2005). Therefore, this analysis will use the ideological scores of the home-state Senators of circuit court judges on the date of nomination of each judge using the same method it applies to district court judges.

While the issue is beyond the purview of this dissertation, it is worth noting that the idea that senatorial courtesy is exercised only by Senators from the President’s party, though generally accepted in the literature at this time, may prove to be too narrow to consistently reflect reality. Although its implementation has varied across Presidential administrations and Senates, as mentioned above, senatorial courtesy has been implemented by Senators who are not of the President’s party when those Senators are in the majority in the chamber (Palmer 2005; and Scherer 2005). Also, under the ‘traditional’ concept of senatorial courtesy, it would be conceivable that the chair of the Senate Judiciary Committee from the majority party during a period of divided government would enforce courtesy for a Senator from the minority party, if that Senator

\textsuperscript{170} 28 U.S.C. §134.
belonged to the same party as the President, but not for a Senator from the chair’s own political party because that Senator would not belong to the President’s party. Such a scenario does not appear to be plausible in reality and, as a result, future research should attempt to operationalize the concept of senatorial courtesy with more precision by taking into account specific historical variations of the norm.

**Calculation of Ideological Scores for Individual Judges Incorporates Concept of Senatorial Courtesy**

As mentioned in the previous subsection, the calculation of the ideological score for each individual district and circuit court judge incorporates the concept of senatorial courtesy. The norm of senatorial courtesy has been an inescapable part of the nomination process for federal judges since the beginning of the republic (Bell 2002). It is “(t)he custom which requires the President to consult with Senators from the state in which a vacancy occurs, and to Nominate a person acceptable to them; if he fails to do so, the Senate as a courtesy to these Senators will reject any other nominee regardless of his (or her) qualification” (Harris 1953). Binder and Maltzman (2004) provide a definition of the “traditional” form of senatorial courtesy:

For a good part of our history, ‘senatorial courtesy’ could be defined accurately as a custom by which Senators would support one of their number who objected to an appointment to a federal office in his state, provided the Senator and the (P)resident were of the same party…. In our day, senatorial courtesy has come to mean that Senators will give serious consideration and be favorably disposed to support an individual Senator of the (P)resident’s party who opposes a nominee to an office in his state (emphasis added) (citing Chase 1972).
The implementation of senatorial courtesy has varied across Presidential administrations and Senates (Hendershot 2010; Palmer 2005; and Scherer 2005). There are, however, common threads to the custom that political science literature has coalesced around in the last decade.

First, senatorial courtesy is a structural incentive that compels Presidents and Senators to consult about judicial nominees in advance of their selection and prompts Presidents to rationally anticipate the interests of the key Senators in the process (Binder and Maltzman 2004; Jacobi 2005). Rowland and Carp (1996) argue that Senators perceive the process as interactive, whereby Presidents and Senators anticipate each others’ preferences and incorporate them into their own selection strategy. This process allows the preferences of Senators to constrain the choice of nominee by the President.

The potential weakness of a proxy for judicial ideology that lacks measures to account for senatorial courtesy thus becomes evident. Where senatorial courtesy is present, the judicial nominee does not reflect merely the preferences of the appointing President, but also the preferences of at least one and perhaps two home-state Senators. Incorporating senatorial courtesy into the analysis therefore increases the efficiency of the ideological measure because it adds information to the calculation that enhances the explanatory power of the independent variable (Epstein and King 2002). Also, the additional data input increases the variance and allows for more nuanced measures of ideology to be included in the model (Ruger 2007).

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171 Former Federal Circuit Judge Charles Pickering (selected through a recess appointment, but never confirmed by the Senate) stated that since 1960, every chair of the Senate Judiciary Committee has interpreted senatorial courtesy somewhat differently. News Hour with Jim Lehrer, Transcript, May 11, 2005.
Second, political science literature recognizes the main implementation of senatorial courtesy as the ‘traditional’ form, primarily between the appointing President and the Senators from the nominee’s home state who are of the same political party as the President (e.g. Basinger and Mak 2010; and Johnson and Songer 2002). Therefore, the dissertation follows Giles, Hettinger and Peppers (2001), who incorporate the traditional form in their method for determining the judicial ideology of individual federal judges.

These independent variables test the primary hypothesis (H1) I present above in Chapter 3. As the median ideological score of a district or circuit court becomes more positive, the ideology of the court becomes more conservative. According to my theory, the more conservative score should correlate positively with an increased likelihood of the SEC deciding to file an action with its ALJ corps.

Other Independent Variables

The independent variables I use in addition to the primary variables are designed to probe the robustness of the theory and ensure that the models are sufficiently specified. These independent variables enable me to test for alternatives to the political ideology of the lower federal courts as the primary factor(s) driving the decision making and behavior of the SEC. Some of these variables pertain to enforcement-case characteristics and to the state of the economy. I use additional independent variables to test for the influence of the ideology of the SEC’s political principals both in Congress and in the executive branch on the agency’s decision making and behavior.
Other Independent Variables, Part 1: Case Characteristics

These independent variables tease out whether, once the SEC has decided to file a civil enforcement case, there is an element inherent in the case that is not related to the political ideology of the lower federal courts or the agency’s political principals that influences the SEC to choose a particular forum. If the SEC acts as an independent agency through its enforcement function as the theory portrays, it does not make most of its strategic decisions about forum because of its own political preferences, the way the lower federal courts view the SEC does not shift based on changes to the ideology of the agency’s political principals that cause ideologically motivated shifts in SEC behavior, and the SEC’s main strategic enforcement goal is to generally maximize its civil prosecution success. The agency will, therefore, rationally consider other factors, like the real costs and benefits of filing an action in a particular forum.

Number of Statutory Charges Brought in Civil Enforcement Action

This variable is the number of statutory charges brought by the SEC in a civil enforcement action. This is a proxy for the legal and investigatory complexity and relative cost of an enforcement action. Scholars have used the number of legal provisions and dimensions in a case as a proxy for case complexity in other contexts (Atlas 2007; Hoekstra and Johnson 2003; and Johnson, Wahlbeck, and Spriggs 2006).

This independent variable may reveal whether the SEC prefers to bring cases that emerge from more complicated frauds involving larger numbers of legal theories and statutory provisions, requiring the development of larger amounts of evidence, in federal district court to take advantage of what it perceives as the enhanced efficiency of court
proceedings. The SEC uses substantial resources to develop its civil enforcement cases, especially when a case involves multiple violations, so efficiency is a material consideration for the agency. In addition, the SEC may perceive that some district courts have superior experience and can apply more expertise to particularly complicated matters, especially where the agency is looking to establish new common law precedent. This district-court preference, however, would not necessarily pertain to all districts relative to the SEC’s ALJ corps. The independent variable will reveal if this practical consideration comprises part of the agency’s enforcement strategy, and how widespread it may be across districts.\footnote{Cf. A justification for delegating administrative powers to agencies is that they can wield expertise to solve technical disputes more efficiently than Article III courts. This “expertise hypothesis” has not been sufficiently examined empirically, however, and remains a potentially rich research issue. A recent study concluded that the FTC as an expert agency did not perform as well as Article III federal district court judges in decision making in antitrust cases. The study also found that the FTC commissioners did not add significant additional value to the ALJ decisions it reviewed (Joshua D. Wright and Angela M. Diveley. December 19, 2012. “Do expert agencies outperform generalist judges? Some preliminary evidence from the Federal Trade Commission.” \textit{Journal of Antitrust Enforcement}, 1-22).}

**Number of Defendants in Public Civil Enforcement Action**

This control variable is the number of defendants charged by the SEC in a public civil enforcement action, and represents a second proxy for the legal complexity and cost of an enforcement action. It measures these effects from the perspective of the procedural difficulty for the SEC of bringing a case against multiple individuals residing in various locations (or corporate entities with various places of business) rather than from the substantive legal complexities of a case.

The independent variable tests whether the SEC prefers to bring cases that originate in complicated frauds involving larger numbers of persons and/or business entities, requiring more resources to prosecute, in federal district court.
This variable together with the number-of-statutory-charges independent variable test the “case complexity” hypothesis (H2).

**Type of Defendant in Civil Enforcement Action – Individual or Corporate**

The effects of the type of defendant in a civil enforcement action are operationalized with a set of two dummy variables indicating the type of defendant in each case. The reference category for the defendant dummy variables is a corporate defendant. The two dummy variables indicate, first, whether there are only individual defendants in a case (0 = not individuals only, 1 = individuals only) and, second, whether there are both individual and corporate entities together as defendants in a case (0 = not together, 1 = both individual(s) and corporate entity(ies) together).

Many cases the SEC brings against corporate entities pertain to issues regarding the defendants’ public filings and disclosures with the agency. The SEC often handles these matters administratively to minimize cost and maximize convenience, especially since the agency’s headquarters in Washington, DC manages corporate filings. This case-characteristic variable controls for whether the actual nature of the defendant affects the agency’s forum choice.

This variable tests the “corporate defendant” hypothesis (H3).

**Nature of Harm Alleged in Civil Enforcement Action**

This is a dummy variable that focuses on the nature of the harm allegedly committed by the defendant(s) in a public civil enforcement case. The variable is 0 when the nature of the harm is directed primarily at an individual, and is 1 when aimed
primarily at a significant corporate entity or more generally against the financial and securities markets (e.g. defrauding the markets by trying to defeat a process rather than targeting an individual victim).

The independent variable is designed to identify whether there is something about the nature of the alleged victims of financial harm in a civil enforcement case that may signal to the SEC that the case would be more appropriate in a liberal or a conservative judicial setting. For instance, does the agency believe that the direct impact of a Ponzi scheme on a group of individuals would draw closer scrutiny from a liberal court that emphasizes the key role of the government in preventing fraud on vulnerable investors in securities markets? In contrast, does it believe a conservative court would be more attuned to the harm to the markets caused by a more esoteric form of financial fraud?173

I test this independent variable in two ways: first, as part of model 1, which contains no interaction terms; and second, as comprising part of an interaction term together with the political ideology of the district (model 2, where it is statistically significant) and circuit courts (where it was not statistically significant), respectively, to determine whether the nature of the alleged harm affects the way the SEC perceives the impact of the ideology of those courts.

This variable tests the “harm” hypothesis (H4).

173 The SEC states publicly that while high-profile cases “generate significant returns of enforcement dollars” and help deter future violations, it continues to also focus on those civil frauds traditionally aimed at individual investors, like pump-and-dump or boiler room operations, Ponzi schemes, and affinity frauds (see notes 46 and 47, supra). Kathleen L. Casey, SEC Commissioner. September 5, 2007. “Keynote Address at the Southwest Regional Enforcement Conference,” p. 2. Fort Worth, Texas. Linda Chatman Thomsen, Director, SEC Division of Enforcement. November 6, 2008. “True to Our Mission: Why We Need the SEC.” Speech at Fordham University Law School, New York, New York.
Unique Geography – SDNY

There is one federal district court that has a relationship with the SEC that is unique enough to warrant a control variable. Perhaps there is something inherent simply in the geographical origins of certain cases that affects the SEC’s choice of forum.

Figure 4.3 illustrates that the SDNY is the agency’s most heavily utilized district. This is likely because Manhattan and the surrounding area originally spawned much of the private sector that comprises the U.S. financial markets now regulated by the SEC. The SEC brought about 18% of all of the district court cases in the primary data set in the SDNY. Of these, about 28% emerged from the SDNY through direct jurisdiction.

The percentage of administrative cases in the data set that I ascribe to the SDNY based on direct jurisdiction is 12%.

It is evident that the SDNY plays an unusual role in the enforcement strategy of the SEC. The agency views the large SDNY as having a set of judges who are intellectually strong and well-versed in handling financial – as well as generally complex – litigation. In addition, the SEC field office in the SDNY is the agency’s largest, comprised to deal with myriad financial market issues that arise from the district through Wall Street and the many banks and other financial institutions that are based in Manhattan. Moreover, the SEC will occasionally use the SDNY as well for the statement cases it utilizes for deterrence, and to forge new common law, as I discuss in Chapter 2.
Figure 4.3 Public Civil Enforcement Actions by Federal District Courts Most Utilized by SEC, CY 1992 through CY 2007

X axis = Federal District Court Jurisdiction

Y axis = Percentage of Cases in Data Set Originating from Jurisdiction

Source: Original Primary Data Set

Therefore, I test whether the SDNY can be classified under the primary theory as similarly situated to the other federal district courts, or whether there is something about the nature of this court that influences the SEC’s decision making. This dummy variable has a value of 1 if SDNY and 0 if another district court. The theory logically produces a prediction that the coefficient will be negative, reflecting its reasoning that the SEC is more likely to file a case emerging from the jurisdiction of the SDNY (relative to other federal districts) in federal court rather than utilize its ALJ corps.

This independent variable tests the “favorite court” hypothesis (H5).
Other Independent Variables, Part 2: State of the Economy

I utilize two independent variables as separate proxies to incorporate the state of the U.S. economy into the models as a control, but do not test a separate hypothesis regarding the economy because my theory does not naturally include a component involving how the state of the economy would affect the decision making of the SEC specifically regarding enforcement actions. Nevertheless, changes to the economy may affect the agency’s behavior indirectly as it pertains to enforcement, so it is worthwhile to include it solely as a control in the models.

This independent variable is motivated by literature debating whether the state of the economy affects the rigor with which agencies like the SEC pursue their enforcement agenda. If the agency is completely independent from political influence, the state of the economy may not affect the aggressiveness of its enforcement agenda, but may impact the types of cases it encounters.

If political influence does affect the SEC, however, the performance of the economy may influence how the agency conducts the strategic decision making surrounding its enforcement program. One side of the political-effect debate argues that bureaucracies like the SEC are more likely to rigorously enforce their respective mandates when the economy is performing well, and less eager to regulate during a weak economy in order to limit the possibility of worsening the contraction of the economy (Krause 1996).\textsuperscript{174} A factor that would compound this effect, according to the argument, is that firms are traditionally more likely to comply with regulations in a strong economy and, as the economy worsens, commit fewer scarce resources to compliance because they

\textsuperscript{174} Atlas (2007) tested this theory in the context of penalty levels for EPA enforcement cases and found the independent variable was not statistically significant in his regression model.
receive fewer market rewards from their investments in regulatory compliance (Olson 1999).

The agency may come under pressure from its political principals who also adhere to this economic attitude to lighten up its regulatory program to prevent the diversion of resources needed for investment and hiring to legal and compliance concerns. These political principals would influence the SEC to eschew a certain level of regulatory control to enable the establishment of new businesses and the growth of existing entities to encourage job creation and drive up share prices. Thus, under this theory, as the economy weakens the SEC would be less confident politically, and less likely bureaucratically, to prosecute actions in district court and would opt to keep those cases it decides to pursue in lower risk-reward administrative proceedings.

The other side of the political-effect debate is convinced, however, that causality flows in the opposite direction, particularly when the SEC is involved. Under this view, a sagging economy spurs agencies to become more active in enforcement and other high-profile areas to achieve symbolic goals – to overtly oppose undesirable economic and policy activity. The agencies demonstrate responsiveness to the concerns of the public – and the pressure of their anxious political principals – to show that the bureaucracy is actually capable of making a positive difference in the macro economy (Li 2006). Sagging job numbers can be a motivator for the political principals of the SEC.

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“(T)he SEC was born out of just such a rush to regulation following the 1929 market crash.”^{176}

**Dow Jones Industrial Average (DJIA)**

The main economic variable is the level of the DJIA on the date that the SEC filed an enforcement action. Though published initially in May 1896, the DJIA still provides a quick, simple view of the stock market and remains a touchstone for many investors, and others, trying to get a snapshot of the current general perception of the economy. The DJIA allows these persons to readily compare individual stocks to a measure of the overall performance of the stock market and to compare the market with other economic indicators. About two-thirds of the DJIA still comprises publicly traded manufacturers of industrial and consumer goods, but the average has evolved to include companies in entertainment, financial services and information technology.^{177}

Setting aside debate about the effectiveness of the DJIA as an indicator of the actual health of U.S. stock markets, I use this measure to incorporate the psychological effect it may have on SEC bureaucrats, political principals, litigants and federal judges into the model. And as I explained in Chapter 2, the mission of the SEC throughout its history has been to protect investors, maintain fair and efficient markets, and facilitate capital formation. So the DJIA has been viewed traditionally as inextricably bound with U.S. equities markets and materially affects public perceptions of their health, whether or not those perceptions are accurate.


^{177} See [www.djaverages.com](http://www.djaverages.com).
The second economic variable is the unemployment rate. The unemployment rate is a monthly, rather than daily, measure of the health of the economy that incorporates a different perspective into the model. Though it focuses on jobs instead of the value of equities, it may also have a significant impact on the players in an SEC civil enforcement action because it is a common indicator of how the macro economy is performing – and plays a substantial role in influencing the federal electorate in its attitude towards incumbent elected officials. Therefore, it may also influence the agency’s political principals.

Both of these control variables on the surface test whether the SEC is less likely to file an enforcement action in federal district court – where it may seek a more onerous penalty against a defendant, but the outcome is less predictable for the agency – than in an administrative proceeding where the risk to both parties is lower, when the economy is performing poorly. These variables may indicate, on another level, whether the political principals of the SEC pressure the agency to behave differently within its enforcement program depending on the state of the economy.

I initially tested each of these variables separately with the other independent variables that comprise model 1, prior to utilizing them together, to determine if the use of both over-specified the measure of the economy. It did not. Neither variable was significant when used alone or when used together. These measures of the economy each

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176 The seasonally adjusted monthly unemployment for persons 16 years and older is found at the web site for the Bureau of Labor Statistics in the U.S. Department of Labor, [www.bls.gov](http://www.bls.gov). This unemployment rate is derived from a monthly survey of households (the Current Population Survey) conducted by the Bureau of the Census located within the Bureau of Labor Statistics.

177 Though this control variable has proved statistically significant in previous studies of regulatory behavior – e.g. antitrust enforcement and IRS audits – predictions are typically tempered with caution (see Scholz and Wood 1998; Wood and Anderson 1993).
represent distinct elements of the economy – and the national political psyche
surrounding economic performance. In addition, they contribute some explanatory value
to the models and, therefore, are included together.  

**Other Independent Variables, Part III: Political Principals**

Each of the independent variables pertaining to political principals is designed to
test the robustness of the political-independence component of my theory. That is, a
change in ideology to one or more of the key political principals of the SEC should not
affect how the agency views the lower federal courts. And the agency’s preferences
toward the courts regarding its civil enforcement program should remain consistent. This
reflects the independent agency illustrated in Figure 3.3a.

In contrast, if these independent variables detect political influence on the agency,
the predicted effects would be similar to those presented in Figures 3.4a and 3.4b,
respectively, depending on the direction of the ideology of the political principal
exercising the influence. While the primary theory predicts no effect, the alternative
leaves open the possibility. It does not predict that these independent variables, by
themselves, will significantly affect the dependent variable. For instance, should the
President grow more conservative, the ideological change itself will not be a cause of the
agency selecting one forum over another in a civil enforcement action. As the notes

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180 I also tested a second economic control variable, the change in U.S. Gross Domestic Product (GDP) from the previous quarter, as a robustness check in place of the unemployment rate. This control variable is a common and respected proxy for the economic vitality of the U.S. economy. I calculated the real percentage change in GDP from the preceding quarter based on real, not 2005 chained, dollars. I used real dollars because I believe this value best represents the impact of this variable on persons at the respective times the change actually occurred, rather than pegging it to a value from a somewhat arbitrary year. The data is available from the Bureau of Economic Analysis of the U.S. Department of Commerce at [www.bea.doc.gov](http://www.bea.doc.gov). This variable was not statistically significant and did not significantly change the outcome of the logit analysis when used in this capacity. Therefore, I do not report it in Table 4.3.
following Figures 3.4a and 3.4b explain, what such a change may affect, however, under this alternative is the preferences of the SEC. The preference shift, in turn, would alter how the agency responds to the ideology of the lower federal courts when making strategic decisions.

Therefore, I interact the political principal variables described below with the primary independent variables that measure the ideology of the lower federal courts. In this way, the statistical analysis detects whether politics influences the way the primary variables – judicial ideology – affect the dependent variable. The coefficients, standard errors and marginal effects of the interaction terms that are statistically significant (and have the highest level of significance in those cases where more than one independent variable from a category is significant) are included in models 2-6 (all derived from model 1) in Table 4.3.

**DW-Nominate Scores**

In order to obtain the original continuous ideological scores, I used Poole and Rosenthal (2007 and 1997) DW-Nominate scores\(^1\) as proxies for the policy preferences of the President and members of Congress in each of the independent variables that incorporates a measure of the political ideology of either of these political principals. The DW-Nominate scores are estimates of the ideal points of the President and members of Congress derived from a spatial model of voting\(^2\). These scores range from +1, for the most conservative ideological score, to -1, for the most liberal score, per President or

\(^{1}\) The measure of the first-dimension coordinate.

\(^{2}\) DW-Nominate scores and accompanying detailed explanations of their calculations are found at [http://voteview.com/dwnomin.htm](http://voteview.com/dwnomin.htm).
member of Congress. Also, for lower federal court judges I use DW-Nominate scores as proxies for the policy preferences of the nominating President and the home-state U.S. Senators, as appropriate, in the estimation of the ideological preferences of the federal court judges comprising the primary independent variables (precise formula described below).

**Executive Branch**

In this chapter I test a component of the primary hypothesis – that the SEC is an independent agency, particularly with regards to its public civil enforcement function – and its decision making is, therefore, not influenced significantly by its political principals. I analyze whether ideologically derived policy preferences of either of the political principals of the agency situated in the executive branch, the politically appointed Commissioners of the SEC or the President, significantly affects the decision making of the agency regarding civil enforcement actions.

**Ideology of SEC**

As I discuss in Chapter 2 in the subsection “Structural/Legal Independence, Institutional Design,” it is possible that the President projects policy preferences through new political nominees to the SEC even though the structure of the independent commission is designed to insulate the agency from politics.

I use this independent variable to test whether a change in the ideology of the five-member Commission affects the decision making of the SEC regarding the dependent variable. It incorporates into the model an estimate of the political ideology of
the SEC Commissioners as a unit, represented by the political ideology of the Commission on the date a civil action was filed. In general, there is a dearth of literature on determining the ideology of an independent agency like the SEC (Nixon 2004). Here, however, I follow Hume (2009) and remain consistent with the ideological measurement method I use for the President, Congress and federal lower court judges. Table 4.1 provides a list of SEC Commissioners who served during the period of the primary data set, including their respective terms in office, political parties, and the measure of ideology for each Commissioner.

183 See Bailey and Chang (2001) (emphasizing the importance of using measures of ideology that are comparable across independent variables. Here, the ideological measures of the federal judiciary, Congress and SEC Commissioners are all based on first dimension DW-Nominate scores to avoid conflating apples and oranges).
Table 4.1 Terms, Political Party and Ideology of SEC Commissioners, CY 1992 - 2007

<table>
<thead>
<tr>
<th>Commissioner</th>
<th>Party</th>
<th>PresDWNom</th>
<th>Ideology</th>
<th>PeriodOfTerm(s)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Edward H. Fleischman</td>
<td>R</td>
<td>0.49</td>
<td>0.745</td>
<td>1/3/92 - 3/31/92</td>
</tr>
<tr>
<td>Mary L. Schapiro</td>
<td>I</td>
<td>0.49</td>
<td>0.245</td>
<td>1/3/92 - 10/13/94</td>
</tr>
<tr>
<td>Richard C. Breeden</td>
<td>R</td>
<td>0.452</td>
<td>0.726</td>
<td>1/3/92 - 5/7/93</td>
</tr>
<tr>
<td>Richard Y. Roberts</td>
<td>D</td>
<td>0.452</td>
<td>-0.274</td>
<td>1/3/92 - 7/15/95</td>
</tr>
<tr>
<td>J. Carter Beese, Jr.</td>
<td>R</td>
<td>0.452</td>
<td>0.726</td>
<td>3/10/92 - 11/14/94</td>
</tr>
<tr>
<td>Arthur Levitt</td>
<td>D</td>
<td>-0.44</td>
<td>-0.72</td>
<td>7/27/93 - 2/9/01</td>
</tr>
<tr>
<td>Steven Wallman</td>
<td>D</td>
<td>-0.44</td>
<td>-0.72</td>
<td>7/5/94 - 10/2/97</td>
</tr>
<tr>
<td>Norman S. Johnson</td>
<td>R</td>
<td>-0.44</td>
<td>0.28</td>
<td>2/13/96 - 5/10/00</td>
</tr>
<tr>
<td>Isaac C. Hunt, Jr.</td>
<td>D</td>
<td>-0.44</td>
<td>-0.72</td>
<td>2/29/96 - 12/20/01</td>
</tr>
<tr>
<td>Paul R. Carey</td>
<td>D</td>
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<td>-0.72</td>
<td>11/3/97 - 6/14/01</td>
</tr>
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<td>Laura S. Unger</td>
<td>R</td>
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<td>0.28</td>
<td>11/5/97 - 1/25/02</td>
</tr>
<tr>
<td>Harvey L. Pitt</td>
<td>R</td>
<td>0.594</td>
<td>0.797</td>
<td>8/3/01 - 2/17/03</td>
</tr>
<tr>
<td>Isaac C. Hunt, Jr.</td>
<td>D</td>
<td>0.594</td>
<td>-0.203</td>
<td>1/23/02 - 8/2/02</td>
</tr>
<tr>
<td>Cynthia A. Glassman</td>
<td>R</td>
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<td>0.797</td>
<td>1/28/02 - 7/14/06</td>
</tr>
<tr>
<td>Harvey J. Goldschmid</td>
<td>D</td>
<td>0.594</td>
<td>-0.203</td>
<td>7/31/02 - 7/31/05</td>
</tr>
<tr>
<td>Paul S. Atkins</td>
<td>R</td>
<td>0.594</td>
<td>0.797</td>
<td>8/8/02 - 8/1/08</td>
</tr>
<tr>
<td>Roel C. Campos</td>
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<td>-0.203</td>
<td>8/22/02 - 9/18/07</td>
</tr>
<tr>
<td>William H. Donaldson</td>
<td>R</td>
<td>0.594</td>
<td>0.797</td>
<td>2/18/03 - 6/30/05</td>
</tr>
<tr>
<td>Christopher Cox</td>
<td>R</td>
<td>0.594</td>
<td>0.797</td>
<td>8/3/05 - 11/20/09</td>
</tr>
<tr>
<td>Annette L. Nazareth</td>
<td>D</td>
<td>0.594</td>
<td>-0.203</td>
<td>8/4/05 - 1/31/08</td>
</tr>
<tr>
<td>Kathleen L. Casey</td>
<td>R</td>
<td>0.594</td>
<td>0.797</td>
<td>7/17/06 – Present</td>
</tr>
</tbody>
</table>

Source: [http://www.sec.gov/about/sechistoricalsummary.htm](http://www.sec.gov/about/sechistoricalsummary.htm) *Covered by primary data set.
To derive this continuous independent variable, I first calculated the ideological score for each Commissioner on the date a case was filed by averaging: (i) the DW-Nominate score of the President who appointed that Commissioner with (ii) a separate score for the political party of the Commissioner. I operationalized ‘political party’ on the following scale: -1 assigned to a Democratic Commissioner, +1 for a Republican, and 0 for an Independent. After calculating this score for each Commissioner, I use the median score on the Commission to estimate the ideology of the SEC Commissioners as a unit on the date a case was filed. This median score is particularly significant to the SEC, as it represents the tie-breaking vote in a 3-2 split (which has traditionally been common) among Commissioners.

As with the other independent variables pertaining to the agency’s political principals, I interact this independent variable with the ideology of the lower federal courts (primary independent variables). This helps to determine specifically whether the ideology of the Commission affects the preferences of the SEC towards the courts and, thus, whether this variable affects the influence of the primary independent variables on the dependent variable. That is, I test whether a change in the politics of a principal of the agency significantly alters how the SEC perceives its likelihood of favorable outcomes in civil enforcement cases. The change in the SEC’s perception may be the result of the agency changing its enforcement strategy to better reflect the different ideology of its principal and/or the agency believing it is now viewed more favorably by those judges who have an ideology similar to that of the new political principal. I illustrate the dynamics of such (analogous) effects in Figures 3.4a and 3.4b.
This independent variable tests the “Commissioners’ political influence” hypothesis (H6).

**Ideology of President**

As a robustness check, I also used an independent variable to examine the effects of the ideology of the President directly on the agency through interaction terms involving the primary independent variables. To calculate the ideology of the President, I utilized an estimate of political ideology – the DW-Nominate score of the President on the date a civil enforcement action was filed. This independent variable measures whether the ideology of the apex political principal of the agency – the President – directly affects SEC decision making. The rationale is similar to that supporting the use of the Commissioners’ variable, but the President – and his or her presumed influence on the agency – is one step further removed in the context of the ‘independent agency’ structure. This independent variable was not statistically significant in the multivariate logit analyses I performed.

I do not include these results in the logit-related data in Table 4.3 because the interaction term, SEC ideology*Judicial Ideology, contributed more explanatory power to the model overall and was sufficient to represent the potential political influence (or lack thereof) originating in the executive branch. Therefore, I also do not include in the dissertation a test of a hypothesis relating specifically to presidential influence over the SEC.
In the Introduction in Chapter 1, I explain that at least as early as the emergence of the congressional dominance line of bureaucracy literature three decades ago, scholars have tried to demonstrate that Congress influences agency behavior and decision making. Thus, I naturally test whether Congress influences the decision making of the SEC-as-independent-regulatory-agency with regards to its public civil enforcement function.

As I describe in Chapter 2, the agency publicly takes pride in promoting what it sees as its traditionally independent enforcement process. According to this narrative, enforcement policy trends percolate up from career civil prosecutors who base their decision making on practical considerations of pursuing the Division of Enforcement’s mandate with minimal political interference. The robustness of the SEC’s independence is unclear, however, when it comes to the agency’s relationship with Congress because of that branch’s direct oversight responsibilities and control over the agency’s budget. Thus, the SEC may not be as efficient at resisting political interference from Congress as it may be from the President.

I calculated the ideology of Congress from different perspectives (see discussion below) and created distinct independent variables for the House and Senate respectively. I tested each of the separate independent variables in the models. These variables, like those for the political principals in the executive branch, are continuous and were incorporated into interaction terms with the primary independent variables. The variables were not statistically significant when interacted with circuit court ideology, but

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184 I have on file for reference the written guidelines I developed for calculating and coding congressional ideology.
some of them (from both the Senate and the House set of independent variables) were significant when interacted with district court ideology.

**Oversight Subcommittees**

The first set of variables represents the ideology of the subcommittee with primary oversight responsibility for the SEC in the Senate and the House, respectively. It is a continuous independent variable that I calculated as follows.

The ideological measure comprising the independent variable is a median score,\(^{185}\) using the first dimension DW-Nominate scores for each voting member of the respective subcommittees.\(^{186}\) In determining the median score, the ideological score for the subcommittee chair is weighted three times\(^{187}\) more heavily than each individual subcommittee member to emphasize the critical role the chair plays in setting the agenda for the subcommittee and corralling the votes necessary to pass legislation to the full floor.

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\(^{185}\) The median is one standard measure of the ideology of Congress and is also consistent with the use of the median in determining the ideology of the judiciary in this dissertation (Krause 1996; Shipan 2004).

\(^{186}\) See Table 4.A3 in the Appendix for a listing of U.S. House and Senate committees and their subcommittees with primary oversight and budget jurisdiction for the SEC during the period covered by the data set. The sources of identifying and confirming jurisdiction include: the Congressional Directory (provides comprehensive lists of members comprising each committee and subcommittee plus relevant voting rules); subcommittee hearings; the Congressional Record; Rule XXV of the Standing Rules of the U.S. Senate (see [www.senate.gov](http://www.senate.gov)); House Rule X (see [www.house.gov](http://www.house.gov)) as included in the 106th Congress House Rules Manual, House Document No. 106-320; and the Rules of the various committees and subcommittees that describe their respective jurisdictions and voting procedures (see, e.g., [www.energycommerce.house.gov](http://www.energycommerce.house.gov)).

\(^{187}\) This follows Moe (1985, n.13) (weighting of committee chair’s ideological score three times more than other committee members to factor in importance of chair’s role).
**Appropriations Subcommittees**

The second set of independent variables represents the ideology of the subcommittee with budget responsibility for the SEC in the Senate and the House, respectively.

The independent variable tests whether an SEC budget subcommittee affects the behavior of the agency. It utilizes measures of ideology for the subcommittees calculated through the identical means applied to the oversight subcommittees – median measures of the DW-Nominate scores of the voting members comprising the subcommittees while weighting the ideology of the chair three times.

My use of this independent variable acknowledges that Congress may attempt to control the SEC, though it is an independent regulatory agency, through either the exercise of direct oversight or the use of its leverage in the budget negotiation process. Scholars have argued that the majority party in Congress tries to ensure that the composition of budget committees reflects the geography and ideology of its own party members as a means of controlling agencies (Kiewiet and McCubbins 1991). Others have also recognized the importance of including appropriations subcommittees in their models (Canes-Wrone 2006; and Scholz and Wood 1998).

The dissertation focuses first on subcommittees because they have the most direct interaction with and authority over the SEC and therefore would, I argue, have the most influence on the decision making of the agency. If a change in the ideology of the members of Congress were to have an effect on agency behavior, this would be the most direct means available (Krause 1996; and Ringquist 1995).
I also tested, however, the ideologies of the respective congressional oversight committees of the House and Senate, as listed in Table 4.A3 in the Appendix, as a robustness check for the models. First, I used the identical means for calculating the ideology of the committees as I did to calculate subcommittee ideology, and found no significant difference in outcome. Next, I re-calculated the median ideology of the oversight committees without weighting the ideological score of the committee chairpersons three times, and then tested those variables in the models. In each respective robustness check, there was no significant difference in outcome. Therefore, I do not report the logit analysis for these variables in Table 4.3.

**Floors of Congress**

This final set of congressional control independent variables comprises the median ideology of the respective floors of Congress. These continuous ideological measures are derived from the DW-Nominate scores of the individual members of Congress on the date a civil action was filed.

Although much political science literature focuses on the potential for subcommittee and committee influence on agencies (Weingast 1984; and Wood and Waterman 1991), some scholars indicate that the behavior of bureaucrats may be influenced by their ultimate concerns over the floor (Shipan 2004). On a practical level, the floor represents a distinct challenge for an agency. At times, the floor may take a cue from a subcommittee vote, particularly when dealing with more technical agency decision making, as is occasionally required of the SEC (Khademian 2002). In such cases, the floor may not have an impact as most of the debate and the development of a
solution are delegated to the subcommittee. There are times, however, when the floor opens a policy issue up to debate and partisan conflicts may be intensified (in contrast to the relative intimacy and homogeneity – and repeat game playing – of a subcommittee that is insulated from the floor through its relationships with interest groups and the agency itself).

The combinations of congressional independent variables that I use do not create significant multicollinearity in the models, even though when Congress changes ideologically, so do its components (Canes-Wrone 2006; and Shipan and Shannon 2003). In addition, I do not lag these independent variables because it is “generally accepted” that congressional oversight variables do not typically have a lagged effect on agency behavior (Krause 1996, n. 22).

These independent variables are designed to indicate whether an ideological shift in subcommittee (or committee) composition – or the floor – has a significant impact on the agency’s behavior, thereby determining whether politics enters the public civil enforcement decision making process through congressional influence. These variables, when interacted with the primary independent variables representing the ideology of the lower federal courts, will help determine how relevant congressional dominance is to the enforcement function of the SEC and, importantly, whether the agency may alter its view of liberal and conservative judges depending on the prevailing ideology and enforcement priorities of its oversight and appropriations subcommittees or the floor.

The independent variables test the “Congress” hypothesis (H7).


**Shock**

The rationale supporting the use of this independent variable is provided in Chapter 3. The variable is designed to indicate the presence of an exogenous shock to that element of the financial sector that is regulated by the SEC and indicate whether it had a significant effect on the decision making of the SEC, as illustrated in Figure 3.3b and the accompanying notes. I use this modified dummy variable in model 3 as part of an interaction term with district court and circuit court ideology, respectively. I also tested this concept with a dichotomous dummy variable (i.e. values of 0 and 1) as a robustness check.

The duration of any effect of this exogenous shock would likely be finite, and its magnitude would phase down over time. That is, the impact of the shock would grow less severe over time, but would not suddenly cease to exist. The operationalization of the variable accounts for this, thereby modifying the dichotomous aspect of the variable: the shock variable is valued 0 (0 = pre-2002) for all years in the data set before 2002 (prior to the Enron scandal emerging and having a lag time to potentially affect the attitudes of political principals; 1 = 2002 (the scandal took hold and led, ultimately, to the passage of Sarbox in an (ostensibly) outraged Congress); 1 = 2003 (the first year of the next congressional cycle in the House; this assumes that much of the House (and any Senators up for re-election that year) ran on the Enron issue and kept the hyperbole up in the media); 1 = 2004 (second year of that congressional cycle); .75 = 2005 (assumes the effect begins to fade after the following congressional election cycle and passage of time); .5 = 2006 (the fade continues as time passes); .25 = 2007 (the effect continues to
wear off but does not disappear completely as reference to Enron has become part of the political vernacular).

The effect of this independent variable may have been significant enough to render certain types of financial enforcement and regulatory power good politics for conservative actors previously opposed to heavy government regulation of the financial markets, thereby potentially changing the dynamics of the SEC decision making process regarding civil enforcement actions.

This independent variable thus tests the “shock” hypothesis (H8).

Models

The estimation equations of the models framing the analysis of the dependent variable, and the equations for the accompanying hypotheses, are presented below. The numerical order of the independent variables in the equations corresponds to the numbering of the variables in Table 4.3 below.\textsuperscript{188} An annotated description of the models also appears below.

\textsuperscript{188} The numbers for ordering appear in parentheses next to the variables listed in Table 4.3.
**Estimation Equations**

**Model 1 – No Interactions**

\[ \text{DV} = \Lambda (\eta_1) = \Lambda (\alpha + \beta_1 X_{i1} + \beta_2 X_{i2} + \beta_3 X_{i3} + \ldots + \beta_{10} X_{i10} + \varepsilon) \]

**Model 2 – Harm*District Court Ideology Interaction**

\[ \text{DV} = \Lambda (\eta_1) = \Lambda (\alpha + \beta_1 X_{i1} + \beta_2 X_{i2} + \beta_3 X_{i3} + \ldots + \beta_{10} X_{i10} + \beta_5 X_{i5} \cdot \beta_9 X_{i9} + \varepsilon) \]

**Model 3 – Shock*District Court Ideology Interaction**

\[ \text{DV} = \Lambda (\eta_1) = \Lambda (\alpha + \beta_1 X_{i1} + \beta_2 X_{i2} + \beta_3 X_{i3} + \ldots + \beta_{10} X_{i10} + \beta_{12} X_{i12} \cdot \beta_9 X_{i9} + \varepsilon) \]

**Model 4 – SEC Ideology*District Court Ideology Interaction**

\[ \text{DV} = \Lambda (\eta_1) = \Lambda (\alpha + \beta_1 X_{i1} + \beta_2 X_{i2} + \beta_3 X_{i3} + \ldots + \beta_{10} X_{i10} + \beta_{14} X_{i14} + \beta_{14} X_{i14} \cdot \beta_9 X_{i9} + \varepsilon) \]

**Model 5 – Senate Appropriations Subcommittee Ideology*District Court Ideology Interaction**

\[ \text{DV} = \Lambda (\eta_1) = \Lambda (\alpha + \beta_1 X_{i1} + \beta_2 X_{i2} + \beta_3 X_{i3} + \ldots + \beta_{10} X_{i10} + \beta_{16} X_{i16} + \beta_{16} X_{i16} \cdot \beta_9 X_{i9} + \varepsilon) \]

**Model 6 – House Oversight Subcommittee Ideology*District Court Ideology Interaction**

\[ \text{DV} = \Lambda (\eta_1) = \Lambda (\alpha + \beta_1 X_{i1} + \beta_2 X_{i2} + \beta_3 X_{i3} + \ldots + \beta_{10} X_{i10} + \beta_{18} X_{i18} + \beta_{18} X_{i18} \cdot \beta_9 X_{i9} + \varepsilon) \]

**Equations for Hypotheses**

\begin{align*}
\text{H1:} & \quad \beta_9 > 0 \text{ and } \beta_{10} > 0 \\
\text{H2:} & \quad \beta_1 < 0 \text{ and } \beta_2 < 0 \\
\text{H3:} & \quad \beta_3 < 0 \text{ and } \beta_4 < 0 \\
\text{H4:} & \quad \beta_5 < 0 \text{ and } \beta_5 \cdot \beta_9 < 0 \\
\text{H5:} & \quad \beta_6 < 0 \\
\text{H6:} & \quad \beta_{15} = 0 \\
\text{H7:} & \quad \beta_{17} = 0 \text{ and } \beta_{19} = 0 \\
\text{H8:} & \quad \beta_{13} < 0
\end{align*}
Annotated Model(s)

Model 1 - Primary Version

DV (Forum where SEC files civil enforcement action; 0 = federal district court, 1 = ALJ corps) =

Λ (α + {Control IV’s: Case Characteristics})

β₁ Number of Charges + β₂ Number of Defendants + β₃- β₄ Type of Defendant (two dummy variables compared to reference category) + β₅ Nature of Harm + β₆ Unique Geography - SDNY

+ {Control IV’s: Economy}

β₇ DJIA + β₈ Unemployment Rate

+ {Primary IV’s}

β₉ District Court Ideology + β₁₀ Circuit Court Ideology
Models 2-6 – Interaction Terms

+ {Control IV: Case Characteristics Interaction}

\( \beta_{11} \) Nature of Harm * District Court Ideology

+ {Shock Interaction}

\( \beta_{12} \) Shock + \( \beta_{13} \) Shock * District Court Ideology

+ {Control IV’s: Political Principals’ Interactions}

Executive Branch

\( \beta_{14} \) SEC Ideology + \( \beta_{15} \) SEC Ideology * District Court Ideology

Congress

+ \( \beta_{16} \) Senate Appropriations Subcommittee Ideology + \( \beta_{17} \) Senate Appropriations Subcommittee Ideology * District Court Ideology

+ \( \beta_{18} \) House Oversight Subcommittee Ideology + \( \beta_{19} \) House Oversight Subcommittee Ideology * District Court Ideology

+ \( \epsilon \)

I test the six versions of the model and present the results side-by-side in Table 4.3. The only variation is that versions 2-6 each include a separate interaction term that is added to the primary model.
Method of Statistical Analysis

*Logit*

I use logit regression for the statistical analysis because the dependent variable in each of these nonlinear models is dichotomous. I present the logit outcomes in Table 4.3 and discuss the results below.

Results - Background

*Results of Logit Analyses – Tables*

Table 4.A2 in the *Appendix* provides a summary list of the predicted signs of the coefficients and marginal effects for the independent variables. Table 4.2 provides the Descriptive Statistics. Table 4.3 reports the coefficients (and signs), standard errors and marginal effects produced through logit analysis for each of the six models. I use marginal effects as a means of approximating the relative likelihood that the SEC will file a public civil enforcement action before an ALJ rather than in federal district court (i.e. dependent variable = 1) given a one-unit, or one-standard-deviation (where appropriate), change to an independent variable.
Table 4.2 Descriptive Statistics (Primary Data Set)

<table>
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<tr>
<th>Variables</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>Min.</th>
<th>Max.</th>
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</tr>
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<td>Forum</td>
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<td><strong>Independent Variables</strong></td>
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<td></td>
</tr>
<tr>
<td><strong>Case Characteristics</strong></td>
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<td></td>
</tr>
<tr>
<td>Number of Charges</td>
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<td>1.980</td>
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<td>16</td>
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<tr>
<td>Number of Defendants</td>
<td>2.472</td>
<td>2.489</td>
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<td>Individual Defendant Only</td>
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<td>1</td>
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<td>Indiv and Corp Defendant</td>
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<td>0.441</td>
<td>0</td>
<td>1</td>
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<td>Nature of Harm</td>
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<td>0.495</td>
<td>0</td>
<td>1</td>
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<td>Harm*DistCt Ideology</td>
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<td>-0.639</td>
<td>0.701</td>
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<td>Harm*CircCt Ideology</td>
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<td>0.471</td>
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<td>Unique Geo – SDNY</td>
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<td>DJIA</td>
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<td>3152.25</td>
<td>13950.98</td>
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<td>7.800</td>
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<td><strong>Political Principals</strong></td>
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<td>Executive Branch</td>
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<tr>
<td>SEC Ideology</td>
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<td>0.696</td>
<td>-0.720</td>
<td>0.797</td>
</tr>
<tr>
<td>SECIdeo*DistCt Ideology</td>
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<td>0.260</td>
<td>-0.520</td>
<td>0.559</td>
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<td>SECIdeo*CircCt Ideology</td>
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<td>0.229</td>
<td>-0.325</td>
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<td>Congress</td>
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</tr>
<tr>
<td>Senate Appropriations</td>
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<td>0.250</td>
<td>-0.311</td>
<td>0.278</td>
</tr>
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<td>SenApps*DistCt Ideology</td>
<td>-0.010</td>
<td>0.094</td>
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<td>SenApps*CircCt Ideology</td>
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</tr>
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<td>HouseOver*DistCt Ideology</td>
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<td>0.102</td>
<td>-0.225</td>
<td>0.247</td>
</tr>
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<td>HouseOver*CircCt Ideology</td>
<td>0.004</td>
<td>0.092</td>
<td>-0.135</td>
<td>0.159</td>
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<td>Primary</td>
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</tr>
<tr>
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<td>-0.653</td>
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<td>Shock* DistCt Ideology</td>
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<td>0.208</td>
<td>-0.639</td>
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<tr>
<td>Shock*CircCt Ideology</td>
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<td>0.189</td>
<td>-0.383</td>
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Number of cases in Data Set = 1,617
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<tr>
<th>Variable</th>
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<th>Model 2 – Harm Interaction</th>
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<th>Model 3 – Shock Interaction</th>
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<td>Coeff (SE)</td>
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<td>Coeff (SE)</td>
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<tr>
<td>Forum (0 = filed in federal district court, 1 = filed in administrative proceedings)</td>
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<td><strong>Control IV’s</strong></td>
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<tr>
<td><strong>Case Characteristics</strong></td>
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</tr>
<tr>
<td>Number of Charges (1)</td>
<td>-0.433*** (0.042)</td>
<td>-0.100</td>
<td>-0.433*** (0.042)</td>
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<td>-0.448*** (0.054)</td>
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<td>Harm*DistCtIdeology (11)</td>
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<td>-0.165*** (0.063)</td>
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<td>[See Figure 4.4a]</td>
<td></td>
</tr>
<tr>
<td>Harm*CircCtIdeology</td>
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<td>Unique Geo – SDNY (6)</td>
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<td>-0.551** (0.190)</td>
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<td>DJIA (7)</td>
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<td>0.000 (0.000)</td>
<td>0.000</td>
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<td>-0.095 (0.097)</td>
<td>-0.022</td>
<td>-0.118 (0.147)</td>
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<tr>
<td><strong>Executive Branch</strong></td>
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<tr>
<td>SEC Ideology (14)</td>
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<tr>
<td>SECIdeo*DistCt Ideology (15)</td>
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<tr>
<td>SECIdeo*CircCt Ideology</td>
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<td>Senate Appropriations (16)</td>
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<td>SenApps*CircCt Ideology</td>
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<td></td>
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<tr>
<td>House Oversight (18)</td>
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<td></td>
</tr>
<tr>
<td>HouseOver*DistCt Ideology (19)</td>
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<td></td>
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<td><strong>Primary IV’s</strong></td>
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</tr>
<tr>
<td>District Court Ideology (9)</td>
<td>0.825*** (0.187)</td>
<td>0.190</td>
<td>1.225*** (0.239)</td>
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<td>1.259*** (0.259)</td>
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<tr>
<td>Circuit Court Ideology (10)</td>
<td>-0.800*** (0.229)</td>
<td>-0.184</td>
<td>-0.781** (0.229)</td>
<td>-0.180</td>
<td>-0.755** (0.232)</td>
<td>-0.173</td>
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<tr>
<td>Shock (12)</td>
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<tr>
<td>Shock* DistCt Ideology (13)</td>
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<td></td>
<td></td>
<td></td>
<td>-0.181** (0.076)</td>
<td>[See Figure 4.8a]</td>
</tr>
<tr>
<td>Shock*CircCtIdeology</td>
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<td></td>
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<td></td>
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<tr>
<td>Constant</td>
<td>3.903 (0.764)</td>
<td>3.977</td>
<td>3.977 (0.766)</td>
<td>3.990</td>
<td>(1.097)</td>
<td>3.990</td>
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</tbody>
</table>
**Table 4.3  Influence of Judicial Ideology on SEC Decision Making in Civil Enforcement Actions, Logit (Continued)**

<table>
<thead>
<tr>
<th>Observations</th>
<th>1,617</th>
<th>1,617</th>
<th>1,617</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percent Correctly Predicted</td>
<td>76.86 %</td>
<td>77.29 %</td>
<td>77.23 %</td>
</tr>
<tr>
<td>LR Chi²</td>
<td>502.11 (p &lt; .001)</td>
<td>509.64 (p &lt; .001)</td>
<td>508.47 (p &lt;.001)</td>
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</tbody>
</table>

Significance levels:

* = p < .10,

** = p < .05, and

*** = p < .001
Table 4.3 Influence of Judicial Ideology on SEC Decision Making in Civil Enforcement Actions, Logit (Continued)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Model 4 – SEC Interaction</th>
<th>Model 5 – Senate Interaction</th>
<th>Model 6 – House Interaction</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Coeff (SE)</td>
<td>ME</td>
<td>Coeff (SE)</td>
</tr>
<tr>
<td>DV</td>
<td>197</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forum (0 = filed in federal district court, 1 = filed in administrative proceedings)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Control IV’s</td>
<td></td>
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<tr>
<td>Case Characteristics</td>
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<td></td>
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<tr>
<td>Number of Charges</td>
<td>-0.433*** (0.042)</td>
<td>-0.042</td>
<td>-0.434*** (0.043)</td>
</tr>
<tr>
<td>Number of Defendants</td>
<td>-0.450*** (0.054)</td>
<td>-0.054</td>
<td>-0.451*** (0.054)</td>
</tr>
<tr>
<td>Individual Defendant Only</td>
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<td>-0.195</td>
<td>-1.207*** (0.196)</td>
</tr>
<tr>
<td>Indiv and Corp Defendant</td>
<td>-1.036 (0.241)</td>
<td>-0.061</td>
<td>-1.015 (0.241)</td>
</tr>
<tr>
<td>Nature of Harm</td>
<td>-0.075 (0.127)</td>
<td>-0.043</td>
<td>-0.071 (0.127)</td>
</tr>
<tr>
<td>Harm*DistCt Ideology</td>
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<td></td>
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</tr>
<tr>
<td>Harm*CircCt Ideology</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unique Geo – SDNY</td>
<td>-0.562** (0.190)</td>
<td>-0.111</td>
<td>-0.581** (0.190)</td>
</tr>
<tr>
<td>Economy</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>DJIA</td>
<td>0.000 (0.000)</td>
<td>0.000</td>
<td>0.000 (0.000)</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>0.033 (0.213)</td>
<td>-0.006</td>
<td>-0.114 (0.101)</td>
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<tr>
<td>Political Principals</td>
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</tr>
<tr>
<td>Executive Branch</td>
<td></td>
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<tr>
<td>SEC Ideology</td>
<td>-0.149 (0.202)</td>
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<td>[Figure 4.5a omitted]</td>
</tr>
<tr>
<td>SECIdeo*DistCt Ideology</td>
<td>-0.052 (0.044)</td>
<td>[Figure 4.5a omitted]</td>
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</tr>
<tr>
<td>SECIdeo*CircCt Ideology</td>
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<td></td>
<td></td>
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<tr>
<td>Congress</td>
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<td></td>
</tr>
<tr>
<td>Senate Appropriations</td>
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</tr>
<tr>
<td>SenApps*DistCt Ideology</td>
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<td>SenApps*CircCt Ideology</td>
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<tr>
<td>House Oversight</td>
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<td>HouseOver*DistCt Ideology</td>
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<td>HouseOver*CircCt Ideology</td>
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<tr>
<td>Primary IV’s</td>
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</tr>
<tr>
<td>District Court Ideology</td>
<td>0.887*** (0.194)</td>
<td>0.197</td>
<td>0.973*** (0.201)</td>
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<tr>
<td>Circuit Court Ideology</td>
<td>-0.802*** (0.229)</td>
<td>-0.164</td>
<td>-0.780** (0.229)</td>
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<tr>
<td>Shock</td>
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<tr>
<td>Shock* DistCt Ideology</td>
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<tr>
<td>Shock*CircCt Ideology</td>
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<tr>
<td>Constant</td>
<td>2.877 (1.634)</td>
<td>3.974</td>
<td>3.984 (0.785)</td>
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</table>
Table 4.3  Influence of Judicial Ideology on SEC Decision Making in Civil Enforcement Actions, Logit (Continued)

<table>
<thead>
<tr>
<th></th>
<th>Observations</th>
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<tbody>
<tr>
<td></td>
<td>1,617</td>
<td>1,617</td>
<td>1,617</td>
</tr>
<tr>
<td>Percent Correctly Predicted</td>
<td>76.86 %</td>
<td>76.92 %</td>
<td>77.10 %</td>
</tr>
<tr>
<td>LR Chi²</td>
<td>503.97 (p &lt; .001)</td>
<td>506.80 (p &lt; .001)</td>
<td>511.49 (p &lt; .001)</td>
</tr>
</tbody>
</table>

Significance levels:
*  = p < .10,
** = p < .05, and
*** = p < .001
Marginal Effects and Interaction Terms in Logit Analysis: Caution!

Scholars urge caution when interpreting marginal effects to explain models that use logit to analyze dichotomous dependent variables – particularly when interaction terms are included in those models.

In general, marginal effects estimate how much the dichotomous dependent variable will change given a one-unit – or one-standard-deviation (where appropriate) – change in an independent variable. The marginal effects in this dissertation – excluding interaction terms, which cannot be summarized with a single number – are calculated by simulating probabilities. The independent variables in the model are set at their mean and are perturbed one unit in value – or perturbed one standard deviation in value if they are continuous – in order to calculate the marginal effects.

Also, models with dichotomous dependent variables are nonlinear, with the result that the marginal effects differ with each individual observation. This creates a distribution of varying magnitudes of marginal effects – potentially some with different signs – across the data set. Therefore, it is not possible to point to a single number and assert that it is the marginal effect for all values of the independent variables, but a researcher can calculate the marginal effects for stand-alone independent variables, as I have done here, to provide a baseline measure for relative analysis (Farhang and Wawro 2004).

In a technical context, the marginal effect in this logit analysis is the slope of the probability curve of Pr(Y=1|X), holding the other independent variables at their means. When the other independent variables are held constant, the marginal effect can be considered an instantaneous rate of change, thereby reflecting a point along the slope.
With this in mind, the marginal effects I present in Table 4.3 estimate the effect of moving an independent variable one unit, or one standard deviation, from its mean while holding all of the other independent variables in an estimation equation at their respective means. While not comprehensive (because no single number represents all of the marginal effects), Table 4.3 provides this single-point marginal effects data as a baseline for illustrating the relative effects of the independent variables on the dependent variable.

Importantly, the dissertation uses a means for calculating the coefficient, standard error, marginal effect, and z-statistic for the interaction terms in models 2-6 that differs from the method used to calculate those measures for stand-alone independent variables. As has been noted in recent literature, researchers sometimes apply a method for estimating interaction effects of linear models to nonlinear models, causing them to occasionally misinterpret the coefficient and marginal effect of the interaction term (Ai and Norton 2003). A *Stata* command – *inteff* – was developed to address this issue and provide a check for researchers interpreting the results for interaction terms in logit analyses (Norton, Wang and Ai 2004).

I utilize the *inteff* command in this section. The command computes the magnitude of the interaction effects in the dissertation’s models by calculating the cross partial derivative of the expected value of the dependent variable (E(y)) with respect to the interacted independent variables (x₁*x₂) – that is, an approximation of how much the derivative of the estimated value of the dependent variable with respect to one independent variable (x₁) changes for a unit change in the other independent variable (x₂). This is in contrast to the straightforward calculation of the first derivative of the interaction term (x₁*x₂) that is typical for a linear model (Id., and Buis 2010).
The data generated by the \textit{inelff} command for the coefficients, standard errors and $z$-statistics for the interaction terms in model 2-6 is incorporated into Table 4.3. It is important to note that the $z$-statistics vary along with the values of the interaction terms,\footnote{Models 2-6 include not only an interaction term, but also each of the two individual independent variables the product of which comprise the interaction. The inclusion of these terms avoids omitted variable bias. Further, the general concern over increasing multicollinearity by including the individual terms “has been overstated” (Brambor, Clark, and Golder 2005, 70). For the models in this dissertation in particular, the inclusion of the constitutive terms does not create particularly large standard errors, which tends to discount the existence of multicollinearity.} and their values – and varying degrees of statistical significance – are presented below in Figures 4.4b – 4.8b.

Moreover, the most appropriate comprehensive means of reporting the marginal effects of the interaction terms in these models is by presenting the figures generated by the \textit{inelff} command because the marginal effects cannot be summarized in a single value, and may even change signs depending on the value of the interacted terms. These Figures, 4.4a through 4.8a below, plot the correct value of the interaction effect along the y-axis against the predicted probability that the dependent variable $= 1$ along the x-axis for each of the 1,617 cases in the primary data set.

Models 2-6 are designed to include only a single interaction term added to the baseline model 1, even though the addition of multiple interaction terms to a single model might improve the overall goodness-of-fit. This is because of a limitation inherent in the \textit{inelff} command. The formulas included in the command cannot accommodate more than one interaction term that uses the same independent variable (Seymour 2011). Yet, the dissertation tests only interaction terms that include the independent variable for either median district court ideology or the same measure for circuit court ideology. Therefore, due to the need to utilize the \textit{inelff} command to compute accurate measures, but also
given the limitations built into the command, I include only a single interaction term in each of models 2-6.

**Goodness-of-Fit of the Models**

One common measure of goodness-of-fit that tests how well the models perform, and how comprehensively they explain the outcome for the dependent variable, is the “percentage correctly predicted.” In a logit model, the analysis ‘predicts’ as a baseline that a case would fall into the modal category, or the category with the highest probability of being the outcome on the dependent variable. This measure compares the actual case outcomes to this baseline to see the ‘percentage correctly predicted’ – or the percentage of cases where the outcomes correspond to the predictions.

When using data with heavily skewed results, using a modal category for outcome predictions in this form will often produce a high degree of accuracy which may be misleading in terms of goodness-of-fit. In such cases, the percentage may provide a sense of the chances of an accurate prediction, but not reveal much about the degree to which different variables affect the outcome. The data underlying my models, however, do not have heavily skewed results. As Table 4.2 lists, the percentage of cases in the modal category for each model is about 57%, which is close to ideal for using this measure.

As Table 4.3 shows, the percentages correctly predicted are, with slight variation, roughly 77% for each of models 1 through 6. These results indicate that the models perform solidly, are in the same range of explanatory power, and may have been improved by the ability to include multiple interaction terms into a single model.
Results – Discussion

Primary Hypothesis (H1)

District Court Ideology

Table 4.3 shows that the primary independent variable measuring district court ideology is statistically significant at $p < .001$ and, as predicted, has a positive coefficient. This is true for each of the six models I tested. In addition, with the exception of the case-characteristic variable indicating whether the defendant is an individual, district court ideology has the largest marginal effect in each of the models.

This result supports the primary hypothesis – as it relates to federal district courts – that the likelihood the SEC files a civil enforcement action in the forum of administrative proceedings before an ALJ rather than in the forum of federal district court increases as the ideology of the court the agency is likely to face in litigation becomes more conservative.

Specifically, the marginal effect in model 1 (no interactions) reveals that the probability the SEC will file a civil enforcement action before an ALJ (that is, $P(Y=1)$) increases 19 percentage points as the conservatism of the district court increases one standard deviation in value from its mean – when the other independent variables are held constant at their means. Another way to interpret this result is that the marginal effect of .190 represents an instantaneous rate of change because the district-court ideology variable is continuous. So, for each amount that this independent variable increases for a particular case, the probability of the SEC filing with its ALJ corps increases by $(.190 \times \text{the amount of increase})$.
It is important to note, however, that this marginal effect – or rate of change – is not necessarily the same for each value of this independent variable because the relationship between the independent variable and \( P(Y=1) \) is nonlinear, and there is potentially a range of different marginal effects. Though these are useful concepts to keep in mind,\(^{190}\) I discuss – for simplicity – marginal effects for all of the independent variables mostly in terms of the increase in \( P(Y=1) \) for a one-standard-deviation increase in an independent variable from its mean when the other independent variables in the estimation equation are held at their means. I provide a range of marginal effect and \( z \)-statistic values, however, as illustrated through figures in the presentation of the results of the interaction terms below.

In this context, the marginal effects for district court ideology produced in models 2-6 range from about 20 to about 40 percentage points, so they initially appear to be substantial. To put these marginal effects in context, however, an increase in the ideological conservatism of one standard deviation in value would be substantial (~73 percentage points) for the independent variable since its aggregate range is -.653 (most liberal) to .714 (most conservative) (see *Descriptive Statistics* in Table 4.2). Also, the marginal effect as measured when all of the independent variables in a logit model are held at their means is, in general, the largest in magnitude of those produced across the spectrum of values of the independent variable. So, the combination of these factors likely inflates the real size of the marginal effect revealed through the logit analysis.

Nevertheless, this independent variable produces a statistically significant and substantively important effect on the dependent variable in the direction predicted. In

addition, the relative importance of this variable does not decrease with the addition of other significant influences on the dependent variable in the models. Moreover, the range of district courts I randomly selected for the data set also makes the outcome more interesting. This range is quite large – comprising most of the 94 extant districts – so it encompasses SEC decision making pertaining to various geographical, as well as legal, settings. The logit outcomes across the models tend to indicate that the SEC exercises caution in selecting a forum for an enforcement action that has percolated up through its selection process when potentially confronting a conservative district court.

It appears as though the enforcement decision-makers in the agency accurately assess the general ideology of federal district courts – particularly those comprising relative ideological extremes, where such determinations may be easier to make – and factor ideology into their choice of forum. This tends to confirm that the professional civil prosecutors in the agency recognize that much of the time ideologically conservative and liberal judges inherently view SEC civil enforcement actions differently, and the agency has the wherewithal to act on this knowledge. When the agency determines that the risk from filing an enforcement case in front of a conservative district court outweighs the potential enhanced benefits, it will trade off those benefits and utilize its option to file enforcement cases in the friendlier confines of administrative proceedings. Importantly, consistent with the Canes-Wrone (2003, 2006) and Howard and Nixon (2002) findings, the SEC appears to adapt its public civil enforcement behavior based on how it anticipates federal district courts, as guided by ideology, may ultimately respond to the agency if enforcement-related litigation were to fully play out.
Circuit Court Ideology

Table 4.3 illustrates that the primary independent variable measuring circuit-court ideology is statistically significant in models 1 and 4 at \( p < .001 \), and for each of the remaining four models at \( p < .05 \). This independent variable, contrary to what I predict in H1, has a negative coefficient in each version of the model. It does not support the notion that the likelihood the SEC files a civil enforcement action with its ALJ corps increases as the ideology of the circuit court becomes more conservative, but reveals an opposite effect to district-court ideology. The magnitude of this effect is not as large as the effect for district court ideology, but it is larger than many of the other variables in the models.

The marginal effect of circuit court ideology in model 1, for example, shows that the probability the SEC will file a civil enforcement action before an ALJ decreases about 18 percentage points as the conservatism of the circuit court increases one unit value – when the other independent variables are held at their means. The marginal effects for circuit court ideology in models 2-6 have a narrow range, from 16 to about 18 percentage points. To provide context to these marginal effects, an increase in the ideological conservatism of one standard deviation in value would be very large for this independent variable (~117 percentage points) since its range of values is -.383 to .471 (Descriptive Statistics, Table 4.2). So, the size of the marginal effect is inflated, but is nonetheless relatively significant.

Potential explanations for this negative confounding outcome provide fertile options for future research that are beyond the scope of, but can readily build on, my research. First, the issues that the SEC litigates in circuit court are far fewer in number
and, arguably, inherently different than the issues it typically litigates in district court. The agency, for instance, may only appeal issues pertaining to interpretations of law, not findings of fact, to the circuit courts. This effect could be coded and measured empirically. Therefore, it is possible that judicial ideology affects the outcome for the agency on the appellate level differently than at the trial level – and the agency may be aware of this distinction. Also, at the circuit-court level, conservative courts may be more likely to be minimalist generally in their approach to reviewing securities law matters than are liberal courts. They may more likely to attempt to decide cases on narrower issues that pertain to the fact pattern a case presents, whereas liberal courts may be more likely to try to forge broader precedent to create new – and perhaps unexpected – common law in securities cases. The SEC may not be willing to accept such a risk on some occasions. These possible theoretical dynamics could also be assessed empirically.

In addition, it is possible that the respective ideologies of district courts and the circuit courts with jurisdiction for them do not correlate significantly – i.e. conservative (liberal) district courts may not always feed cases into conservative (liberal) circuit courts. A correlation matrix of the independent variables in the primary data set reveals only a moderate positive correlation (.32) between district court and circuit court ideology. Thus, if the ideology of district courts takes precedence as a factor in SEC decision making – as my theory argues and the logit results tend to indicate – those dynamics might confound my statistical results pertaining to circuit courts.

Moreover, while the SEC must make a decision on forum for every public civil enforcement action it files (including settlements), securities cases that actually proceed to federal circuit court are far more rare. As a result, it is possible that the SEC takes into
account the ideological reputation, and expertise, of the more ‘distant’ circuit courts only in a far narrower band of cases – such as those that contain key enforcement-related legal issues that have yet to be decided elsewhere (or where there may be a split among circuits). This potential focus by the agency on federal district courts relative to circuit courts of appeal could also be responsible for confounding the statistical results here.

Results for Other Independent Variables: Case Characteristics (H2 – H5)

Case Complexity Hypothesis (H2)

The two variables in this category – (i) number of charges filed by the SEC and (ii) number of defendants in a case – are statistically significant at \( p < .001 \) in all six of the models. In each model, the coefficient of each of the independent variables has a sign in the predicted direction – negative – meaning that the more complex, and potentially expensive, an enforcement case gets, the more likely the SEC will file it in the forum of federal district court.

Using model 1 as a representative example of the results, the marginal effect of the variable ‘number of charges’ in Table 4.3 indicates the probability the SEC will file a civil enforcement action with its ALJ corps decreases 10 percentage points as the number of charges increases by one (the variable’s unit value) from its mean value (i.e. from ~3 to ~4 charges, from Table 4.2). The marginal effects for this independent variable in models 2-6 range from 1% to 10%. To provide context to these marginal effects, the range of this variable (from Table 4.2) is 1 to 16, but its mean is 2.741 – so it is likely that the marginal effect grows weaker as the number of charges grows larger (as the variable moves away from its mean).
Similarly, the marginal effect of the ‘number of defendants’ in model 1 indicates that the probability the SEC will file with an ALJ decreases over 10 percentage points for a one-unit increase in the number of defendants from the mean (from ~2.5 to ~3.5 defendants, from Table 4.2). The marginal effects for this independent variable have a very narrow range, 10.3 to 10.5 percentage points (with the exception of model 4, which includes the SEC interaction term, where it is 5.4 percentage points). The range of this variable is 1 to 26 (an outlier), but its mean is 2.472 – so its marginal effect also grows weaker as the number of defendants increases and moves away from the variable’s mean. These independent variables individually produce moderately sized marginal effects. Yet, when the marginal effects of these variables are combined, in some of the models the aggregate impact on the dependent variable is comparable to the marginal effects produced by district court ideology.

This outcome signals that the SEC prefers to bring cases that originate in complex frauds involving multiple defendants and legal issues in the forum of federal district court over the forum of administrative proceedings. This is driven partly by practical decisions made by professional civil prosecutors in the SEC who want to take advantage of what they believe is the enhanced efficiency of court proceedings. These professionals in the Division of Enforcement deploy finite resources to develop cases; efficiency is a material consideration especially when a case is complex and may require substantial pre-trial (or pre-settlement) discovery.

The results also tend to support the finding that the SEC perceives some district courts to have superior experience and expertise to apply to complex cases. This is particularly helpful when the agency wants to establish new common law precedent that
will work in its favor in future enforcement efforts. The SEC can further leverage the expertise – and high profile – of some district courts to pursue its strategy of deterrence to potential future securities law violators by filing more severe charges against defendants. Many of these ‘show’ cases emerge out of complex, far-ranging financial frauds and, therefore, show up in these results.

A future opportunity for research would be to determine how uniform the SEC’s district-court preference for complex cases is across districts over time. In general, however, these independent variables are devoid of an ideological undertone. Rather, they involve independent, pragmatic decision making by bureaucrats comprising the Division of Enforcement.

These results tend to support the Case Complexity Hypothesis (H2).

**Corporate Defendant Hypothesis (H3)**

The dissertation uses two dummy variables in this category – (i) whether the defendant(s) in an SEC civil enforcement action was an individual(s) only, and (ii) whether the defendants were a combination of individuals and corporate entities. The reference variable, which is not included in the logit model, is whether the defendant(s) was solely a corporate entity. Therefore, the results for the two dummy variables are considered relative specifically to the baseline of the effect of a corporate defendant on the dependent variable.

While the mixed individual/corporate variable is not statistically distinguishable from zero, the individual-only variable is statistically significant at \( p < .001 \) in all six of
the models. Further, the coefficient for this independent variable in each model has a sign in the predicted direction – negative.

The marginal effect of the dummy variable signaling when the defendant is an individual is the largest in each model, being generally in the range of 28 percentage points (with the exception of model 4). This translates into the probability the SEC will file with an ALJ decreases about 28 percentage points when the SEC brings a civil enforcement action against an individual only as compared to when it brings an action solely against a corporate entity.

This variable illustrates that practical considerations, like the nature of the parties to an enforcement case, affect the agency’s choice of forum. Many of the bread-and-butter type cases the SEC brings against corporate entities involve the myriad public filings regulated companies must make with the agency. After all, as described in Chapter 2, the model for the regulation of securities markets embodied in the establishment of the SEC is based heavily on financial disclosure. A large part of the original goal of the SEC-as-regulator was to enforce the provision by participants in U.S. financial markets of full and accurate information to investors. Even modern-day enhancements to the SEC’s powers of regulation and enforcement, such as Sarbox, often focus on revising disclosure rules.

This result confirms that the SEC is more likely to enforce disclosure cases against corporate entities, relative to general cases against individuals, in administrative proceedings to minimize cost and maximize convenience, especially since the agency’s headquarters in Washington, DC manages corporate filings.

These results tend to confirm the Corporate Defendant Hypothesis (H3).
Harm Hypothesis (H4)

The stand-alone dummy variable representing the nature of the harm alleged by the SEC against a defendant in a civil enforcement action is not statistically distinguishable from zero. This result discounts the variable’s effect as a pure case-characteristic indicator.

More importantly to my study, though, the interaction term combining this independent variable with the ideology of the federal district courts is statistically significant at p < .05. Its coefficient is also negative, as predicted. This result indicates that the variable is meaningful in the context of political ideology. The interaction term that utilizes ideology of the federal circuit courts, however, is not statistically significant.

Model 2 includes this interaction term. Figure 4.4a below illustrates that the marginal effects of this interaction term range from ~ 0 to ~ -0.25 – almost all of these effects are therefore negative.
This range in the size of the interaction effects depends on the other independent variables in model 2 (Norton, Wang, and Ai 2004). For example, for those cases where the predicted probability of the SEC filing with its ALJ corps is .5, the interaction effects range from -.20 to -.25; for those with predicted probabilities of .2 and .8, respectively, most effects are near -.15. This curve makes intuitive sense since this interaction effect would have the largest potential impact in those cases where the other variables do not already cause the predicted probability to be near 0 or 1 (i.e. the extremes).
Figure 4.4b Model, Version 2: Distribution of z-Statistics of Interaction Term Harm*District Court Median Ideology

Source: Primary Data Set, Produced by `inteff` Command in Stata 9.0

Figure 4.4b above shows that, in addition to the interaction term itself, most of the individual interaction effects, particularly where the marginal effects are relatively larger (in Figure 4.4a), are statistically significant. The statistical significance of the harm*federal district court interaction term thus indicates that when the harm perpetrated by a defendant is aimed primarily at a corporate entity or the functioning of the financial market system in general rather than being directed at an individual, the SEC is more

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191 Here, and in discussions of statistical significance involving other interaction terms below, I follow interpretations provided by (Ai and Norton 2003, 127) and (Norton, Wang and Ai 2004, 164).
These results tend to indicate that the SEC believes, generally, that liberal district
courts will be more responsive to enforcement cases brought against securities law
violations that impact individuals. This is consistent with my theory that the direct
impact of such violations on an individual (or group of persons) would likely draw closer
scrutiny from a liberal court that emphasizes the role of the government in preventing
fraud on vulnerable investors. Similarly, the results signal that the SEC views
conservative district courts as being more attuned to addressing systemic harm caused by
fraud on the market and more esoteric forms of financial fraud. This is also consistent
with my theory describing conservative courts as focused on the efficient functioning of
U.S. financial markets – and supporting enforcement initiatives that encourage such
market activity – in the context of a more laissez-faire approach to financial regulation.

This outcome tends to confirm the Harm Hypothesis (H4).

**Favorite Court Hypothesis (H5)**

The dummy variable I use to test this hypothesis, indicating whether or not a civil
enforcement case originated from the SDNY, is statistically significant at p < .05 in all
six of the models. Also, in each model, the coefficient of each of the variables has a sign
in the predicted direction – negative.

Using model 1 to present a representative example of the results, the marginal
effect of this independent variable indicates the probability the SEC will file a civil
enforcement action with its ALJ corps decreases by about 12 percentage points when the
action originates from the SDNY than when it does not, holding all of the other independent variables at their mean. The marginal effects for this variable in models 2-6 range from 11 to about 12 percentage points.

This result demonstrates that the SEC enforcement bureaucracy has at least one ‘go-to’ court for litigation. This may be due to the SDNY’s ability to handle complex financial litigation, as well as the value of the court’s high profile when the agency embarks on litigation that may have deterrence value. Part of the statistical significance of this variable is also attributable purely to location. The SEC field office in the SDNY is the agency’s largest, built to handle the financial market issues that arise from Wall Street and the many banks and other financial institutions that are based in Manhattan.

This outcome tends to confirm the Favorite Court Hypothesis (H5).

**Results for Other Independent Variables: Political Principals – Executive Branch and Congress**

**Executive Branch – Commissioners’ Political Influence Hypothesis (H6)**

The results for model 4 listed in Table 4.3 show that the interactions of the continuous variable comprising the median ideology of the SEC with the continuous variables for either district court or circuit court ideology are not statistically distinguishable from zero, when the other independent variables are held at their means. Moreover, Figure 4.5b illustrates that even at different values of the independent variables, and across the entire spectrum of the predicted $P(Y=1)$, the interaction term is not statistically significant.\(^{192}\)

\(^{192}\) Please note that because this interaction term, and virtually all of the individual interaction effects, are not statistically significant, I do not include Figure 4.5a, which illustrates the distribution of marginal effects for this term.
Figure 4.5b  Model, Version 4: Distribution of z-Statistics of Interaction Term SEC Ideology*District Court Median Ideology

The outcome indicates the SEC exercises some independence from its political principals in the executive branch when making decisions, such as choice of forum, to implement its enforcement mission. A change in ideology among the Commissioners does not result in SEC enforcement bureaucrats viewing conservative courts differently vis-à-vis the agency’s ALJ corps. Presumably, then, such a change in ideology does not shift the preferences of the SEC – or of the federal lower courts toward the agency – in the context of its enforcement program. This comports with the portrayal of the SEC in Figure 3.3a rather than the portrayal in the theoretical alternative in Figure 3.4a.

Source:  Primary Data Set, Produced by inteff Command in Stata 9.0
The results also support my argument that part of the SEC’s ability to fend off influence on its decision making from principals in the executive branch is attributable to institutional design components. Table 2.6, for example, illustrates that it takes significant time for the President to change the ideological make-up of the SEC, constraining an administration’s ability to project policy preferences through new Commissioners. In addition, absent extreme circumstances, newly elected Presidents in the modern era do not quickly begin transforming SEC policy preferences through nominating new chairs. As Table 2.7 shows, the mean number of days it takes a President to get a nominee for SEC chair confirmed is 161. The SEC also exercises independence in its enforcement program by controlling its litigation docket. The agency is authorized to conduct its own litigation on all matters before every court except the Supreme Court. So, these factors, taken in combination, tend to mitigate direct political influence from the executive over the agency and may underlie this logit outcome.

These results also support the Commissioners’ Political Influence Hypothesis (H6).

**Congressional Dominance Hypothesis (H7)**

Each of the two interaction terms the dissertation uses to test the influence of Congress on the SEC’s public civil enforcement process is statistically significant at p < .05.
First, as model 5 in Table 4.3 shows, the interaction term that combines the continuous variable comprising the median ideology of the Senate Appropriations Subcommittee with the ideology of the federal district courts is statistically significant. Its coefficient is also negative, as my theory predicts. The interaction term combining Senate Appropriations ideology with the ideology of the circuit courts is not statistically distinguishable from zero and is not included in the table.

Figures 4.6a and 4.6b illustrate the range of marginal effects and z-statistics, respectively, for this interaction term in model 5. Figure 4.6a shows specifically that these marginal effects range from ~ 0 to ~ -0.45 and, thus, virtually all of these effects are negative, though they vary in magnitude. Again, the range of interaction effects depends on the value of the other independent variables in model 5. For instance, for those cases where the predicted probability of the SEC filing with its ALJ corps is .5, the marginal interaction effects range are mostly about -.375; for those with predicted probabilities of .2 and .8, respectively, most effects are near -.25. This curve also makes intuitive sense since the interaction effect would have the largest potential impact in those cases where the other independent variables do not already cause the predicted probability to be near the extreme values of 0 or 1.
Figure 4.6a Model, Version 5: Distribution of Marginal Effects of Interaction Term Senate Appropriations Subcommittee Ideology*District Court Median Ideology

Source: Primary Data Set, Produced by `inreff` Command in Stata 9.0
The z-statistic distribution of this interaction term in Figure 4.6b is consistent across the spectrum of predicted P(Y=1) and indicates that the term is statistically significant for about half of the cases in the primary data set and that the test for significance is clearly one-sided.

**Figure 4.6b Model, Version 5: Distribution of z-Statistics of Interaction Term Senate Appropriations Subcommittee Ideology*District Court Median Ideology**

Source: Primary Data Set, Produced by `inteff` Command in Stata 9.0

**House Oversight Subcommittee**

Next, model 6 in Table 4.3 shows that the interaction term that combines the continuous variable comprising the median ideology of the House Subcommittee with
oversight responsibility for the SEC with the ideology of the federal district courts is statistically significant. Its coefficient is also negative, as my theory predicts. The interaction term combining House Oversight ideology with the ideology of the circuit courts is not statistically distinguishable from zero and I do not include it in the table.

**Figure 4.7a Model, Version 6: Distribution of Marginal Effects of Interaction Term**

House Oversight Subcommittee Ideology*District Court Median Ideology

![Interaction Effects after Logit](chart)

- **Source:** Primary Data Set, Produced by *inteff* Command in Stata 9.0

Figures 4.7a and 4.7b illustrate the range of marginal effects and z-statistics, respectively, for this interaction term in model 6. Figure 4.7a shows specifically that these marginal effects range from ~ 0 to ~ -1.1 and almost all of the effects are negative. Since the range of the marginal interaction effects depends on the value of the other
independent variables in model 6, the effects vary substantially in magnitude. For those cases where the predicted probability of the SEC filing with its ALJ corps is .5, the marginal interaction effects range are mostly about -.90; for those with predicted probabilities of .2 and .8, respectively, most effects are near -.55. This curve, like the one in Figure 4.6a, makes intuitive sense.

It also reveals that the marginal effects of the House subcommittee on model 6 are roughly more than twice those of the Senate subcommittee on model 5. This indicates that the House may have more influence than the Senate on the strategic decision making process of the SEC with regards to its civil enforcement program.

Figure 4.7b Model, Version 6: Distribution of z-Statistics of Interaction Term
House Oversight Subcommittee Ideology*District Court Median Ideology
The z-statistic distribution of this interaction term in Figure 4.7b is slightly curved across the spectrum of predicted P(Y=1) and, unlike the Senate interaction term, indicates that the term is statistically significant for a large proportion of the cases, with the exception of some of those cases lying near the extreme values (0 and 1) of P(Y=1).

Congressional dominance rears its head through these results.

As I described in Chapter 2, even in the prior absence of empirical studies, (former and active) SEC commissioners have recognized that the SEC is probably not as efficient in resisting the political influence of Congress as it is in resisting political entreaties from the executive branch. The logit results bear this out. There are likely two main reasons for this congressional-executive disparity.

First, the structural design of the SEC as independent regulatory agency was intended by Congress to insulate the agency from political influence by the executive – not legislative – branch. The results show it may actually function the way it was intended. Next, Congress exercises active oversight of the Commission via its oversight and appropriation subcommittees. Congress often takes an active role through ex post controls because many issues the SEC confronts – like high profile financial scandals – present the opportunity to earn political capital with constituents.

Moreover, even the SEC’s professional civil prosecutors in the Division of Enforcement know that Congress controls their resources and they must pay close attention to the preferences of their subcommittees in order to maintain, or increase, their funding levels on an annual basis. This close coordination can help transfer preferences from congressional subcommittees (and committees) to the agency. So, when there is a shift in ideology in Congress, it is possible that there will be some degree of shift in
preferences in the SEC, and the agency will adjust its choice-of-forum process accordingly. This is represented in Figure 3.4b illustrating an alternate version of my theory – one that includes ideological effects.

As I describe in Chapter 2 and in the Addendum, the agency publicly takes pride in promoting what it sees as its traditionally independent enforcement process. According to this narrative, enforcement policy trends percolate up from career civil prosecutors who base their decision making on practical considerations of pursuing the Division of Enforcement’s mandate with minimal political interference. My findings indicate, however, that the robustness of the SEC’s independence wanes with regard to the agency’s relationship with Congress because of the legislature’s direct oversight responsibilities and control over the agency’s budget.

The results for both of these interaction terms thus tend to contradict my Congressional Dominance Hypothesis (H7).

**Shock Hypothesis (H8)**

Model 3 in Table 4.3 presents the logit results for the interaction term that combines the shock variable, a categorical independent variable with more than two possible values, with the ideology of the federal district courts. The interaction term is statistically significant at $p < .05$. Its coefficient is negative, as my theory predicted. The interaction term combining the shock variable with the ideology of the circuit courts is not statistically distinguishable from zero and I therefore do not include it in the table.

Figures 4.8a and 4.8b illustrate the range of marginal effects and z-statistics for this interaction term in model 3. Figure 4.8a shows these marginal effects ranging from ~
0 to ~0.30 and that virtually all of the effects are negative. The marginal effects vary in magnitude depending also on the value of the other independent variables in model 3. For instance, for those cases where the predicted probability of the SEC filing with its ALJ corps is .5, the marginal interaction effects range are mostly about -.275; for those with predicted probabilities of .2 and .8, respectively, most effects are near -.175. The curve illustrating the distribution of the marginal effects is U-shaped. This is similar to the figures of the marginal effects of the other interaction effects, and is supported as well by the same logic underlying the interpretations of those figures.

Figure 4.8a  Model, Version 3: Distribution of Marginal Effects of Interaction Term Shock*District Court Median Ideology

Source: Primary Data Set, Produced by inteff Command in Stata 9.0
The z-statistic distribution of this interaction term in Figure 4.8b is slightly curved across the spectrum of predicted P(Y=1) and indicates that the term is statistically significant for a substantial proportion of the cases, with the exception of some of those cases lying closer to the extreme values (0 and 1) of P(Y=1). This is intuitively consistent with the distribution of the marginal effects, as both the magnitude of the effects and the statistical significance of the interaction term are stronger when P(Y=1) is closer to 0.5 – a value that indicates generally that the other independent variables would
not necessarily influence the outcome of the dependent variable, leaving room for an effect by this interaction term.

These results tend to support the theoretical narrative in Figure 3.3b. The statistical significance of the shock variable, and the fact that it reversed the sign of the coefficient when interacted with federal district-court ideology, may signal that the variable imparted a temporary partial partisan reversal that affected the attitude of conservatives toward the SEC’s civil enforcement agenda via the courts and, perhaps, through the agency itself. The agency’s usual preference for liberal over conservative district courts may have become less distinguishable as its perception of the likelihood of a favorable outcome became more similar for both ideological categories of courts.

In addition, for robustness I conducted a logit analysis on the same model, but substituted a dichotomous dummy variable (pre-shock = 0 and post-shock = 1) for the categorical variable that I used to test the temporary nature of the effects of the shock. The resulting interactions terms when the variable was combined with the ideology of the federal district and circuit courts, respectively, were not statistically significant. Therefore, I do not report the results of this robustness check in Table 4.3. In general, this result tends to support the concept of the exogenous shock creating a temporary effect that wanes over time, allowing the ideological preferences of the actors to return to their previous relative positions.

The results thus tend to support the shock hypothesis (H8).
Conclusion

The findings I describe in this chapter, based on the results of logit analyses on six models I drew from my primary data set, support 6.5 of my 8 hypotheses. The analyses portray the SEC as an independent regulatory agency that appears to adapt its public civil enforcement decision making and behavior based on how it anticipates federal district courts, as guided by ideology, would ultimately respond to active enforcement-related litigation.

They confirm that the agency is less likely to utilize the forum of federal district court for civil enforcement actions, and will opt instead for an administrative forum, when the ideology of the court that will likely hear a case is conservative. Similarly, the SEC is more likely to use the federal district courts over its ALJ corps when the ideology of the court that will likely hear a case is liberal. I discovered further that this narrative does not hold true when applied to circuit courts, and I provide possible explanations, couched as research questions, that may hold the key to explaining this disparity in outcomes.

The findings show, however, that the exogenous shock caused by the Enron scandal may have imparted a temporary partial partisan reversal that may have affected the attitude of conservatives toward the SEC’s civil enforcement agenda. The agency’s usual preference for liberal over conservative district courts seemed to have become less distinguishable temporarily, but the effect may have waned over time.

The logit analyses in this chapter also support a finding that the characteristics of individual civil enforcement cases play a significant role in the SEC’s strategic decision making. These findings support the narrative portraying the SEC’s enforcement
bureaucracy as comprising competent, professional civil prosecutors who work with the practical realities of having to succeed on behalf of the independent agency.

The independence of the SEC fared well with regard to the ideology of the executive branch. I did not find the presence of political influence from the SEC’s Commissioners or the President. Congressional dominance, though, made an appearance. The political ideology of the agency’s oversight and appropriations subcommittees in Congress was statistically significant. Thus, the findings in this chapter draw attention to a dichotomy I describe in this chapter between the SEC’s efficient efforts at fending off the politics of the executive, but having to deal at every level with the politics of Congress to maintain its annual budget.

Overall, this chapter is able to provide a relatively well-rounded perspective on the divergent influences that affect the decision making and behavior of the SEC as an independent pursuing a public civil enforcement program as a critical component of its mission.
Politics and ideology do matter to this watchdog – the SEC – in multiple, divergent contexts. This independent regulatory agency was born out of political and economic turmoil nearly eighty years ago, and it intermittently finds itself thrust back into the middle of such tumult given the challenging, sometimes contradictory, nature of its mission. The image of the SEC that emerges from my in-depth study of its enforcement decision making and behavior is of an agency that strategically manages its independence and reputation for fairness while fending off, with varying degrees of success, attempts at influence from political principals.

The reputation of the SEC, for better or for worse, has become closely tied to its enforcement activities. Its performance as civil prosecutor largely defines its brand to its political principals – who determine the scope of its authority and annual budget – and the general public. The SEC’s enforcement program is thus subject to intense scrutiny from players that have competing ideologies and interests. This remains a difficult balancing act for the agency, and begs the question, ‘Who controls this bureaucracy?’ I find the answer to be a mixed bag, but one that lies primarily with the agency itself.

The SEC regularly deals with political ideology as a potential adversary. My research finds that the agency adapts to the effects of ideology to carry out the critical enforcement component of its mission. The SEC appears to sometimes shift its enforcement behavior based on its experience and accurate interpretation of the ideology of the lower federal courts. This finding has interesting implications because it tends to support generally the Canes-Wrone (2003, 2006) and Howard and Nixon (2002) research
that provided the original seed for my study. Those works extended the literature on bureaucratic control by identifying a key behavior – how an agency can adapt based on how it anticipates courts, guided by ideology, would ultimately respond to its decision making should its bureaucratic processes culminate in litigation. This represents a form of political control by federal courts, but with behavior flowing in a direction – from the controlled to the controlling party – that is atypical.

I theorize that the SEC can anticipate how lower federal courts would behave in certain circumstances, rather than only responding to judicial decisions once already rendered. The agency utilizes the uncommon, two-track legal structure that Congress granted it to prosecute civil enforcement cases. In this context, I find the SEC is less likely to utilize the forum of federal court for civil enforcement actions, and opt instead for its alternative – an administrative forum before its ALJ corps – when the ideology of the court that is likely to hear a case is conservative. Similarly, the SEC is more likely to utilize the federal court system when the ideology of the court that will likely hear a case is liberal.

I concluded during my research that it was impracticable to identify the political ideology of the SEC ALJ’s who served during the sixteen years of my primary data set. Thus, I do not use ALJ ideology as a variable in my analysis. Instead, I provide ample information on the ALJ corps to place it in proper context in my study. I lay out the role of SEC ALJ’s, and explain how ALJ roles in general differ significantly across agencies. I support my discussion of the performance of the ALJ corps at the SEC with detailed research and data that has not, to my knowledge, been presented previously in any other scholarly format.
My study traces the origins and rationale of the SEC’s binary option for civil enforcement to the nineteenth century. I demonstrate that both the SEC and its adversaries in public enforcement litigation usually have more riding on a case in district court than in administrative proceedings. Yet, I also present original data showing that the agency actually fares better on its home turf before its ALJ corps. Thus, I develop a theory of the SEC’s ‘trade-off’ of eschewing the potential for more severe sanctions in federal court for a higher probability of success, but lower penalties, before an ALJ depending on the political ideology of a federal district court. In the Introduction in Chapter 1, I use a brief case study from the SDNY, Rajat K. Gupta v. SEC, to illustrate this concept in practice. The trade-off theory incorporates three related, substantive assumptions that I find significant support for in my research.

My research assumes as valid the attitudinal model of judicial decision making and I describe how it applies, in mitigated form, to the lower federal courts. I then develop an explanation of why conservative judges are less likely than their liberal colleagues to favor the prosecutorial program of an independent agency like the SEC. I base this on a portrayal of the conservative political attitude as favoring less bureaucracy and a relatively laissez-faire approach to financial market control. Similarly, liberal courts are more likely to view SEC civil enforcement actions favorably because of the liberal political attitude that government plays a key role in preventing fraud on investors in U.S. securities markets.

The conservative-liberal conceptual dichotomy is important because it can be applied and tested in other settings involving agency decision making and litigation to determine if bureaucrats across agencies respond to courts consistently in this manner. If
so, this would be a significant finding and extend another avenue in bureaucratic-control literature. Finally, I connect these two strands of logic by describing how SEC bureaucrats and commissioners possess information about the ideology of the federal courts they consider in their strategic enforcement deliberations, and have the wherewithal to use it effectively.

Inherent in the nature of the mission of the SEC, I believe the agency must also manage exogenous shocks to the SEC-regulated financial community that occasionally arise from profound financial scandals. The exogenous shock from the Enron scandal (followed by swift bipartisan congressional action via Sarbox legislation), which occurred during the period of my primary data set, provided an excellent opportunity to test this idea. Specifically, I argue that in the wake of the Enron shock, SEC civil enforcement cases became more attractive to the personal policy preferences of many conservatives (including many district court judges) and the agency quickly recognized, or anticipated, this temporary shift. As a consequence, the preference of the SEC for liberal over conservative federal courts became temporarily less distinguishable, because its perception of the likelihood of a favorable outcome became similar for both ideological categories of courts. My statistical analysis tends to bear this out. I indicated a partial partisan reversal affecting the SEC’s relationship with conservative courts, but this reversal faded over time as the effect of the shock waned among the agency’s political principals.

In the framework of my research, I argue further that the SEC does not make strategic decisions about civil enforcement based on its own ideological preferences. Instead, I frame the SEC as essentially an independent agency when pursuing its
enforcement mandate, and test this portrayal in my study. The SEC’s strategic goal is to maximize its public civil enforcement success. The agency in this role succeeds mainly by winning cases and secondarily by achieving the maximum penalties it seeks against defendants. My statistical analysis also tends to support this view, as case characteristics such as complexity, cost, type of defendant, and favorite venue all significantly affect where the SEC files an enforcement case. The bureaucrats in the SEC deploy finite enforcement resources, so efficiency in maximizing outcome is usually a material consideration. Success in the enforcement program is also an important means for the agency to impress its political principals, some of whom hold the key to its annual budget and scope of authority.

Thus, the independence and professionalism of the SEC’s enforcement program is theoretically important. I present an original classification of the sources of the SEC’s independence as a federal agency into, first, the agency’s structural and legal design and, second, its public rhetorical independence. The SEC’s independent role is clearly important in this context because it has the potential to partially insulate the agency from politics.

Moreover, I emphasize that the SEC’s public civil enforcement program is analogous to a federal criminal prosecutor because of the magnitude of the impact its decision making and behavior can have on individuals or business entities. The agency’s civil enforcement process should be relatively free from politics in order for the agency to remain credible with litigants and regulated parties.

My analysis shows the SEC generally does well exercising independence from its political principals in the executive branch. A shift in ideology among SEC
Commissioners, or the President, does not result in enforcement bureaucrats viewing conservative courts differently relative to the agency’s ALJ’s. Presumably, then, such a change in ideology does not shift the preferences of the SEC, or of the federal lower courts toward the agency.

The SEC does not appear as efficient in resisting the political influence of Congress, however, as it is in resisting pressure from the executive branch. The political ideology of the agency’s oversight and appropriations subcommittees in Congress affect the agency’s decision making. These findings draw attention to possible reasons for this disparity in outcome. First, I argue that the structural design of the SEC as independent regulatory agency was intended by Congress to insulate the agency from political influence by the executive, not legislative, branch. The results show it may actually function the way it was intended. Next, Congress exercises active oversight of the Commission via its oversight and appropriation subcommittees. Congress often takes an active role through ex post controls because many issues that the SEC confronts, like high profile financial scandals, present the opportunity to earn political capital with constituents. Moreover, even the SEC’s professional civil prosecutors in the Division of Enforcement know that Congress controls their resources and they must pay close attention to the preferences of their subcommittees in order to maintain annual funding.

To complete the analysis of the SEC’s enforcement program, my research presented in the Addendum demonstrates that the SEC significantly leverages its public enforcement program via private securities litigation initiated by private-sector victims of fraud against SEC-regulated defendants. The SEC actively participates in this private securities enforcement regime directly through the strategic use of amicus briefs, and
indirectly by producing fruits of litigation that significantly help private plaintiffs (without intentional coordination from the agency, though) in actions spawned from public civil enforcement actions filed by the agency.

I find that this aspect of the SEC’s enforcement efforts distinguishes the SEC from most other federal agencies in that it balances its powerful, public role as civil prosecutor with a material presence in private litigation. Few agencies are so empowered. Despite changes to the ideology of its Chair, the President and its congressional oversight committees (and subcommittees), the SEC consistently embraces the concept of the private enforcement regime. The agency is cognizant of its role as civil prosecutor as well as regulator, and therefore tries to maintain a balanced public posture towards private litigation. In addition to this jurisprudential self-awareness, the SEC is also cautious to not overreach for at least two reasons that involve ideology and the separation of powers.

First, the SEC generally views private litigation that abuses the system as a threat to its own public mission. It considers the potential for backlash from federal courts, especially among conservative judges, to private securities cases that are overly aggressive or are based on faulty premises. The SEC strategically tries to avoid common law outcomes where lower federal courts would apply broad, substantive restrictions on private actions that would end up limiting the litigation options of all investors. This is more likely in cases of private litigation that overreaches. In addition, the SEC realizes that unfettered support for expanding the private regime could backfire with ideologically conservative members of its congressional oversight and appropriations committees. These members of Congress could, like the courts, respond to non-meritorious private
litigation by enacting broader limitations on private rights of action, thereby adversely affecting the SEC’s private enforcement options. As a consequence, the SEC generally tries to maintain a balanced, strategic approach to its advocacy for the private securities litigation regime. This is consistent with the agency’s approach toward public civil enforcement. Over eight decades it has learned to balance a strategy of optimizing enforcement success with presenting a relatively non-ideological posture to its political principals and regulated community.

As with much scholarly research, my study raises as many questions as it provides answers, and suggests future avenues of research. For instance, I focused here on the political and ideological influence on the SEC’s enforcement program because, ideally, it should be relatively insulated from politics since it is prosecutorial in nature and is implemented by an independent agency. The other side of the mission of the SEC, however, is its regulatory role. A separate study of the SEC’s regulatory side compared and contrasted with its enforcement mission would yield many beneficial insights.

To start such a study, I would presume that politics should play a larger role in the development of regulation by the agency because it is a pseudo-legislative function. As such, it should encompass some of the ideology of the agency’s political principals. Any such study would determine how efficiently ideological preferences are transferred from political principals in Congress and in the executive branch to the ultimate regulatory outcome. Also, such a study would identify whether, on the regulatory side, there is a modified set of players with different relative influence over the SEC’s decision making and behavior. For example, the SEC-regulated community has direct input on rules and regulations via the comment period mandated by the APA. Moreover, federal courts play
a different role in their review of agency regulations than they do in the civil prosecution cases comprising the SEC’s enforcement mission. Also, I would identify areas where, perhaps, regulation and enforcement overlap.

Future research should also delve more deeply into the role of the SEC Chair and how that position may influence the policy of the agency in ways that I did not detect through the SEC’s enforcement decision making and behavior. Such research would examine whether and how the Chair reflects the preferences of the appointing President, and it would identify across agencies potential differences in these effects and determine the political and legal or structural reasons why such differences might exist. In my study, it is clear that the Chair, and the President, are somewhat constrained in the enforcement setting. There is a dearth of history illustrating attempts by the executive to steer SEC enforcement outcomes. And the little history there is, such as the Vesco affair described in Chapter 2, did not turn out well for the administration. Such constraints, if they exist, are diluted on the regulatory side. Thus, the different set of political, ideological, and legal/structural dynamics that exist within the same agency would provide a potentially rich source of information to compare and contrast to search for political influence in outcomes. Such a study would be essential to complete the analysis of the effects of ideology and politics on the independence of the SEC.
References


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How the SEC Protects Investors and Maintains Market Integrity.”

http://www.sec.gov


Performance & Accountability Reports.


Addendum

The Process and Politics of How the SEC Leverages Its Public Enforcement Program through the Private Securities Litigation Regime in the U.S.

Introduction

The publicly prosecuted civil enforcement program of the SEC, constrained by its annual budget and bureaucratic inefficiencies, is significantly leveraged by private securities litigation, brought in federal court by shareholders and other alleged private-sector victims of fraud against defendants regulated by the agency. Congress built this concept in limited form into the fiber of the agency through its founding legislation in both the 1933 and 1934 Acts. Congress decided early on that a monopolistic federal agency would not and, perhaps, should not be able to project concentrated control on a sector of the economy in an effort to avoid repeating the financial-market abuses that compelled the establishment of the SEC.

The federal courts, with persistent prodding by the SEC, expanded the scope of these statutory private causes of action through the promulgation of common law creating additional, implied rights – i.e. those that do not appear explicitly in statute – for plaintiffs to sue individuals and entities under an expanded universe of securities laws.

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193 Private securities litigation since 1966 – when the modern-era class action emerged – has been largely in the form of class action lawsuits. Rule 23 of the Federal Rules of Civil Procedure was amended in 1966, shifting the class-action mechanism from “opt-in,” which had placed the onus on a potential plaintiff to join a lawsuit, to “opt-out,” where plaintiffs would automatically be part of class-action suits unless they wanted to remove themselves. The definition of “class action” is: “…(P)rovides a means by which, where a large group of persons are interested in a matter, one or more may sue…as representatives of the class without needing to join every member of the class.” (Black’s Law Dictionary, 5th Edition. 1979. St. Paul, Minnesota: West Publishing Company, p. 226).

194 An SEC Director of Enforcement characterized the agency’s civil enforcement role as “one piece of a larger mosaic” of public and private enforcement of the securities laws. Stephen M. Cutler, Director, SEC Division of Enforcement. November 1, 2002. “Speech by SEC Staff: Remarks at University of Michigan Law School.” Ann Arbor, Michigan.
The nature and scope of these implied rights were originally broad, and though they remain an important vehicle for the compensation of defrauded plaintiffs and for the deterrence of malfeasance by bad actors, they have been gradually honed down over more than thirty years of federal litigation.

This aspect of the SEC’s enforcement efforts distinguishes the SEC from most other federal agencies in that it balances its powerful, public role as civil prosecutor with its participation in private litigation to achieve its mission. The agency has consistently embraced this dual role publicly – through congressional testimony, speeches by commissioners and senior staff, and amicus briefs\textsuperscript{195} it files in federal court.

The SEC walks a fine line, however, between acknowledging how private suits complement its public enforcement program and being cautious to not overstep the demarcation of its role in private federal litigation by appearing to favor one class of litigant (i.e. plaintiffs) over another without regard to the facts of each case.\textsuperscript{196} This necessary balancing occasionally leads to political tension, both intra-agency and inter-branch, that runs along an ideological continuum. The ideological divide, though, is often softened by the institutional role of Commissioners and senior staff, who are invested professionally in the extension of the SEC’s enforcement regime through private litigation. This is evident, for instance, when the SEC heavily touts the performance of its Enforcement Division in its primary marketing document – the agency’s Annual (and

\textsuperscript{195} See, e.g. Caldeira and Wright (1990) (for discussion of the various dimensions of the use of amicus briefs). The definition of ‘amicus curiae’ is: “...(L)iterally, friend of the court. A person (entity, or federal agency) with strong interest in or views on the subject matter of an action may petition the court for permission to file a brief, ostensibly on behalf of a party but actually to suggest a rationale consistent with its own views” (\textit{Black’s Law Dictionary} (1979), 75) (parenthetical added).

\textsuperscript{196} Since its early years as an agency, the SEC has recognized the need to balance these interests with caution, particularly with regards to its participation as amicus in federal private litigation (Timbers 1954).
Performance & Accountability) Reports — but modestly portrays its participation in private litigation in those reports and refuses to provide the detailed data it does for most other categories of performance.

This Addendum discusses the SEC’s role in private litigation as an indirect extension of its civil enforcement program, and analyzes how the agency uses the private regime strategically to achieve its mission. In this Addendum I also discern whether and how political ideology affects the SEC’s leveraging of its unusual role in private litigation, and whether its fundamental approach changes with different political principals. The Addendum is important to rounding out the analysis of the SEC’s civil enforcement program, especially since it is generally recognized that “the public, Congress, courts and even the securities bar do not fully appreciate the interrelationship between public and private (SEC) enforcement” (Walter 2011, 6).

The next two sections of this Addendum explain the evolution and legal foundations of the private securities enforcement regime – as well as the SEC’s place in that regime – from the earliest days of the agency to the present. The fourth section describes how political ideology helps to frame the SEC’s role in private litigation, and the fifth section discusses in detail how the SEC embraces that role and the caution it exercises – as a federal agency with profound civil prosecutorial powers – to take a balanced approach toward private litigants and their respective interests. The sixth


198 In light of this, Grundfest (1993-1994) argues that the SEC does not provide a public, systematic analysis of the results of its amicus program, in contrast to the way it presents detailed data regarding its public enforcement program; Prezioso (2004) claims that the agency intentionally does not publicize its amicus briefs or program.

199 Following Shipan (2004, 468), I define regime “simply and specifically as a given configuration of institutions and preferences.”
section puts the private securities regime in context by comparing it to private regimes in other policy areas where agencies have varying degrees of influence over those regimes. The final section explains in some detail how the SEC actually participates in the private regime – both directly and indirectly – and uses a brief, but important, case discussion to illustrate how the agency manages potential political influences that challenge its balanced approach.

In the Beginning: Congress Provides Explicit Private Causes of Action; Federal Courts Extend Private Regime through Implied Rights

In 1933, even before it created the SEC, Congress expressly provided a private option for securities law enforcement by giving investors the ability to sue in federal court signers of registration statements containing material misstatements or omissions, as well as the issuer of securities sold pursuant to such flawed registrations. In 1934, along with establishing the independent agency to enforce the new federal financial disclosure provisions, Congress provided additional express private rights of action for investors to confront a panoply of fraudulent market activities it had identified through public testimony following the market crash of 1929. These new private rights to confront fraudulent market activities included suing for damages resulting from manipulation or deception, recovering short-swing trading profits from corporate insiders, and recovering damages for false or misleading statements filed with the new

\(^{200}\) 15 U.S.C. §77k (§11 of the 1933 Act: imposes absolute liability on the issuer and separate potential liability on individuals who signed registration statements containing material flaws if they are unable to demonstrate that they performed adequate due diligence prior to signing).

\(^{201}\) Specifically, in §10(b) Congress granted the SEC broad power to promulgate rules prohibiting manipulation or deception in connection with the purchase or sale of securities. In 1942, the SEC used this authority to develop Rule 10b-5 (17 C.F.R. §240.10b-5), which remains its most effective weapon against financial fraud (Rose 2008).
agency.\footnote{202} It was not long, however, before federal courts began to opine that these initial, limited enforcement provisions were inadequate for protecting the public interest from the range of fraudulent behavior it confronted as financial markets grew more complex.

**Dawning of Implied Rights of Private Action**

A federal district court opinion in 1947 initially spawned implied rights of private action in securities suits. *Kardon v National Gypsum*\footnote{203} recognized the right to sue by plaintiffs bringing a complaint under Section 10(b) and Rule 10b-5 of the 1934 Act, even though such a right was not included explicitly by Congress in the statute’s original language.\footnote{204} This case is also important historically because it was the first successful manifestation of the SEC’s strategy of utilizing amicus briefs\footnote{205} to achieve an outcome that enhanced its enforcement regime through the federal judiciary that it did not, or could not, achieve initially through the legislative process in Congress. As I discuss below, the agency has continued to use this strategy, with varying degrees of success, for over seventy-five years (see Ruder 1989).

The rationale of the *Kardon* opinion had been adopted by the lower federal courts in successive decades, helped along by a persistent strategy of the agency filing amicus

\footnote{202} 15 U.S.C. §§78r(a), 78i and 78p(b) (also §§9(f), 16(b) and 18(a), respectively, of the 1934 Act).


\footnote{204} Neither the legislative history of the statute, nor the background of the drafting of the accompanying rule eight years later, shed any light on the issue because they both lacked any reference to private securities suits (*Blue Chip Stamps et al. v. Manor Drug Stores*, 421 U.S. 723, 729-730 (1975)).

\footnote{205} The agency recognized the potential behind this strategy of expanding its enforcement powers through the judiciary early on, filing its first amicus brief in 1936 – a mere two years after its establishment (Prezioso 2004).
briefs promoting the issue throughout the federal circuits. The SEC finally received the imprimatur of the U.S. Supreme Court on the legitimacy of these implied rights of action through the Court’s opinion in *J.I. Case v. Borak*. The Court reasoned, as has been cited with approval by SEC Commissioners and enforcement staff ever since, “(p)rivate enforcement…provides a necessary supplement to SEC (civil enforcement) action,” and that reading implied private rights of action into certain sections of the 1934 Act was consistent with congressional intent to protect investors.

Also, the Court for the first time explained how, from a public policy perspective, though these causes of action were incentivized by private gain, they essentially empowered “private attorneys general” to help enforce public securities laws and deter financial fraud (*see* Rabkin 1998). The Court apparently agreed with the amicus brief filed in the case by the SEC that argued private actions of this type would appropriately supplement the public enforcement efforts of the agency (Walter 2011).

For a brief period following this decision, the trend in the development of common law as applied to private securities litigation flowed toward the ‘private attorneys general’ model. This was made clear by the Court’s opinion in *Superintendent of Insurance v. Bankers Life & Casualty*, where the Court recognized, as already given, an implied private right of action in a case brought under the antifraud provisions of

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206 “(A) private right of action under Section 10(b) of the 1934 Act and Rule 10b-5 has been consistently recognized for more than 35 years.” *Herman & McLean v. Huddleston*, 459 U.S. 375, 380 (1983).


208 *Id.* at 432 (emphasis added).

209 The relevant section of the 1934 Act in *Borak* was §14(a), relating to the antifraud provisions of the SEC’s shareholder proxy rules.

210 *Supra* note 208.

211 404 U.S. 6 (1971).
§10(b) of the 1934 Act and Rule 10b-5. The Court cited its opinion in *Borak* as support, even though that decision dealt with a different section of the 1934 Act (*Id.*).

**On Second Thought…Federal Courts and Congress Narrow Private Regime**

Soon after these precedents, however, a countervailing view of the role of private securities litigation emerged in the federal judiciary, driven by a post-Warren Court that was becoming more conservative. Some scholars argue that this change in ideology gave rise to a contrary perspective of the utility of private suits to SEC enforcement and the agency’s mission (Cox, Thomas and Kiku 2003).

The Court in *Blue Chip Stamps v. Manor Drug Stores*\(^2\) began to limit its expansive reading of the language of securities fraud statutes, utilizing a more strict constructionist approach to interpreting §10(b) and Rule 10b-5. It coined the phrase “vexatious litigation”\(^3\) – arguing that a narrower interpretation of the statute and accompanying rule, which are core components to much securities fraud litigation, was necessary – partly on policy grounds – to limit the potential for private litigation “strike suits.”\(^4\) This rhetorical counterpart to the private attorneys general model, incorporating an ideologically conservative attitude towards interpreting the plain language of statutes in these cases, established a dichotomy that essentially remains intact today.

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\(^2\)421 U.S. 723 (1975).

\(^3\) *Id.* at 743.

\(^4\) *Id.* ‘Strike suits’ are private securities fraud claims generally settled for a low-dollar amount, are considered nuisance litigation because they have limited merit, but defendants will not commit resources to defend them because the cost of litigation outweighs the cost of settling. As the cases settle and plaintiffs’ attorneys receive payouts, they are incentivized to search for cases with similar fact patterns for future suits (see, e.g. *Private Litigation Under the Federal Securities Laws: Hearings before the Subcommittee on Securities of the Senate Banking, Housing & Urban Affairs*, 103\(^\text{rd}\) Congress (1993)).
The federal judicial debate on the perils of ‘vexatious litigation’ percolated for nearly two decades, reaching a consensus with the Court’s opinion in *Central Bank of Denver v. First Interstate Bank of Denver et al.*\(^{215}\) There, a 5-4 majority of the Court, divided along ideological lines, rejected the plaintiff’s claim – that was supported by an amicus brief filed by the SEC – that defendants who aided and abetted, but did not themselves commit, securities fraud should be liable under the provisions of §10(b). It reasoned that the plain language of the statute did not extend its provisions to aiders and abettors, and the Court was not willing to imply such a right to private action. In refusing to extend such a right, the Court rejected the policy arguments the SEC proposed in its amicus brief and, instead, cited the potential danger private securities litigation posed to start-up and smaller companies, professional secondary advisors, and to the very investors it was supposedly designed to protect (*Id.*).

When the SEC filed its amicus brief in this case, which was argued before the Court in November 1993, the agency had a median ideological score of -.015 and was comprised of two Democratic Commissioners, one Republican, and one Independent. It was also in the early stages of an eight-year term of an activist Chair, Arthur Levitt (ideological score of -.72) (*see* Table 4.1) appointed by the incumbent Democratic President, Bill Clinton. The ideology of its congressional political principals was also relatively liberal. For example, the ideological score (as I calculated for my primary data set) of the Senate committee with appropriation authority for the SEC at that time was -.285, and the ideology of the House subcommittee with oversight authority for the SEC was -.172. Since the ideology of all of the agency’s political principals trended in the

\(^{215}\) 511 U.S. 164 (1994).
same (liberal) direction, this begs the question whether ideology played a role in the expansive position the SEC took in its amicus brief. In contrast, the SEC’s argument may have simply reflected the natural proclivity of the agency to expand the scope of its powers, particularly with regard to an issue it had sought closure on for a significant time. I’ll return to this theme below in the discussion of the SEC’s decision making and behavior in the context of its amicus program.

**Congress Weighs in on Reforming Private Regime**

Congress soon followed suit. A new Republican House majority, as part of Speaker Newt Gingrich’s Contract with America, along with a new Republican majority in the Senate,\(^{216}\) overrode President Bill Clinton’s veto of the Private Securities Litigation Reform Act of 1995 (PSLRA) to enact far-reaching limits on private litigation.\(^ {217}\) These changes affected private litigation procedures, including toughening pleading requirements and making the threshold for becoming a lead plaintiff in a class action more difficult, and they altered both the standards for and consequences of liability in private securities cases (Avery 1995-96). The PSLRA clarified that only the SEC – not private plaintiffs – could bring suit based on the aiding and abetting of fraud.\(^ {218}\) It also eliminated joint and several liability, effectively limiting the exposure of each defendant

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\(^{216}\) Scholars have noted that trial lawyers, particularly those focused on securities class-action suits, traditionally contribute disproportionately to Democratic candidates for Congress. Some have suggested a connection between trial-lawyer influence and both (i) the refusal of the prior Democratic Congress to move any form of private securities litigation reform, and (ii) the subsequent passage of the PSLRA under the 104\(^ {th}\) Congress that was newly controlled by Republicans (see, e.g. Fallone 1997, 9). See infra this section for a more detailed discussion of conventional expectations regarding ideological alignment and private securities litigation – and how those expectations do not always reflect real outcomes.

\(^{217}\) 141 Congressional Record S19180 (December 22, 1995).

\(^{218}\) Kathleen L. Casey, SEC Commissioner. October 24, 2007. “Speech by SEC Commissioner: Address to the Institute for Legal Reform’s Annual Legal Reform Summit.” Washington, D.C.
to the share of liability proportionate to that defendant’s responsibility for a violation. This limited a private plaintiff’s ability to pursue proverbial deep-pocketed defendants.

This legislative process occurred within a public policy atmosphere where tort reform concepts had gained traction. It was triggered by an ongoing concern – reflected in episodic litigation in the federal courts over the previous two decades – that the private securities litigation system, as it had grown out of the securities-enforcement statutes and related rules, too readily accommodated ‘strike suits’ and related litigation-market distortions that failed to serve the public policy rationale underlying securities civil enforcement.

Despite these changes to the scope and application of private securities litigation – as driven at least partially by shifts in ideology – neither Congress, the federal judiciary, nor the SEC challenged the fundamental concept that private litigation provided a ‘necessary supplement’ to the agency’s public enforcement program. The policy focus remained, rather – particularly among ideological conservatives – on how to refine the use of the private enforcement option.

Congress under the PSLRA, for example, incorporated policy based on scholarly research arguing that the material issues surrounding the effectiveness and fairness of private securities litigation originated in an agency problem.219 That is, the incentives of the class of plaintiffs and their counsel were typically misaligned, and one goal of the

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219 This ‘agency problem’ refers generally to the inability of clients who allegedly suffered injury from financial fraud – as the principals – to exercise significant control over their attorneys – the agents – in class action suits as the cost of exercising such control becomes prohibitively expensive for individual, particularly in relation to that individual’s potential payoff within a group of plaintiffs. As a result, the class-action plaintiffs’ attorney can exercise more autonomy, and prioritize his or her own pecuniary interests rather than maximizing social utility and remediating commensurately the harm suffered by the individual. See, e.g., John C. Coffee. 1986. “Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions.” Columbia Law Review 86(4):669-727.
reform should be to reduce the agency costs of this relationship (Rose 2008). One means Congress identified for trying to realign economic incentives between these actors was the ‘lead plaintiff provision’ referenced above, pursuant to which the plaintiff with the largest potential interest in the litigation must select and monitor lead counsel, presumably to reflect most accurately the interests of the remaining members of the class (Id.). Aligning the interests of defrauded investors and their counsel more accurately would, presumably, align them better as well with the public policy interests of the SEC that are designed to maximize social utility and protect investors rather than maximize returns for plaintiffs’ counsel.

21st Century - Federal Courts Continue to Pare Back Private Regime

Federal courts, for their part, continue to try to ‘improve’ private securities litigation by chipping away at the breadth of implied rights of action through strict construction of the statutes comprising the 1934 Act. In Stoneridge Investment Partners v. Scientific-Atlanta, Inc. et al. (Stoneridge),220 the Court concluded that secondary actors could not be found liable in a private action under the aider and abettor provisions of §10(b), and that their own conduct would have to satisfy each element of the anti-fraud statute in order to be subject to a claim. The five-Justice majority, built along conservative ideological lines with Justice Anthony Kennedy authoring the opinion – mirroring the Court’s Central Bank of Denver opinion fourteen years earlier – found that the statute explicitly empowers the SEC to bring proceedings against such secondary actors, but there exists no equivalent implied right of action for private plaintiffs. This opinion effectively shields secondary actors like accountants, attorneys and bankers from

suits when a company commits securities fraud. Part of the Court’s stated policy rationale for the holding was that unrestricted secondary actor liability would raise the cost of being publicly traded on domestic exchanges and cause a shift of investment capital to stock markets outside of the U.S.

The Court continued this narrowing significantly in *Morrison v. National Australia Bank Ltd. et al. (Morrison)*,\(^{221}\) reading the plain text of §10(b) to find that there was no implied private right of action based on alleged financial fraud in connection with securities traded on foreign exchanges. The same five-justice majority that produced the *Stoneridge* opinion, with Justice Antonin Scalia writing for the Court, made clear that §10(b) could apply only to alleged fraud perpetrated in connection with securities traded on domestic exchanges. The Court’s strict constructionist reading of the statute effectively reversed years of common law in the lower federal courts that upheld such an implied right against issuers on foreign exchanges based on a public-policy approach.\(^{222}\)

Most recently, in *Janus Capital Group, Inc. et al. v. First Derivative Traders*\(^{223}\) – a case that has been described by an SEC Commissioner as the Court’s “strictest construction to date” of the 1934 Act – the same five-member majority from *Stoneridge* and *Morrison* (this time Justice Clarence Thomas writing for the Court) used the language of Rule 10b-5 to conclude that an investment advisor could not be sued under

\(^{221}\) 130 S.Ct. 2869 (2010).

\(^{222}\) Congress responded to this ruling within a month with a two-part approach through §929Y of the Dodd-Frank Act. This section (i) confirmed explicitly that the SEC had authority to bring public civil enforcement cases in fact patterns involving securities traded on foreign exchanges, but (ii) regarding private rights of action, mandated that the SEC solicit public comments and submit a report regarding its view of what the scope of private actions on cross-border suits involving securities traded on such foreign exchanges should be under §10(b). (Luis A. Aguilar, SEC Commissioner. May 6, 2012. “Defrauded Investors Deserve Their Day In Court.” [http://blogs.law.harvard.edu/corpgov/2012/05/06/defrauded-investors-deserve-their-day-in-court/#more-28218](http://blogs.law.harvard.edu/corpgov/2012/05/06/defrauded-investors-deserve-their-day-in-court/#more-28218).

\(^{223}\) 131 S.Ct. 2296 (2011).
rules pertaining to false statements in its clients’ mutual fund prospectuses because the advisor did not actually “make” the statements, even though the advisor effectively acted on behalf of the mutual funds (Walter 2010, 5). One SEC Commissioner, a Democrat, also foresees that the judicial narrowing of implied rights of private action may eventually seep into the public civil enforcement options of the SEC under the plain language of the 1934 Act (Id. at 6).

**Political Ideology in Framing SEC’s Role in Private Enforcement Regime**

The dichotomy between the ‘private attorneys general’ and ‘vexatious litigation’ models outlined above, and its manifestation in the debate over expanding or narrowing the scope of the private securities enforcement regime, is analogous to the effects of ideology on the political attitudes of federal judges toward the SEC’s civil enforcement program that I lay out in Chapter 3 and analyze in Chapter 4. The ideologically conservative view in the federal judiciary – and in Congress – is skeptical, though not dismissive, of the utility of private litigation to achieve a public policy goal, particularly where it involves civil prosecution. While accepting fundamentally that private securities litigation is a ‘necessary supplement’ to the SEC’s public enforcement regime, the conservative approach is to refine, or ‘improve,’ its application by restricting its reach. This is consistent with the assumption incorporated into my primary theory that conservative federal courts are less likely than ideologically liberal courts to consistently favor the arguments in a prosecutorial format of an independent regulatory agency like the SEC, and would more likely tend to constrain the scope of its public enforcement power.
In contrast, the more expansive attitude of liberal federal judges adheres to the need for an aggressive private litigation regime to extend the SEC’s civil enforcement program, which is naturally limited by a relatively modest federal budget and bureaucratic inefficiencies. This is manifest, for example, in the dissenting opinions of liberal members of the Court in the seminal cases described above in this Addendum. This half of the dichotomy comports with the part of my theory that argues a liberal court would more likely view SEC civil-enforcement actions positively because of the liberal political attitude that government plays a key role in preventing fraud on vulnerable investors in securities markets. Under this ideological approach, private litigation appropriately extends the reach of the SEC’s enforcement efforts to achieve a public policy goal and help the agency achieve a core part of its mission – protecting investors and maintaining fair, orderly and efficient markets, as I describe in Chapter 2.

Moreover, consistent with my theory, I argue this ideological dichotomy is significant, but not absolute. The shock variable described in Chapter 4 is designed to capture the impact of a partisan reversal effect that may have emerged in the wake of a significant exogenous shock to the U.S. economy. This effect had the potential to temporarily render civil enforcement good politics for conservative actors previously opposed to enhancing government regulation of the financial markets, and thus shift their preferences.

Analogously, there are situations when enacting and supporting private enforcement regimes appeal to conservative political actors, though they are more likely to appeal to liberal actors. Farhang (2010, 80) finds support, for instance, for a “weak” theory of “party alignment,” pursuant to which higher levels of Democratic control of
Congress are related to more extensive enactment of private litigation regimes across the federal government. The “strong” version of this theory – that the “construction of private enforcement regimes is a uniquely Democratic (liberal) phenomenon, abhorred by Republicans (conservatives)” – was not statistically significant in his study (Id., 71).

Farhang provides historical examples that help demonstrate how liberal congresses have over time, as would be expected, enacted more private enforcement regimes to regulate business. He also demonstrates, though, that “(l)ess consistent with conventional expectations,” conservative congresses have also utilized the creation of private enforcement regimes to regulate business through legislation (citing, among others, the Taft-Hartley Act of 1947) (Id. at 68).

The behavior of the Commissioners and senior staff of the SEC towards the private securities enforcement regime, analyzed along an ideological continuum, is generally consistent with these politically nuanced findings. Liberal Commission members and staff take a more aggressive, expansive view of this element of the agency’s enforcement ‘mosaic.’ Their more conservative counterparts, meanwhile, are relatively cautious and encourage judicial and legislative boundaries that restrict the reach of private litigation, and are more acceptable to Republican policy sensitivities. The conservatives who comprise the SEC, though, typically accept the legacy and ongoing utility of private enforcement to achieving the mission of their agency.

SEC Publicly, Though Cautiously, Embraces Private Enforcement Regime

I found that the SEC, despite changes to the ideology of its Chair, the President and its congressional oversight subcommittees (and committees), consistently embraces
the utility of the private enforcement regime. The agency is cognizant of its role as civil prosecutor as well as regulator, and therefore tries to maintain a balanced public posture towards private litigation. In addition to this jurisprudential self-awareness, however, the SEC is also cautious to not overreach in its rhetoric for at least two other reasons that involve ideology and the separation of powers.

First, the SEC generally views abusive private litigation as a threat to its own public mission, foreseeing the potential for backlash from federal courts – particularly in conservative districts – to securities cases that overreach. The agency strategically attempts to avoid common-law outcomes where lower federal courts would consider applying broad, substantive restrictions on private actions that would end up limiting the litigation options of all investors (Fallone 1997). In addition, the agency presumably realizes that unfettered support for the private regime might backfire with respect to ideologically conservative members of its congressional oversight and appropriations committees. These members of Congress could, like the courts, respond to non-meritorious private litigation by enacting broader limitations on private rights of action, thereby adversely affecting a component of the SEC’s enforcement regime. As a consequence, the SEC generally tries to maintain a balanced, strategic approach to its advocacy for the private securities litigation regime.

**SEC Public Commentary on Private Securities Enforcement**

Testimony nearly twenty years ago by SEC Chair Arthur Levitt to the House subcommittee with primary oversight responsibility for the agency, whose membership reflected a newly elected Republican majority, exemplifies this public balancing act by

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224 See Table 4.A3.
the agency. This particular testimony has also proved over time to be a definitive statement on behalf of the SEC. Levitt initially provided the SEC’s baseline support for private litigation as a tool of enforcement:

(T)he Commission has consistently stressed the importance of private remedies against securities fraud…(P)rivate actions…provide a ‘necessary supplement’ to the Commission’s own enforcement activities by serving to deter securities violations. Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers…to meet their obligations under the securities laws.  

He then balanced the agency’s approach by recognizing the importance of congressional policy focused on refining and improving, but not diminishing, the private enforcement option:

These hearings are being held…to consider proposals to make the private litigation system work more effectively. The Commission supports this effort, because private litigation imposes substantial unnecessary costs when it is abused by private plaintiffs…The threat of misdirected litigation also tends to impede beneficial corporate disclosure…Finally, meritless lawsuits may adversely affect the development of substantive securities law, as courts develop broad doctrines…to curb what they perceive to be vexatious litigation.

The Director of the Division of Enforcement at the time echoed this argument in the hearings, reiterating that the Court had repeatedly referred to the private litigation option as a necessary supplement to the power of the SEC to enforce securities laws.

225 Arthur Levitt, SEC Chair (ideological score from Table 4.1 = -0.720). Testimony Concerning Litigation Reform Proposals before the Subcommittee on Telecommunications and Finance, Committee on Commerce, United States House of Representatives, 104th Congress (1995) (footnote omitted).

226 Id. These comments mirror closely testimony SEC Chair Levitt gave to this House oversight committee under a different Congress the previous year when it was beginning to explore concepts of securities litigation reform in anticipation of drafting legislation that eventually became the PSLRA. See Arthur Levitt, SEC Chair. “Statement on Litigation under the Federal Securities Laws.” Hearings before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, United States House of Representatives, 103-156, 103rd Congress (1994).

227 1995 House Hearings at 75 (comments of William McLucas, SEC Enforcement Director, cited in testimony of Professor Joel Seligman, University of Michigan Law School).
Richard C. Breeden, a Republican SEC Chair with a substantially conservative ideological score, equal to 0.726 in Table 4.1, who served the agency from October 1989 to May 1993, provided similar public support for the private enforcement option. In testimony on behalf of the SEC to the House Subcommittee with primary oversight responsibility for the agency (see Table 4.A3), Breeden emphasized that “(p)rivate suits...are instrumental in recompensing investors who are cheated...If (the private-enforcement option) were not the case, investors would be far less willing to participate in our securities markets.” Breeden’s testimony embodies the raison d’être of the SEC that puts mission above ideology that I discuss in Chapter 2. Interestingly, the testimony also applied an identical policy rationale – attracting capital to domestic securities markets – for the precisely opposite outcome regarding private litigation that the Court used twenty-five years later in *Stoneridge*.

Nearly a decade after Breeden’s testimony, during the Republican Administration of President George W. Bush, Republican SEC Chair Harvey Pitt (ideological score = 0.797 in Table 4.1) echoed the agency line in congressional testimony: “Private litigation, when properly formulated, is a very necessary supplement to the SEC’s mission.” His colleague, Democratic Commissioner Harvey Goldschmid (ideological score = -0.203), confirmed this as a longstanding agency position in a lecture around the same time: “The traditional SEC view, which I fully believe in, is that private actions are

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228 *Hearings before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, U.S. Senate, on A Growing Increase in Class-Action Securities Litigation Against Publicly-Traded Companies, 103rd Congress (1993).*

229 *Testimony Concerning Accounting and Investor Protection Issues Raised by Enron and Other Public Companies, before the Senate Committee on Banking, Housing and Urban Affairs, 107th Congress (2002).*
a necessary supplement to make the securities laws work.” Contemporary SEC senior
staff also offered a unified policy front on behalf of the agency: “(P)rivate securities
litigation has always formed a major – and essential – component of the enforcement of
the federal securities laws. The Commission has long advocated private rights of action
precisely because they supplement its own enforcement program…”

The SEC remains consistent in its approach, even though the tension of balancing
its institutional advocacy of private enforcement, the desire of some liberal
Commissioners and agency senior staff to expand the private option more aggressively,
and the counterweight of conservative Commissioners supporting the Court’s efforts to
narrow its scope, is evident in the agency’s public commentary. Former SEC Chair and
Democratic Commissioner Elisse B. Walter, has argued that “…both the public and
private aspects of securities enforcement are critical…they complement each other,
and…are interrelated. The Commission as an institution has taken this view for quite a
long time…” (Walter 2011, 1). Her colleague, Republican Commissioner Paul S. Atkins,
has consistently used his role to publicly remind the SEC – and signal Republicans on the
relevant congressional oversight and budget subcommittees – that the agency must
balance its approach. “(T)he SEC must resist efforts – internal or external – to broaden

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230 Harvey Goldschmid, SEC Commissioner. December 2, 2002. “Speech by SEC Commissioner - Post-


Chairman Mary Schapiro.” http://www.whitehouse.gov/the-press-office/2012/11/26/statement-president-
 obama-departure-sec-chairman-mary-schapiro
securities laws beyond their existing boundaries…By…not ‘pushing the envelope,’ the SEC provides predictability to investors, individuals and companies…”

There are distinct factors about the private enforcement regime that have compelled the SEC to manage this debate effectively over the decades. The differences I describe above, though running essentially along ideological lines, remain within a defined spectrum of acceptance of the private regime. There are ideologically based differences within the SEC on how best to frame the use of the private option, but the agency does not call its legitimacy into question. The SEC evidently realizes that the private securities litigation regime has become an inextricable part of its own civil enforcement program – in this way setting the agency apart from some of its federal counterparts, while drawing it closer in structure to a limited number of others. This is why, in order to maintain the viability and effectiveness of the private enforcement regime, the agency balances the interests of potential plaintiffs and defendants and remains an active part of the regime, through the strategic use of amicus briefs, among other practices.

SEC Enforcement in Context of Other Private Litigation Regimes

Securities enforcement in the U.S. is distinct from its role in other developed nations because of the funding and breadth of the SEC’s public civil enforcement program, and the extent of the private securities litigation regime in the U.S. (Cox, Thomas, and Kiku 2004-05). Scholars attribute the relative robustness of the private regime in the U.S. largely to the “American Rule” of litigation. Under this ‘Rule,’ parties

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are responsible for their own attorneys’ fees and litigation costs (in contrast, for instance, to the ‘loser pays’ basis of the “English Rule”), those costs can be paid via contingency fees, and plaintiffs have the option of participating in a class action suit (Id. at 894; Farhang 2010, 61).

In general, private litigation regimes apply in some form to more than fourteen policy areas on the federal level in the U.S. (Farhang 2010). Clearly one of the most aggressive forms of private regime, however, is the securities class action.234 These private suits comprise on average about half of all class actions filed annually in the U.S., distinguishing this genre as the “800-pound gorilla” when compared to other private regimes, such as antitrust and civil rights, that are utilized for federal civil enforcement (Coffee 2006, 1539). Nearly sixty percent of U.S. companies have a securities class action pending against them at any moment in time.235 Because of the sheer volume as well as the complexity of many of the cases, this category of private enforcement consumes a disproportionate amount of the federal judiciary’s resources. In effect, this compels the U.S. taxpayer to subsidize the private securities litigation regime (Id. at 1540).

**Social Utility of Private Litigation Regimes: Deterrence and Compensation**

Scholars generally accept that the social utility supporting the existence of the private securities enforcement regime can be simplified into two prongs: to deter future malfeasance and to compensate actual victims (see, e.g., Helland 2006). In extreme incidences of the deterrence prong, Congress has explicitly extended the right of private

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234 See *supra* note 193.

235 See *supra* note 218.
action to parties to help agencies enforce statutes even when those parties have not
directly suffered “tort-like” damages that can be compensated through litigation (Rose
2008, 1307). The policy area where Congress pioneered this structure is environmental
enforcement.

**Deterrence: Comparing EPA’s Private Enforcement Regime to SEC’s**

Most core enforcement statutes administered by the EPA since 1970 contain
“citizen suits” clauses that – similar to the private securities enforcement regime –
empower ‘private attorneys general’ to bring suit and extend the agency’s reach to
compensate for its finite resources. The key differences between the EPA- and the
SEC-related private regimes, though, apply to the powers vested in the EPA-based
private attorneys general.

Under the private environmental regime, plaintiffs need not allege that they
suffered personal harm from an environmental violation that necessitates compensation
by the defendant in order to file a case. Congress therefore permits plaintiffs in the
environmental regime to circumvent the usual rules of judicial standing. Instead, private
plaintiffs are authorized to function effectively as a true extension of the Office of Civil
Enforcement of the EPA by investigating violations and strategically targeting alleged
polluters across federal district jurisdictions. As a result, the typical plaintiffs that have
emerged are not private individuals represented by tort-injury counsel in a class action,

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but rather they are environmental interest groups established to take advantage of this unusual, aggressive private enforcement regime.\textsuperscript{237}

In addition, the primary goal of plaintiffs in this private regime is to obtain monetary penalties against polluters – not to recoup personal losses as in securities litigation. The plaintiffs are not entitled to any such penalties awarded by a federal district court. Rather, the penalties are deposited into a U.S. Treasury fund. The provisions of these citizen suits also circumvent the ‘American Rule’ discussed above, since they enable cost-shifting as district courts will award attorneys’ fees and other litigation costs to the prevailing party.\textsuperscript{238}

The proverbial wild card in this regime is that private citizens are empowered to bring suit against the EPA Administrator to compel the agency to perform its role in specific cases under the relevant environmental acts. In this way, Congress actually delegated a qualified oversight role to private citizens over the agency. A comparable direct oversight role of the SEC is clearly absent from the private securities enforcement regime.

The EPA, on the other hand, may intervene as of right in any cases brought under this regime against private defendants. The SEC’s involvement in private litigation is more circumspect – it can become involved directly through amicus briefs or indirectly through the fruits of litigation outcomes such as the development of evidence and the application of the doctrine of collateral estoppel, as discussed below.\textsuperscript{239} The Attorney

\textsuperscript{237} See Blomquist (1988) for well-argued critical analysis of the environmental citizen-suit structure.

\textsuperscript{238} This structure mitigates the problem of misaligned incentives that is sometimes present in class action securities litigation and manifests as an agency problem as described in note 219 \textit{supra}.

\textsuperscript{239} \textit{Cf.} Note that private litigants sometimes attempt to intervene in ongoing SEC public enforcement cases where their legal interests may be linked to issues being litigated or where they may be planning to file
General litigates on behalf of the EPA when the agency intervenes; the SEC OGC typically represents the SEC when it becomes involved in private litigation. Thus, the EPA’s option to intervene gives the agency a direct ability to monitor private plaintiffs. The SEC, in contrast, can only monitor and attempt to control private securities enforcement indirectly through the strategic use of direct and indirect means.

Although beyond the scope of this dissertation, an excellent research question that emerges from this discussion would be to determine to what extent the environmental litigation interest groups that evolved in response to this private enforcement regime ultimately played a role in the political realm. These interest groups would have a well-defined hierarchy, fundraising capability, and natural constituency – as well as the attention of EPA bureaucrats – and could have readily leveraged those factors into political power. It would also be fair to presume that such groups would have an ideologically liberal leaning. Thus, in theory, the creation by Congress of such a private litigation regime may have also spawned political interest groups, intentionally or not, that would support environmental causes and help foster the nascent bureaucracy, while promoting a liberal environmental agenda and helping to perpetuate their own existence in the long-term.

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private litigation separately in the same matter. Section 21(g) of the 1934 Act, passed as an amendment in 1975, prohibits consolidation of private cases with SEC public enforcement actions unless the SEC consents to such combination. It is not clear whether a prohibition on consolidation also prevents any form of intervention, but that has been the SEC’s argument for nearly four decades because it does not want to cede authority from its enforcement program to private litigants. The federal circuit courts remain split on this issue. (For a good discussion, see John F.X. Peloso and Stuart M. Sarnoff, Morgan Lewis (law firm). “Private Litigant Intervention in SEC Cases,” http://www.morganlewis.com/pubs/8BAAF7F4-3EB3-481B-BF44AC4745FEE4F4_Publication.pdf).

240 Except for Supreme Court litigation, which the Solicitor General handles for the government on behalf of the SEC (see discussion in Chapter 2).
Also, it is interesting to consider what would occur if the SEC had to interact with such empowered activist groups as part of its regular constituency. Imagine groups of private citizens – who would not need to establish standing by being shareholders of a regulated company – being statutorily authorized to investigate potential securities violations and litigating not for personal recompense, but to penalize financial wrongdoers? An interesting research topic would be to compare the SEC and the securities law regime to the EPA and its legal regime and analyze why such an approach never took hold in securities law and also to determine why such a regime would simply not be appropriate – or would work well if given the chance – in private securities enforcement. I do not advocate a position here, but simply posit potentially fertile research questions.

**Hybrid: Qui Tam Private Enforcement Regime**

The qui tam provisions of the False Claims Act comprise private litigation that is a hybrid of elements of the SEC and EPA regimes. The relevant federal agency can directly monitor private plaintiffs who are partially incentivized by the potential financial awards of filing suit. These provisions are designed to encourage private parties to function as whistleblowers and sue federal contractors who allegedly defraud the government.

This private litigation enforcement process under the False Claims Act is straightforward. A private plaintiff delivers a complaint, and supporting evidence,

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241 Qui tam provisions authorize private litigants to bring law suits on behalf of the government to recover a statutory penalty (see, e.g., Beck (2000)).

against a defendant to the DOJ for evaluation. This triggers the federal government’s
direct monitoring mechanism (Rose 2008). It can decide to intervene in the litigation and
have the DOJ take over responsibility for the case, or remain completely on the sidelines
and permit the private party to file suit. This functions as an ‘either-or’ component –
where the federal agency litigates, the private plaintiff cannot participate.

Under either option in the qui tam regime, the private plaintiff receives a
percentage of the penalty plus litigation costs if the defendant loses (Stephenson 2005). I
view this as a ‘bounty’ for successful whistle blowing. The proceeds of successful qui
tam litigation do not compensate for direct tort-like injury to the plaintiff, but do
compensate for indirect damages on the private-plaintiff citizen as a taxpayer who had
been harmed via contractor fraud on entity the plaintiff supports financially – the federal
government.

This statutory qui tam structure makes the regime truly supplemental and
complementary – public and private forms of enforcement cannot overlap. This is not
necessarily the case for the SEC.

Compensation Prong: The EEOC Private Enforcement Regime

The private enforcement regime under the jurisdiction of the Equal Employment
Opportunity Commission (EEOC)\textsuperscript{243} contains a direct-monitoring element, but also
typifies an aggressive victim-compensation prong of the social utility justification for

\textsuperscript{243} See Farhang (2010) for an excellent, detailed history of the development of the private enforcement
regime of the EEOC. When the EEOC was founded, Congress had not yet delegated to it the power to
prosecute claims in federal court. Farhang’s work, in part, describes how Democrats in Congress drove the
expansion of the EEOC private enforcement regime in the early 1990’s in the face of conservative
opposition from the White House and federal judiciary. His study tends to show there was clearly an
ideological component to the expansion of the EEOC private-enforcement regime.
By statutory design, the agency has a distinct monitoring role over the private litigation regime that distinguishes it from the SEC. In practice, however, the EEOC has been criticized as being relatively weak implementing its enforcement role (Selmi 1996) – in contrast to the more aggressive SEC – resulting in the private litigation regime picking up much of the agency slack.

In terms of the direct monitoring authority of the EEOC, every party wanting to bring a discrimination claim under the statutes the EEOC administers must initially file a charge with the agency, and this filing generally frames any subsequent litigation. The agency is then mandated to complete an investigation into the merits of the claim within 180 days to determine whether to stay involved – and encourage the parties to voluntarily negotiate a settlement – or withdraw (Farhang 2010). This statutorily directed filtering and direct participation by the agency is absent in the structure of the private securities enforcement regime. In practice, though, the EEOC system often grows backlogged, sometimes preventing the agency from performing a substantive review, thus defeating purpose of the agency monitoring structure (Selmi 1996).

When the EEOC does not review the claim within the allotted time period, it must issue a right-to-sue notice, giving the plaintiff jurisdiction to file a claim privately in either federal or, when relevant, state court. In these cases, the agency process serves little purpose other than delaying the onset of private litigation (Id.). When the EEOC

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244 The EEOC is responsible for investigating and enforcing claims of discrimination under Title VII of the 1964 Civil Rights Act (still the agency’s primary mandate), the Equal Pay Act of 1963, the Age Discrimination in Employment Act of 1967, the Americans with Disabilities Act of 1990, and the Genetic Information Nondiscrimination Act of 2008. The Equal Employment Act of 1972 provided the EEOC with prosecution authority that it lacked when established, while maintaining the private enforcement regime under the rubric of Title VII (Id. at 147).

completes its investigation within the parameters of the statutory design, however, it has the option of finding that the case has merit, in which case it will invite the parties to voluntarily negotiate a settlement – or a “conciliation” – to resolve the claim. Thus, the EEOC, as distinct from the SEC, has the option of taking a direct, active role in encouraging settlement between the parties.

Should the parties fail to reach agreement, the EEOC may file suit on behalf of the claimant, which is an option the SEC does not have in the private securities enforcement regime. In contrast, if the agency determines that the discrimination claim lacks merit, it will issue a “no-cause” letter to the plaintiff explaining that the agency will not file suit. This decision by the EEOC, however, does not preclude the plaintiff from still pursuing a claim. A plaintiff has 90 days from the ‘no-cause’ determination to bring an action against the defendant (Id.). As a result, the statutory filtering is compromised. The EEOC cannot directly prevent the plaintiff from pursuing a relatively weak claim from inappropriately utilizing judicial resources through private litigation. Its no-cause letter, though, may have an indirect, and important, evidentiary influence on the outcome and help shorten the litigation path through an early motion to dismiss by a defendant. The SEC, under the private securities enforcement regime, does not have as direct a role as the EEOC, but its own public enforcement efforts can produce an indirect effect through the legal doctrine of collateral estoppel, as discussed below.

246 The concept of giving the SEC authority to bring suit on behalf of investors, however, has been suggested intermittently over recent decades (Hazen 1979-80 (SEC option to handle suits above certain floor of damage claims); cf. Arthur Levitt, SEC Chair. February 10, 1995. “Testimony Concerning Litigation Reform Proposals before the Subcommittee on Telecommunications and Finance Committee on Commerce, United States House of Representatives” (proposing before congressional oversight subcommittee that SEC be given formal role to testify on material legal issues in any private litigation); cf. Rose 2008 (“oversight approach” proposal, to give SEC ability to screen meritorious private claims under §10(b) pre-filing in private litigation)).
Private Enforcement Regime in Absence of Agency Role

Finally, the NLRB provides an example of a federal agency that – in stark contrast to the SEC – is not empowered to participate in either a direct or indirect role in a private enforcement regime. This is, in part, because the agency’s authorizing statute – the NLRA – does not provide explicitly for a private cause of action. Scholars have noted also that the NLRB, unlike the SEC, as discussed above, has not pursued an implicit private right of action through the strategic use of amicus briefs or other litigation-related submissions to the federal courts since its founding nearly eighty years ago (Brudney 2004-05).

This is likely a vestige of the NLRB’s original weak enforcement authority which, under the NLRA, resides solely with its board. The agency’s adjudication of unfair labor practice claims is purely administrative – Congress did not empower it to use the lower federal courts for enforcement. Thus, the agency has not been delegated, and has not created, a natural vehicle for developing common law in the federal courts that would support an implicit right of action for unfair labor practices as defined under the NLRA. In this context, some labor activists have argued Congress should revise the NLRA to authorize the NLRB to have powers of case-merit review and the ability to authorize jurisdiction for private litigation in a regime that parallels the powers of the EEOC under the 1964 Civil Rights Act (Civil Rights Act). 247 Given the decidedly mixed effectiveness of the EEOC under its respective private regime, and the absence of support in Congress for this type of proposal, the concept as applied to the NLRB will likely remain in the

form of a proposal. Nonetheless, it is useful for illustrating some of the key distinctions of the private enforcement regime supporting the SEC’s civil enforcement program.

Table A.1 Summary Comparison of Models of Private Enforcement Regimes

<table>
<thead>
<tr>
<th>Agency or Regime</th>
<th>Role of Private Plaintiffs</th>
<th>Litigation Goal of Plaintiffs</th>
<th>Agency Authority to Intervene</th>
<th>Unique Authority or Characteristic</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEC</td>
<td>File suit on own behalf independently from SEC</td>
<td>Recover personal damages</td>
<td>Not as of right; direct participation through amicus, indirect through ‘fruits’ of litigation</td>
<td>Agency enforcement gives rise to many private suits</td>
</tr>
<tr>
<td>EPA</td>
<td>Obtain penalties against violators of anti-pollution statutes</td>
<td>Not for personal recovery; don’t need to allege personal harm</td>
<td>As of right; Attorney General litigates for agency; agency can be compelled by private plaintiffs to litigate in some cases</td>
<td>‘Citizen suits’ spurred creation of environmental activist groups to serve as private plaintiffs</td>
</tr>
<tr>
<td>Qui Tam</td>
<td>Whistleblower; confront fraud against federal agencies</td>
<td>Personal harm not necessary; can recover statutory ‘bounty’</td>
<td>As of right; DOJ litigates; cannot be compelled by private plaintiff to litigate</td>
<td>‘Either or’ component: where federal agency litigates, private plaintiffs are barred</td>
</tr>
<tr>
<td>EEOC</td>
<td>Must first file with agency to pursue claim; can’t be prevented from following through by agency, though</td>
<td>Recover personal damages</td>
<td>Option for agency to file on behalf of private plaintiff; can permit plaintiff to proceed alone; can issue ‘no-cause’</td>
<td>Distinct monitoring/filtering role by agency does not work efficiently</td>
</tr>
<tr>
<td>NLRB</td>
<td>None</td>
<td>None</td>
<td>Litigation power is purely administrative</td>
<td>Activists have sought EEOC-type authority for this agency to no avail</td>
</tr>
</tbody>
</table>

Source: Discussion in Addendum
SEC’s Participation in Private Securities Enforcement Regime

The SEC actively participates in the private securities enforcement regime through two means, but only one of these is direct. The direct and far more substantial and controllable form of participation occurs through the strategic use of amicus briefs in the federal courts. This is also the primary means the agency has for influencing the private regime. The indirect form is through producing fruits of litigation, such as the production of evidence and enabling the application of the doctrine of collateral estoppel,\footnote{The definition of ‘collateral estoppel’ is: “When an issue of ultimate fact has been determined by a valid judgment, that issue cannot again be litigated between the same parties in future litigation.” (Black’s Law Dictionary, 5th Edition. 1979. St. Paul, Minnesota: West Publishing Company, p. 237).} that significantly assist a plaintiff in a private action that is spawned from, or running parallel to, a public enforcement action filed by the SEC.

**Direct: Strategic Use of Amicus Briefs**

The SEC’s longstanding strategic use of amicus briefs is natural and sensible from a rational economic perspective. The SEC has been perceived publicly for decades by disparate sources as an agency whose profound enforcement mandate and resource allocation do not align well.\footnote{See, e.g., Timbers (1954, 10-11) (explaining that “(b)udget limitations” compel agency to select amicus cases with care); Hazen (1979-80, 461) (citing “limited resources” of agency); and GAO (2002, 32) (“ongoing resource limitations” contribute to SEC not keeping up with growing volume and complexity of financial fraud). This critique continued even after enhanced funding for the agency provided by Sarbox.} In this context, the agency’s use of amicus briefs is a low-risk, low-resource-intensive strategic behavior.

It empowers the SEC to achieve legislative goals it did not – or could not – obtain from Congress, or by means of agency rulemaking, through influencing the promulgation of common law favorable to its enforcement program via the federal judiciary. In
contrast to its public civil enforcement program, the SEC does not have to invest the resources and time into a full-blown investigation and potentially complex litigation in order to influence an outcome when using amicus briefs. Importantly, as with its public posture towards the private securities litigation regime in general, the SEC consciously balances its approach to the strategic application of amicus briefs and also avoids over-utilizing them so as not to instigate a backlash from the federal courts. This caution limits the SEC’s exposure and stands in contrast to its public enforcement program, where the agency is compelled to try to win or settle most of its cases to justify its annual appropriations and expenditure of resources.

**Amicus Process within the SEC**

The OGC, chief legal officer of the agency who provides a variety of legal services to the SEC and its staff, administers the amicus program for the agency. The OGC is distinct from the Division of Enforcement at the SEC, and reports directly to the Commissioners. The Appellate Litigation Group within the OGC assesses cases and develops amicus recommendations for private securities actions in the federal circuit courts, and the OGC’s General Litigation Group handles the far smaller volume of potential amicus cases in the district courts.

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250 Goelzer (1988, 2), for instance, estimated that less than .5% of overall SEC staff time and less than 10% of Office of General Counsel time was dedicated to amicus briefs during his tenure as General Counsel.

251 There are only three public accounts – each via public address by an active SEC General Counsel – describing the fundamentals of the agency’s amicus program – Timbers (1954), Goelzer (1988), and Prezioso (2004). This section discussing SEC amicus process and decision making draws partially on these primary source documents in its description of the program within the agency.

252 [http://www.sec.gov/about/offices/ogc.htm](http://www.sec.gov/about/offices/ogc.htm)
SEC career senior staff who lead these groups in the OGC and manage the process are critical for ensuring that the agency’s policies are essentially consistent as expressed through amicus briefs over time. This bottom-up process attempts to mitigate the potential effects of short-term preference shifts driven by changes in the political ideology of SEC Commissioners and the agency’s political principals. It also reflects, to an extent, the cautious positions toward the private litigation regime that the SEC takes publicly. Through this depoliticizing element, the agency has also tried to strategically build credibility in the federal courts that have handled private securities litigation through the decades. The federal courts now typically expect a technically competent, useful amicus brief from the SEC even if they do not ultimately agree with the agency’s arguments.

**Sources of SEC Amicus Cases**

In contrast to the relatively organic generation of cases populating the SEC’s public civil enforcement program, the SEC becomes aware of potential amicus cases basically from three sources. The sources are, first, where one or both of the parties in a private securities case will request that the SEC file an amicus in support of their position. This is so common that the SEC has published basic guidelines and contact information for litigants on its web site.²⁵³ Remarkably, members of both houses of Congress would sometimes directly pressure the SEC on behalf of constituents involved in private securities litigation to file amicus briefs supporting the arguments of those

constituents (Timbers 1954). This practice seemed to have subsided in recent decades, though overt political pressure has been applied quite recently to the amicus decision making process and is described below in the *Stoneridge* case discussion.

Next, all levels of the federal judiciary seek the agency’s input on matters ranging from, at the Supreme Court, whether a securities issue is appropriate for granting *certiorari*, to district courts seeking technical assistance in handling complex securities cases. In the modern era, the SEC will respond affirmatively with an amicus brief to the request of a federal court to maintain its reputation of reliability and technical competence and take advantage of an opportunity clearly identified by a court to influence an outcome (Prezioso 2004). This policy of cooperation with the federal judiciary did not, however, always prevail in the agency. Finally, the third source of amicus cases is the Appellate and General Litigation Groups in the OCG, who continuously monitor federal dockets for cases containing fact patterns and potential issues that the SEC can utilize strategically to help shape law favorable to its mission.

**SEC Approval and Filing of Amicus Cases**

When the agency contemplates a potential case that is in the lower federal courts, the OGC seeks input and guidance from the divisions or offices within the agency that have a particular expertise in the relevant issue areas and would likely be affected by the outcome. Often, this process involves the Division of Enforcement. In addition, the

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254 Particularly after the Vesco affair, which surfaced during the Nixon Administration, brought the issue of political influence over an independent regulatory agency, the SEC, to the attention of the media and the public (*see* note 92 *supra*).

255 Federal circuit courts had criticized the SEC in published opinions in the past when the agency refused their requests to file amicus briefs (Timbers 1954).
OGC typically invites the parties to the lower-court litigation to offer their arguments to SEC staff and respond to the agency’s questions as it attempts to develop a position towards an amicus case. (Goelzer 1988; and Id.)

Oddly, this form of OGC pre-litigation ‘hearing’ appears to comprise a quasi-judicial exercise that invokes separation of powers issues. The SEC, an independent executive agency, encourages the parties to litigation within the jurisdiction of an Article III federal court to make arguments and present evidence about a case so that the agency can prepare for its role as ‘friend of the court’ – analogous to another litigant. This seems outside the purview of the SEC’s delegated adjudicatory authority exercised through quasi-independent ALJ’s discussed in Chapter 3. Yet, this practice has gone unchallenged by the Article III federal courts for decades and remains an efficient means for the agency of performing due diligence on potential amicus cases.

The final step in the process occurs after the OGC determines that it would be appropriate for the agency to file an amicus brief in the lower federal courts. It drafts a memorandum to the Commission laying out its rationale for accepting the case and its proposed legal arguments. A majority of the Commission members must then vote to approve the amicus filing. The legal positions and policy arguments in an amicus brief in the lower federal courts constitute the official views of the agency (Prezioso 2004).

The SEC amicus process contains an additional component for Supreme Court cases since the agency is authorized to conduct its own litigation before the lower federal courts, but not the Court – where it must be represented by the Solicitor General. For potential amicus cases before the Court, the Commission provides its recommendation to the Solicitor General seeking authorization to file. If the Solicitor General approves an

256 See discussion in Chapter 2 and notes 95-97 supra.
amicus filing, it usually works closely with the SEC to develop the brief, delegating the initial draft to the agency to take advantage of the agency’s technical expertise, and then revising it in preparation for oral arguments before the Court on behalf of the administration.

This interagency process is typically cooperative, though occasionally the Solicitor General and the SEC disagree materially. In the past, the Solicitor General has handled such conflict by permitting the SEC to file a brief on behalf of itself as an agency with the Court, then submitting its own amicus brief on behalf of the administration with arguments contrary to those of the agency. This strategy does not generally work out well for the SEC.\textsuperscript{257} In a recent twist, however, the Bush Administration’s Solicitor General flatly prohibited the SEC from filing an amicus brief with the Court in \textit{Stoneridge}\textsuperscript{258} when the agency’s position – which was consistent with its stance in similar prior cases – contradicted the administration’s position. I analyze this unusual, highly politicized outcome below as a brief case study because it illustrates well many of the key elements of this Addendum.

\textit{Evaluating Potential Amicus Cases}

In stark contrast to its public civil enforcement program, the SEC has almost full discretion over the cases it selects (with the qualified exception of requests from federal courts, as noted above) in its amicus program. The agency submits, on average, 15 – 20

\begin{footnotesize}
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\item[\textsuperscript{258}] See note 220 supra.
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amicus briefs annually,\textsuperscript{259} with most of those filed in the federal circuit courts, some with the Supreme Court, and a very small number filed with federal district courts.\textsuperscript{260} Generally, the SEC avoids committing amicus resources to cases in the district courts because the opinions produced by those judges are often not published and, even when they are, lack the precedential value that would justify the commitment of the agency’s efforts (Ruder 1989).\textsuperscript{261}

The SEC does not maintain official agency rules for determining whether to accept an amicus case (Prezioso 2004), but has posted basic guidance online.\textsuperscript{262} This guidance is essentially a heavily redacted version of a group of “litmus tests” provided by a former SEC General Counsel to an audience of securities law practitioners (Goelzer 1988, 9). The core concept behind these ‘tests’ is that the SEC’s participation in an amicus case is not based on the nature of the parties, but on the legal issues at stake as well as the potential policy statement the agency can make via its commitment of resources. Moreover, the most heavily weighted point is the effect the decision in a private securities case could have on the SEC’s public civil enforcement program. That is, does the case involve core issues that, once decided by a federal court, could provide

\textsuperscript{259} Prezioso (2004, 1) estimates the average number of amicus briefs filed per year is \(~ 15\); Goelzer (1988, 3) estimates 20; and the outlier, Ruder (1989, 1176), estimates a much higher average of 45.

\textsuperscript{260} Ruder (1989) estimated 85\% of amicus briefs were filed in circuit courts.

\textsuperscript{261} A rare exception to this general rule was a line of private litigation involving the interpretation of various elements of the PSLRA, stretching out a decade after its enactment in 1995. The SEC filed 14 amicus briefs addressing key issues in this line of cases – many of them at the district level. The agency determined that some of the cases would not likely progress to the circuit courts and wanted to influence the establishment of early interpretive precedent (see Paul A. Atkins, SEC Commissioner. February 16, 2006. “Remarks before the U.S. Chamber Institute for Legal Reform.” U.S. Securities and Exchange Commission, Washington, D.C.).

\textsuperscript{262} See note 253 supra.
lasting legal precedent that ultimately migrates from the private regime into the SEC’s realm of public enforcement.\textsuperscript{263}

Also, when the SEC is evaluating potential cases pursuant to the substantive guidelines, the realities of private litigation bring other material factors into play. For instance, the SEC may refuse to file an amicus on a key emerging issue in a certain federal district – or with a particular judge – where the agency has a bad track record or believes the court would not take a favorable view toward the agency or its litigation position. According to a former Commissioner, “(t)he Commission may decide not to become involved in a private action which raises important legal issues in an unfavorable posture. When the same issues arise in a number of different forums, the Commission can typically afford to be more selective.”\textsuperscript{264} This aspect of the agency’s amicus behavior is reminiscent of its forum selection behavior in the public civil enforcement program. The distinction with the amicus program, however, is that the agency actually knows which federal judge will hear a case, and has access to the arguments of both sides in the litigation, before it makes its final decision on filing an amicus brief.

**Do Amicus Filings Tend to Favor Positions of Plaintiffs?**

If the SEC’s amicus filings tended to always support the positions of the plaintiffs in private securities litigation, the agency would risk overstepping its role by appearing to favor one class of litigant over another. This would upset the agency’s public balance of interests, discussed above, that it works consistently to present to the federal courts and to its congressional oversight and appropriations subcommittees. The senior staff who

\textsuperscript{263} An example of this is illustrated in the discussion of *Janus Capital Group, Inc. et al.* in this *Addendum.*

\textsuperscript{264} Ruder (1989, 1177).
administer the amicus program and make recommendations to the Commission try to
employ a long-term, macro strategy designed to foster the reputation of the agency as credible, technical and focused on its primary mission as discussed in Chapter 2 – to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.

The challenge for the SEC remains, however, that the amicus role naturally steers the agency toward the side of plaintiffs for two fundamental reasons. First, private securities litigation is often an extension of the SEC’s public enforcement role, where a plaintiff is pursuing a claim against a defendant for an alleged violation of the securities laws. Thus, the issues that arise for the SEC in its civil prosecutorial role are often analogous to those for a plaintiff in a private securities case. Second, plaintiffs introduce through private litigation many new issues regarding the scope and interpretation of securities statutes – and the litigants and federal courts frequently ask the agency to weigh in on them to provide a policy context. Since both of these factors trend in the same direction, the SEC must be conscious of trying to maintain a balance between categories of litigants when deciding to commit resources to filing an amicus brief.

An example of how this remains an ongoing concern for the SEC is the conclusion of a Supreme Court Justice, cited as evidence by a current-day conservative scholar that the SEC typically sides with plaintiffs. “The SEC usually favors all (plaintiffs). I can’t recall a case in which this was not so.” The agency has since tried to offset this impression through public statements for decades to maintain its credibility,

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265 Pritchard (2007-08, 246) (arguing “The SEC consistently sides with the plaintiffs’ bar in its amicus role, and even minor deviations from that role bring a firestorm of criticism from the plaintiffs’ bar and its allies,” citing Justice Lewis F. Powell, Jr. from Bench Memorandum, Herman & MacLean v. Huddleston, from Jim (Browning) to Justice Powell, September 9, 1982, p. 20 (parenthetical added; footnotes omitted)).
because it realizes that should its reputation for legal and policy integrity begin to suffer, the effectiveness of its amicus program would be in jeopardy.\textsuperscript{266}

For instance, in the spirit of emerging securities litigation reform in 1995, SEC Chair Levitt stated in a speech that the agency had actually “…begun to file amicus briefs in support of motions (by defendants) to dismiss” where it felt the plaintiff was overreaching in its attempted application of the securities laws.\textsuperscript{267} An SEC General Counsel related publicly in a speech a situation where the agency had filed an amicus brief in support of the position of a party in private litigation that the agency was suing independently in a public civil enforcement action as proof that the agency ignored the nature of the plaintiffs and focused on policy and precedent in amicus decision making (Prezioso 2004, 4). Moreover, a former Commissioner explained also that the SEC will sometimes disappoint both litigants in a private case by filing an amicus brief that supports elements of the arguments of each side (Ruder 1989, 1169 n. 9).

Although this Addendum illustrates the SEC tries hard to portray a balanced approach to selecting cases for amicus participation in terms of not favoring one class of litigant over another, this decision making process provides another potential opportunity for evaluating empirically whether ideology affects agency behavior. Such an analysis was beyond my time and resource constraints in writing this dissertation. But a future analysis could prove fruitful if it were to tackle such research questions as (i) whether the

\textsuperscript{266} The SEC experienced a taste of this as the Supreme Court grew more conservative during the 1970’s and became less responsive to the agency’s amicus arguments, which at that time focused mostly on expanding the scope of private causes of action under the securities laws. For example, in 1979 Justice Powell summarized the Court’s amicus interactions with the SEC during the decade: “On a number of occasions in recent years this Court has found it necessary to reject the SEC’s interpretation of various provisions of the securities acts.” (International Brotherhood of Teamsters v. Daniel, 439 U.S. 551, 566 n. 20 (1979)).

ideology of the SEC or its political principals affected the type of issue – and the side of
the issue – the agency chooses in amicus briefs, (ii) whether its amicus participation is
affected by the ideology of the lower federal court hearing the case (remember, the SEC
knows the identity of the judge in a particular case prior to filing an amicus brief), and
(iii) whether the ideology of the Solicitor General (or their political principals in the
White House) affects the content of the SEC’s amicus briefs at the level of the Supreme
Court.

The SEC is conscious of its demarcated role in private litigation, but on occasion
its amicus decision making reverberates negatively on the agency. The following brief
case study draws on one of those instances, and illustrates the difficult professional and
political balance the SEC faces when it participates as a federal executive agency in the
private securities litigation regime.

Stoneridge: Complex Outcome for SEC

In the lead-up to the Court’s decision in Stoneridge Investment Partners discussed
earlier in this Addendum, the Commission had approved the recommendation of the OGC
by a 3-2 vote to submit an amicus brief supporting the position of the plaintiffs – i.e. that
the aider and abettor provisions of §10(b) should be extended beyond public civil
enforcement to cases based on implied private rights of action and, therefore, private
plaintiffs could sue accountants, attorneys and other service providers of companies who
allegedly defrauded them. When reaching its decision, as part of utilizing its usual eight-
point litmus-test guidance, the SEC factored in key components such as its unanimous
decision in 2004, under the leadership of a prior Commission Chair, to submit an amicus
brief in *Simpson et al. v. Homestore.com* supporting a broader definition of aider and abettor liability in implied private actions. The agency was incentivized to be predictable to the federal courts and Congress by remaining consistent with its earlier precedent. As the SEC’s new Chair, Christopher Cox, testified before the agency’s primary oversight committee in Congress months before the Court rendered a decision in *Stoneridge*:

> (I)t is my view generally with respect to decisions that are recently taken by the SEC in precedent matters – that, because *Homestore* and *Stoneridge* were very much on all fours with another, I thought it important for the SEC to be consistent and be clear on these (amicus) points…I do not believe the SEC…policies and so on should…change with one or two (new Commissioners) coming on board…I thought it important for us to be consistent.

In addition, Cox brought the agency’s quasi-judicial practice of pre-litigation hearings a step beyond its usual bounds and met with plaintiffs’ counsel, but not defense counsel, from a different case involving private parties litigating Enron-based claims. That litigation was pending the Court’s decision on *certiorari* and would likely turn on the outcome of the *Stoneridge* opinion. Cox had been a conservative Republican congressman prior to his appointment by President Bush to chair the SEC, having even sponsored the PSLRA legislation in the House. Yet, after listening to the arguments of the Enron plaintiffs, Cox decided to move along the aggressive amicus recommendation, and ultimately voted in favor of it. Otherwise, the Commission was split along

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268 519 F.3d 1041 (9th Circuit) (2008).

269 Christopher Cox, SEC Chair. “Testimony - Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission.” *Hearing before the Committee on Financial Services, United States House of Representatives*, 110-46, 110th Congress (June 26, 2007), p. 23 (and see pp. 50-51 where Chair Cox expounds upon this theme) (parentheticals added).

ideological lines in the vote, as Commissioners Paul A. Atkins and Kathleen Casey, two Republican appointees of President Bush, voted against the amicus filing.

The SEC forwarded its brief in *Stoneridge* to the Solicitor General for review and input because the case had been granted *certiorari* by the Court and, as explained above, this form of inter-agency cooperation is statutorily mandated. The SEC was confused and stunned, however, when the Solicitor General did not submit its amicus brief for *Stoneridge* by the Court’s filing deadline.²⁷¹ Unbeknownst to the SEC, because *Stoneridge* represented a case that could define the future course of implied rights of action in the private regime for decades, the political scrutiny it was drawing compelled the Solicitor General to take an “unusual,” but not unethical, step and confer directly with the White House prior to finalizing his amicus decision.²⁷²

The President apparently made it clear that he did not believe the extension of implied private rights of action was appropriate along the lines of the claims made in *Stoneridge*, so the Solicitor General, technically representing the entire administration rather than the SEC as an agency, used his discretion to refuse the SEC’s request to file.²⁷³ Strikingly, whether at the behest of the White House to provide technical economic input behind the scenes, or as the result of independent decision making (the actual motivation remains unclear), other federal agencies such as the Department of the Treasury, the Federal Reserve, and the Office of Comptroller of the Currency officially requested that the Solicitor General not file an amicus supporting the position of plaintiffs


²⁷³ Ibid.
in the case. The Solicitor General ultimately filed an amicus brief on behalf of the Bush Administration opposing the plaintiffs’ position, arguing:

Allowing liability...under the circumstances presented here would constitute a sweeping expansion of the...private right of action in Section 10(b) and Rule 10b-5, potentially exposing customers, vendors, and other actors far removed from the market to billions of dollars in liability... It would be particularly inappropriate to allow private liability under these circumstances in light of Congress’s rejection of a private right of action for aiding and abetting liability under Section 10(b).  

This amicus power play by the Solicitor General compelled an ideologically balanced fraternity of three former SEC Commissioners, including two past Chairs, to successfully petition the Court to file their own amicus brief in support of the plaintiffs’ position and, indirectly, their current brethren at the SEC. A public amicus filing like this by former SEC Commissioners against the government’s position was exceedingly rare. Though from different political parties and spanning the spectrum ideologically, the loyalty of these former Commissioners to the institution of the independent agency and its historical processes unified them in this instance. This also, perhaps, reflected the same dynamics that had convinced Cox, contrary to his ideological conviction, to originally vote to support a filing by the SEC. In addition, former SEC senior staff came out publicly in the media after the filing deadline, but before the Court ruled on the case,


275 Arthur R. Miller, Counsel of Record. August 15, 2007. “Motion for Leave to File Brief Out of Time and Brief Amici Curiae of Former SEC Commissioners in Support of Petitioner.” In the Supreme Court of the United States, Stoneridge Investment Partners v. Scientific-Atlanta et al., 06-43. The Commissioners who signed onto the amicus brief were: William Donaldson, former SEC Chair (Bush 43 Republican appointee, 0.797 ideology score from Table 4.1), Arthur Levitt, former Chair (Clinton Democratic appointee, -0.720 score), and Harvey Goldschmid, former Commissioner and SEC General Counsel (Bush 43 Democratic appointee).
and stated that they could not remember another instance of the Solicitor General essentially pocket-vetoing an amicus brief of the SEC.\textsuperscript{276}

A different set of three SEC Commissioners – all former Chairs – led a contingent of eleven former SEC Commissioners and two former SEC General Counsels to file their own amicus brief in support of the position taken by the government through the Solicitor General.\textsuperscript{277} This unusual public statement by former SEC officials was followed by strong public criticism of the amicus recommendation and the agency’s decision making process from a current Commissioner involved in the proceedings. In an effort that was highly unusual because of its source as well as its targeted political content, SEC Commissioner Paul Atkins took his commentary well beyond the usual general policy statements that SEC Commissioners make through speeches at universities or to bar associations and advocated a position for \textit{Stoneridge} on the very day the Court held oral arguments in the case.\textsuperscript{278} This reflected a trickle-down effect – the political energy of the case in its earlier stages at the SEC was enhanced because of the interaction between the White House and the Solicitor General. This interaction fed into a series of public political statements and acts by current and former SEC officials, White House officials and members of Congress, and basically undermined the usually intentional low-key aspect of the amicus process that the SEC has methodically tried to nurture over the decades.

\textsuperscript{276} See note 270, supra.

\textsuperscript{277} Mark A. Perry, Counsel of Record. August 14, 2007. “Brief for Former SEC Commissioners and Officials and Law and Finance Professors as Amici Curiae Supporting Respondents.” In the Supreme Court of the United States, Stoneridge Investment Partners v. Scientific-Atlanta et al., 06-43.

Despite these protestations, though, Cox had understandably tried to publicly soften the notion of a political conflict between the White House and the SEC, perhaps realizing that even though the agency was independent, having the administration believe he had ‘gone native’ in a bureaucracy would not do much to help him advocate for appropriations or in policy discussions on behalf of his agency – or further his own career. As he testified, accurately, before the SEC’s primary House oversight committee, chaired then by liberal Democratic Representative Barney Frank, Cox explained:

I think those who perceive this as ‘our decision’ misunderstand a little bit the way the process works. The Solicitor General...files with the Supreme Court on behalf of the United States, not on behalf of the (SEC)...It is not uncommon in that process for there to be different agency views expressed for a variety of reasons, including the fact that different agencies have different charters...Banking regulators looked at this case through a slightly different lens. Our lens is primarily investor protection...I think the SG properly takes all of these things into account.279

In fact, there are examples around the same time period of the Solicitor General exercising its authority to act on behalf of the administration rather than a particular agency other than the SEC. For instance, in Lilly M. Ledbetter v. Goodyear Tire & Rubber Company,280 the Solicitor General rejected the EEOC’s amicus brief that would have supported the plaintiff’s position and, instead, filed its own amicus arguing that the case should be time-barred by the plain language of the statute of limitations in Title VII of the Civil Rights Act. The Court ultimately agreed with the government’s position, as

279 See note 269, p. 63 (parenthetical added).

expressed by the Solicitor General, in a 5-4 opinion running largely along ideological lines.\textsuperscript{281}

Also, in a slight variation on the theme, the Solicitor General refused the request of the Federal Election Commission (FEC) not to file a petition for \textit{certiorari} to the Court in \textit{FEC v. Beaumont}.\textsuperscript{282} Instead, the Solicitor General asked the Court to accept the case. The Court subsequently granted \textit{certiorari} and promptly reversed the circuit court opinion, which the FEC had not wanted to challenge, regarding the legality of direct political contributions by nonprofit organizations to individual candidates. These cases illustrate that although inter-agency clashes of this type are relatively rare, they do occur. It remains unclear, however, whether the White House communicated directly with the Solicitor General in either of these cases, as it did with \textit{Stoneridge}, to guide that office’s decision making.

\textit{Indirect: Private Fruits of SEC Public Enforcement Litigation}

Scholars estimate that the percentage of original private securities litigation cases that led to subsequent SEC public civil enforcement actions during the primary data set is roughly 15\% of the private cases filed annually.\textsuperscript{283} It has also been estimated that, in general, less than 10\% of the overall number of private cases involving securities and

\textsuperscript{281} Congress eventually addressed this outcome directly through the “Lilly Ledbetter Fair Pay Act of 2009” (Public Law 111-2, S. 181), the first bill signed by President Barack Obama on January 29, 2009. This law amended the statute of limitations provisions in the Civil Rights Act to avoid similar outcomes in future cases.

\textsuperscript{282} 539 U.S. 146 (2003).

\textsuperscript{283} See, e.g., Cox, Thomas and Kiku (2003, 763) (their data work out to ~15\%);
commodities-related fraud and other similar issues are filed by the SEC each year.\textsuperscript{284} This figure corresponds generally with my independent calculation covering each year of my primary data set. I found that about 10\% of the overall cases for the period of the primary data set that are categorized by the Administrative Office of the U.S. Courts (AOC) as belonging to the “Securities, Commodities and Exchanges” class of lawsuits – i.e. those substantive areas within the jurisdiction of the SEC – were actually filed annually by the SEC in federal district court. The remaining cases were filed by private litigants. The individual annual averages for the period of the primary data set are presented in Figure A.1.

\textsuperscript{284} Seligman (1994, 440-41) (citing Ruder 1989, 1168).
Figure A.1 Average Annual Percentage of Cases Categorized as “Securities, Commodities and Exchanges” Litigation Filed by the SEC (Compared to those Filed by Private Litigants), SEC FY 1993 through FY 2007

The flow of cases in the other direction – i.e. those originating as SEC enforcement cases that spawn parallel private securities cases – represent a “significant percentage” of the SEC’s enforcement docket (Grundfest 1994, 969).\(^{285}\) This number

\(^{285}\) The dynamic of enforcement actions by federal independent agencies leading to private litigation is not unique to the SEC’s enforcement program. For instance, enforcement orders issued by the Federal Deposit Insurance Corporation against financial institutions “have become unexpected sources of liability because (they) create potential ‘roadmaps’ to class action plaintiffs’ attorneys…” (Joseph T. Lynyak, III. May 2010. “Responding to Proposed Enforcement Actions by the Federal Banking Agencies.” The Banking Law Journal).
may be as high as 55% of SEC enforcement cases that are fully litigated, but not settled, according to some estimates (Cox, Thomas and Kiku 2003, 42). Moreover, about half of SEC enforcement actions arise from the type of fact patterns and legal controversies that can provide the basis for private class-action claims (Id. at 15). Based on Figure 3.5, potential private litigants can thus choose from about 260 cases per year to pursue via the private securities enforcement regime.

This imbalance has at least two underlying causes. First, regarding the private-regime-to-SEC flow of cases, consistent with the earlier discussion in this chapter, the finite resources of the SEC render it unrealistic for the agency to pursue a large number of cases that are already being addressed through the private securities enforcement regime. The agency follows its own elaborate process for identifying public civil enforcement actions, described in Chapter 2, and private litigation adds little to the agency’s efforts. The agency therefore takes an economically rational approach by seeking to leverage the private regime – not duplicate its efforts.

Next, as for the flow of cases from the SEC’s public enforcement program to the private enforcement regime, the SEC’s public actions produce substantive results that private litigants can readily utilize to develop their own lawsuits. Initially, through an elaborate web of data flow, as I describe in Chapter 2, the SEC Enforcement Division identifies defendants – who can be subsequently identified and sued by defrauded investors. Moreover, the SEC’s civil prosecutorial investigatory process generates evidence. Scholars have noted that plaintiffs’ counsel, for instance, will make use of evidence developed by the SEC during enforcement proceedings to initiate private cases of action (Banoff and Duval 1984-85). Private plaintiffs can usually compel access to
such evidence during the due diligence process preceding litigation. Further, the existence of an SEC enforcement action for the same alleged misconduct may signal a federal district court that a private suit likely has more merit relative to a private case unaccompanied by an SEC action. One study notes that when a private suit originates in an SEC enforcement action, the damage awards to private plaintiffs are larger and the cases settle more quickly (and thus plaintiffs would need to expend fewer resources on average) than cases in the absence of indirect SEC participation (Cox, Thomas and Kiku 2003). Therefore, it is likely experienced plaintiffs’ counsel are aware of these dynamics and actively monitor the SEC enforcement docket.

**Interplay of Collateral Estoppel between Public and Private Regimes**

The active litigation of the SEC’s public civil enforcement regime also produces judicial outcomes that cannot be re-litigated. Private plaintiffs, in turn, utilize the fruits of the agency’s investment of resources and skilled prosecutorial work, potentially saving them substantial amounts of time and money when forging a case. So, private litigants also leverage the SEC’s efforts, but in a distinctly different form. As a natural result, a large percentage of SEC civil enforcement cases lead indirectly to litigation in the private securities enforcement regime. The process is indirect because the SEC does not guide or control it through any hands-on means. Private litigants simply exploit the products of the agency’s litigation efforts when possible.

Importantly, private plaintiffs will often try to incorporate key findings and decisions of actions already prosecuted civilly by the SEC in the lower federal courts into their own cases – without having to re-litigate those issues that were decided in their
favor – under the doctrine of collateral estoppel to seek compensation for alleged fraud perpetrated by defendants (Id.; Hazen 1979-80). Plaintiffs are restrained in their aggressive use of collateral estoppel in cases where the SEC’s Enforcement Division originally expended the time and resources to identify the defendants and fully litigate or settle a case successfully against them only by four elements that, under longstanding federal common law, must be present in order for a litigant to apply the doctrine.

These four elements, determined on a case-by-case basis by the federal courts, include, first, the identical issue the plaintiff is seeking to use must have been decided squarely in the previous court case. Second, each of these issues must have been actively litigated by the parties. Third, the defendant must have had a fair and full opportunity to argue its side before the result was finalized. And, finally, the resolution of the issue must have been essential to the outcome of the initial case.286

These legal constraints necessarily mean that fully litigated civil enforcement suits in federal Article III courts, though relatively uncommon, are the most clear-cut sources of the SEC’s indirect participation in the private litigation regime. They do not, however, completely rule out other forms of SEC enforcement procedures or outcomes leading to private securities litigation. Yet, variations are less likely to have each of the four required characteristics.

For example, a higher burden of proof in an initial proceeding is more likely to lead to the use of collateral estoppel by a plaintiff in a subsequent action requiring lower standards of proof. Thus, a proceeding prosecuted by a U.S. Attorney’s Office involving allegations of securities-related crimes (discussed in Chapter 2) is more likely to trigger

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the use of collateral estoppel than is a case that the SEC files in administrative proceedings, where the burden of proof is far further down the legal scale. Defense counsel in SEC administrative proceedings, however, are nonetheless aware of the potential, albeit reduced, for collateral estoppel when litigating and settling matters with the agency.\textsuperscript{287} Similarly, defendants typically seek written consent decrees as part of settling with the SEC – where they neither admit nor deny any wrongdoing in a matter. Accompanying settlement negotiations, which are performed largely in private between a defendant and the agency (see Chapter 2), are typically not documented and, therefore, cannot be used subsequently by a plaintiff as part of a claim of collateral estoppel.\textsuperscript{288}

The SEC’s role in each of these permutations of the private enforcement regime is indirect. While the agency is aware of the potential means through which counsel for private plaintiffs utilize the fruits of the agency’s investment of resources and effort, the agency cannot control or guide the separate process that occurs in the context of the private regime. Also, there is no evidence at this stage that the SEC’s activities in its public enforcement program are somehow intentionally designed in certain cases to promote a subsequent private action, and I could not identify any data or research that would point towards any cooperation in this regard between SEC enforcement counsel and private plaintiffs’ attorneys. The agency’s behavior in this context, therefore, is consistent with its public attempt at balancing its rhetoric, and direct participation in suits through amicus briefs, towards the private enforcement regime.

\textsuperscript{287} Id.

\textsuperscript{288} Ibid.
Conclusion

Since its founding, the SEC has played a key role in a perpetually changing private securities litigation regime. This private regime leverages the agency’s core public civil enforcement program, which is naturally constrained by the SEC’s finite resources. The ideology of the agency’s political principals and the federal courts consistently works to redefine the scope of the private regime, and the SEC has not escaped this political process. Although there are competing views running along the ideological spectrum within the agency about the appropriate structure of the private enforcement regime and the SEC’s role therein, the agency remains supportive of its existence and does not fundamentally question its utility. The SEC publicly embraces the regime, but cautiously balances its rhetoric to avoid favoring a class of litigants and overplaying its enforcement hand, particularly to its conservative political principals.

The SEC actively, and directly, participates in the private enforcement regime through a strategic amicus program. The agency has been quite successful influencing legislation and common law outcomes through amicus briefs in private suits in the federal judiciary in furtherance of its public mission as an agency. It has far less control over, but still participates indirectly, in the private regime via the fruits of its public civil enforcement litigation that counsel for private plaintiffs seize upon to develop their own cases. This Addendum rounds out the analysis of the SEC’s enforcement program by revealing an unexpected strategic dimension that the agency has learned to leverage over time to further its enforcement goals.
Appendix

Table 4.A1 Summary List of Variables Comprising Primary Data Set

Dependent Variable

- Forum – where SEC filed case (dummy variable = 0 if in federal court, 1 if before ALJ)

Independent Variables

Control Independent Variables – Case Characteristics

- Number of Statutory Charges Brought in Civil Enforcement Action
- Number of Defendants in Civil Enforcement Action
- Type of Defendant in Civil Enforcement Action – Individual or Corporate (set of two dummy variables indicating type of defendant. Reference category is corporate-only defendant. Two dummy variables: (i) whether only individual defendants in case (0 = not individuals only, and 1 = individuals only) and (ii) whether there are both individual and corporate entities together as defendants in case (0 = not together, 1 = both individuals and corporate entity together).
- Nature of Harm Alleged in Civil Enforcement Action (dummy variable, 0 = when nature of harm alleged by SEC directed primarily at corporate entity or financial/securities markets, and 1 = when harm aimed primarily at individual(s))
- Unique Geography – SDNY (dummy variable, 0 = if case does not originate from jurisdiction of SDNY, 1 = if it does originate from SDNY)

Control Independent Variables – Economy

- DJIA on date case filed
- Unemployment Rate
- Change in GDP from previous quarter (robustness check)
Table 4.A1  Summary List of Variables Comprising Original Data Set (Continued)

**Independent Variables – Political Principals, Executive Branch**

- Median Ideology of SEC (continuous)
- Median Ideology of President (continuous)

**Independent Variables – Political Principals, Congress**

- Ideology of Senate Appropriations Subcommittee (all variables in this section are continuous) (this independent variable utilized in the models)
- Ideology of House Subcommittee with primary Oversight responsibility for SEC (this independent variable utilized in the models)
- Ideology of Senate Subcommittee with primary Oversight responsibility for SEC
- Ideology of House Subcommittee with primary Appropriations responsibility for SEC
- Ideology of Senate Committee with primary Oversight responsibility for SEC (robustness check – with and without weighting chair 3x)
- Ideology of House Committee with primary Oversight responsibility for SEC (robustness check – with and without weighting chair 3x)
- Ideology of Senate Floor
- Ideology of House Floor

**Primary Independent Variables**

- Ideology of District Courts
- Ideology of Circuit Courts
Table 4.A1  Summary List of Variables Comprising Original Data Set (Continued)

- Shock (categorical) (dummy variable indicating presence of exogenous shock to financial sector, triggered by financial scandal involving Enron; valued:  0 = all years before 2002; 1 = 2002 (shortly after event occurred, October 16, 2010); 1 = 2003 (first year of next congressional cycle); 1 = 2004 (second year of next congressional cycle); .75 = 2005 (effect begins to fade after congressional cycle and passage of time); .5 = 2006; .25 = 2007)

- Shock (dichotomous) (dummy variable indicating presence of exogenous shock to financial sector, valued:  0 = all dates before Enron; 1 = all dates after Enron (robustness check)

**Independent Variables – Interaction Terms Used in Models 2-6**

- Nature of Harm * District Court Ideology
- Shock * District Court Ideology
- SEC Ideology * District Court Ideology
- Senate Appropriations Subcommittee * District Court Ideology
- House Oversight Subcommittee * District Court Ideology

**Case Background Variables (included in primary data set, but not used in models)**

- Filing Number of Case
- Date Case Filed by SEC
- District Court Jurisdiction
- Circuit Court Jurisdiction
Table 4.A2 Summary List of Predicted Signs of Coefficients and Marginal Effects
(Note: The theory and hypotheses predict some control variables should not be statistically significant. Nonetheless, this table gives the predicted sign for each independent variable to present a comprehensive summary).

<table>
<thead>
<tr>
<th>Independent Variables</th>
<th>Predicted Sign</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Primary</strong></td>
<td></td>
</tr>
<tr>
<td>District Court Ideology</td>
<td>Positive</td>
</tr>
<tr>
<td>Circuit Court Ideology</td>
<td>Positive</td>
</tr>
<tr>
<td>Shock (Categorical)</td>
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</tr>
<tr>
<td>Shock*DistrictCtIdeology</td>
<td>Negative</td>
</tr>
<tr>
<td>Shock*CircuitCtIdeology</td>
<td>Negative</td>
</tr>
<tr>
<td><strong>Ctrl Variables: Case Characteristics</strong></td>
<td></td>
</tr>
<tr>
<td>Number of Charges</td>
<td>Negative</td>
</tr>
<tr>
<td>Number of Defendants</td>
<td>Negative</td>
</tr>
<tr>
<td>Individual Defendant Only (Dummy)</td>
<td>Negative</td>
</tr>
<tr>
<td>Indiv and Corporate Defendant (Dummy)</td>
<td>Negative</td>
</tr>
<tr>
<td>Nature of Harm (Dummy)</td>
<td>N/A</td>
</tr>
<tr>
<td>Harm*DistrictCtIdeology</td>
<td>Negative</td>
</tr>
<tr>
<td>Harm*CircuitCtIdeology</td>
<td>Negative</td>
</tr>
<tr>
<td>Unique Geography – SDNY</td>
<td>Negative</td>
</tr>
<tr>
<td><strong>Ctrl Variables: Economy</strong></td>
<td></td>
</tr>
<tr>
<td>Change in GDP</td>
<td>N/A</td>
</tr>
<tr>
<td>DJIA</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Political Principals</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Executive Branch</strong></td>
<td></td>
</tr>
<tr>
<td>SEC Ideology</td>
<td>N/A</td>
</tr>
<tr>
<td>SEC Ideology*DistrictCtIdeology</td>
<td>Negative</td>
</tr>
<tr>
<td>SEC Ideology*CircuitCtIdeology</td>
<td>Negative</td>
</tr>
<tr>
<td><strong>Congress</strong></td>
<td></td>
</tr>
<tr>
<td>SenAppropsSubcomm Ideology</td>
<td>N/A</td>
</tr>
<tr>
<td>SenAppropsSubcomm Ideology*DistrictCtIdeology</td>
<td>Negative</td>
</tr>
<tr>
<td>SenAppropsSubcomm*CircuitCtIdeology</td>
<td>Negative</td>
</tr>
<tr>
<td>HouseOversight Subcomm Ideology</td>
<td>N/A</td>
</tr>
<tr>
<td>HouseOversight Subcomm*DistrictCtIdeology</td>
<td>Negative</td>
</tr>
<tr>
<td>HouseOversight Subcomm*CircuitCtIdeology</td>
<td>Negative</td>
</tr>
</tbody>
</table>
Table 4.A3  Congressional Committees and Subcommittees with Primary Oversight and Appropriations Responsibility for the SEC

Part 1  House Committees and Subcommittees with Primary Oversight Responsibility for U.S. Securities and Exchange Commission


Committee: Financial Services
Subcommittee: Capital Markets, Insurance, and Government-Sponsored Enterprises


Committee: Commerce
Subcommittee: Finance and Hazardous Materials


Committee: Energy and Commerce
Subcommittee: Telecommunications and Finance

Part 2  House Committees and Subcommittees with Primary Budget Review Responsibility for SEC

Committees: Appropriations
Subcommittees:

110th Congress/2007-2008  Financial Services and General Government
Table 4.A3 Congressional Committees and Subcommittees with Primary Oversight and Appropriations Responsibility for the SEC (Continued)

Part 3 Senate Committees and Subcommittees with Primary Oversight Responsibility for SEC

Committees: Banking, Housing and Urban Affairs

Subcommittees:

110th Congress/2007-2008

Securities, Insurance, and Investment

109th Congress/2005-2006
through 107th Congress/2001-2002

Securities and Investment

106th Congress/1999-2000
through 102nd Congress/1991-1992

Securities

Part 4 Senate Committees and Subcommittees with Primary Budget Review Responsibility for SEC

Committee: Appropriations

Subcommittees:

110th Congress/2007-2008 Financial Services and General Government


Discussion: Attitudinal Model Applied to SEC Civil Enforcement Actions

In modern political science literature, the attitudinal model is most closely associated with the work of Segal and Spaeth (1993, 2002). Its lineage, however, can be traced back at least to the emergence of behavioralists such as Schubert (1959, 1962, and 1965) – who has been described as the founder of the attitudinal model. He was also one of the first political scientists to apply rational choice theory to political issues – for instance, demonstrating that U.S. Supreme Court justices are strategic decision makers (Epstein and Knight 2000).

Schubert legitimated the notion that the personal political preferences – political ideology – of the justices largely explains their voting behavior on the Court. He supported his argument by operationalizing the political attitudes of the justices and arranging them for the first time on an ideological continuum. His research was a logical evolution of the earlier behavioral work of Pritchett (1948), who was arguably the first political scientist to investigate the voting patterns and policy preferences of the justices, and of contemporaries like Ulmer (1960, 1969), who analyzed the decision making process of the Court within the rubric of small group behavior.

Segal and Spaeth refined the attitudinal model and concluded that judicial outcomes are the product of the facts of a case processed through the predetermined policy attitudes of the justices, and that little else has a material effect. The attitudinal model substantially discounts the role of the traditional legal model in explaining judicial outcomes. The legal model ascribes judicial outcomes to the analysis of case facts in light of four primary variants, including the plain meaning of statutes and the U.S. Constitution, the doctrine of *stare decisis* – i.e. adhering to precedent, the intent of the
framers of legislation, and balancing all of this with the contemporary values of society. The authors essentially write off this model as “meaningless” in the wake of their findings supporting the attitudinal model (Segal and Spaeth 1993, 62). While the reasoning underlying this dissertation does not necessarily adhere to such an absolute view, it nevertheless assumes the attitudinal model is valid and, further, that it applies to the lower federal courts – though the fit of the model is mitigated (and other factors come into play) because of key differences between the lower federal courts and the U.S. Supreme Court.

One of the linchpins of the logic behind the attitudinal model is that the relative independence of Supreme Court justices, enabled by their insulation from the political pressures affecting their colleagues in the other two branches, gives them the freedom to assert their own political preferences when rendering decisions. According to the intuitive “hierarchy postulate,” the influence of personal policy preferences on decision making increases as a federal judge moves up the federal judicial hierarchy (Zorn and Bowie 2010, 1214) – reaching the pinnacle with Supreme Court justices.

Similarly, certain constraints that do not inhibit Supreme Court justices do indeed limit the ability of lower court judges to exercise their political preferences. For example, Supreme Court justices exercise control over their docket by granting *certiorari* to only a select few cases annually (Perry 1994), but lower court judges have no such control over their schedule and must react to a case that appears on their docket when filed or appealed by a litigant. Also, the Supreme Court is the appellate court of last resort and

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289 Positive political theorists have attempted a resurgence (and have met with mixed results) challenging the attitudinal model, arguing that judges are strategic, but that judicial outcomes – while policy-oriented – are nevertheless materially influenced by other political actors and by judges’ institutional settings (Perino 2006, 498).
there is no direct judicial oversight of its decisions. As the highest court in the nation, the Supreme Court produces opinions that have lasting policy implications and create precedent to guide future decision making (Zorn and Bowie 2010). Among the lower courts, the circuit courts of appeal also create binding precedent (solely for the district courts and appellate panels within their own circuit), but are subject to direct oversight by the Supreme Court. Moreover, federal district courts are subject to intense scrutiny by appellate courts and are bound by precedent, so they generally are responsive to the policies developed by those higher courts (Baum 1980). In addition, scholars have suggested district court judges focus on getting judicial outcomes – and their opinions – “right” pursuant to the common law prevailing in their respective circuits to avoid the reputational damage of reversal by an appellate court (Baum 1997, 2006). This factor, however, has two sides, as discussed below. These constraints may naturally mitigate, but do not eliminate, the exercise of political preferences by lower court judges.

On the other hand, like Supreme Court justices, lower federal court judges are insulated from political pressure because they are neither elected nor accountable to a political electorate. In addition, they have lifetime tenure and can only be removed from the bench through a formal impeachment hearing. And while lower federal court judges may not produce as much lasting precedent as Supreme Court justices – and therefore their exercise of personal political preferences may not be as evident upon initial investigation – district court judges make myriad decisions daily on motions, the admission of evidence, and interpreting statutes and common law. Also, their colleagues

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290 Only 13 district court judges and 1 circuit court judge have been impeached since the creation of the Article III federal courts. Impeachment is typically pursued for malfeasance on the bench rather than for the aggressive exercise of political preferences. Impeachment does not represent a significant constraint for a federal judge with lifetime tenure.
on the circuit courts produce policy-laden decisions that do not cover as wide a jurisdictional spectrum as opinions from the Supreme Court, but nevertheless determine the common law for many years in their judicial region. Thus, lower federal courts produce a significant number of judicial opinions and a sizeable amount of precedent.

Skeptics of the attitudinal model occasionally seize upon the observation from Segal and Spaeth (2002) that Supreme Court justices are empowered to vote their personal preferences because they cannot seek higher office. They argue that this differentiates them from lower court judges who, they reason, may have ambition to ascend higher in the judicial hierarchy – and the most efficient way to succeed is to suppress their personal political preferences. The causation attributable to this factor may have become diluted – or reversed – as the selection of federal judges on all levels has become more partisan. Indeed, a federal lower court judge who wants to garner the attention of an administration may very well exercise personal political preferences on the bench with the intention of differentiating him- or herself and becoming noticed by a political principal – such as a Senator or the President – who can further the judge’s career through nomination to a higher court.291

Overall, empirical analysis of the fit of the attitudinal model to federal lower court decision making has been mixed, but it is fair to generalize the findings so far as demonstrating the model does help explain lower court outcomes. The consensus suggests the model tends to fit the federal circuit courts more clearly, and personal policy preferences undoubtedly play a role in judicial outcomes along with other potential influences such as legal factors and institutional norms and characteristics (Kaheny, 291 Revesz (1997, 1720) makes precisely this point regarding judges on the DC Circuit, who may seek nomination to the Supreme Court.
Haire, and Benesh 2008; Zorn and Bowie 2010). Political science literature also provides empirical support that the personal political preferences of federal district court judges affect their judicial outcomes (Perino 2006; Rowland and Carp 1996). A recent article states directly, “Scholars have long acknowledged the importance of ideology in judicial decision making for the United States Supreme Court and for lower courts…to the extent that it is now a scholarly given…” (Taratoot and Howard 2011, 836). These authors, however, also recognize that the lower federal courts – especially district courts – are subject to constraints that are absent on the Supreme Court level.

Thus, this dissertation assumes the attitudinal model, developed originally to explain behavior among Supreme Court justices, validly applies to the lower federal courts. It recognizes, though, that the effects the attitudinal model predicts may be mitigated because of different circumstances prevalent throughout the judicial hierarchy. These mitigated effects may make the identification of the role of judicial ideology through empirical analysis more difficult.
Discussion: Footnote 166 – Calculation of Percentage of Actions Filed in District Courts Located in Jurisdictions where Individual Defendant Resided or Corporate Defendant had Principal Place of Business

The percentage, about 72%, is calculated as follows.

First, the data set includes a variable that identifies those cases filed in district courts that were located in the jurisdiction where an individual defendant resided or a corporate defendant had its principal place of business (referred to below as “direct jurisdiction”). The straight percentage of these cases was 64%.

Next, this calculation was adjusted to account for the unique role of the Washington, DC district court.

Washington, DC District Court

The DC district court is the second-most heavily utilized district by the SEC. Cases filed in the DC district make up 13% of all of the district court cases in the data set. Yet, only 4% of these cases (5 of 115 DC-filed cases) emerged from DC through direct jurisdiction.

This is also reflected in the percentage of administrative cases in the data set that are ascribed to DC based on direct jurisdiction: 3%.

This disparity is attributable to the role the DC district court plays in the overall enforcement litigation strategy of the SEC. The SEC often uses the DC district court when applying the third category of jurisdiction available in the federal venue statutes, i.e. the district where an act or transaction constituting the violation occurred. As applied, when an individual or public company fails to disclose required information or errs materially in complying with SEC filing requirements, the violation occurs upon
filing – in DC. The SEC will bring the related enforcement actions in DC and attorneys from its local office – SEC headquarters – are responsible for conducting the investigations. The SEC heavily utilizes the DC district court through these filings. But cases arising from direct jurisdiction in DC are rare.

In addition, the SEC will sometimes utilize the DC district court for litigation it perceives as crucial for the development of a new enforcement policy. These “statement cases,” as I refer to them, are filed in the DC district with an eye towards having access to the highly respected DC circuit court if an appeal becomes necessary.

Taking this role into account, I removed the DC district court from the calculation of the percentage of actions filed in district courts located in jurisdictions falling under the first two categories of venue in the federal statutes – where an individual defendant resides or a corporate defendant has its principal place of business – to determine the adjusted percentage of about 72%. This percentage reflects more accurately the utilization of direct jurisdiction by the SEC in district courts across the nation.

**Southern District of New York**

As the discussion of the control variable, “Unique Geography – SDNY,” makes clear in Chapter 4, the SDNY also holds a unique place in the SEC’s enforcement program. If I were to take this district’s distinct role into account, I would also remove the SDNY from the calculation of the percentage of actions filed in district courts located in jurisdictions falling under the first two categories of venue in the federal statutes. This adjustment would result in a further adjusted percentage of about 83%. That is to say,
outside of the SDNY and the D.C. district, more than 83% of the cases comprising the data set arose through direct jurisdiction.

Because the specialized role of the SDNY is not as extreme as that of the DC district, however, and about 28% of its cases (as compared to a little over 4% of the D.C. district cases) emerged from direct jurisdiction, I do not use the 83% figure as the adjusted percentage in the dissertation.