

The Influences on Bureaucratic Decision Making Revisited: U.S. Securities and Exchange Commission Enforcement Actions and the Lower Federal Courts*

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Abstract

This paper examines generally whether U.S. bureaucratic decision making is influenced by the ideological composition of the lower federal courts when the decisions relate to policy that helps define the mission of the agency and the decision making process includes substantive review and input from high levels of the bureaucracy. It also suggests other potential influences on bureaucratic decision making that may be more important than the ideology of courts under these conditions. The paper determines the ideological composition of the courts independent of litigation outcomes that may have affected the bureaucracy's regulatory policy. An original data set of cases was developed to perform this analysis. The paper utilizes this data to test the hypothesis that the U.S. Securities and Exchange Commission (SEC) considers the ideological composition of the federal district courts when making strategic decisions about whether to file enforcement actions against defendants in federal district court or through administrative proceedings before an administrative law judge. The analysis tests whether the SEC is less likely to bring an enforcement action in federal district court, and will opt for an administrative proceeding, when the ideological composition of the court that has jurisdiction is conservative and more likely to initiate suit in district court when the composition of the court is liberal. The results do not indicate that the SEC considers the ideological composition of the federal district courts when deciding the choice of forum for prosecuting an enforcement action.

*This paper to be delivered at the Mini-APSA conference in the Department of Political Science at Columbia University, April 29, 2005.

Introduction

A recent analysis of the decisions of the Army Corps of Engineers (Army Corps) for granting permits to develop federal wetlands from 1988 through 1996 broke new ground in the study of the potential effects of the judiciary on bureaucratic decision making (*see* Canes-Wrone 2003). The analysis provided empirical support for the hypothesis that the ideological composition of federal district and circuit courts, even absent litigation in those courts, affected the bureaucratic decisions of the Army Corps about whether to grant development permits (Canes-Wrone 2003, 213). The implication is that the bureaucrats in the Army Corps adapted their behavior based on how they anticipated the federal courts, as driven by their ideological composition, would ultimately respond to the bureaucrats' decision making if there were litigation at the end of the permitting process.

Its primary innovation is that it branches out from prior literature regarding bureaucracies and the judiciary. This literature has argued persuasively and demonstrated empirically that the ideological preferences of judges at times influence their rulings (*see, e.g.,* Segal and Spaeth 1993; and Songer, Sheehan and Haire 2000). It has also provided sound theory, based on well developed formal models, that in a variety of contexts a bureaucrat will adopt policies or render decisions based on what he or she believes the courts will uphold (*see, e.g.,* Ferejohn and Shipan 1990; and Shipan 2000). Specifically, the literature has tried to demonstrate that an agency will alter its behavior in response to either (i) a court opinion that directly addresses the behavior or policies of an agency, whether in a rulemaking context or an administrative decision making setting (*see, e.g.,* Moe 1985; Wood and Anderson 1993; Mather 1995; and Hunter and Waterman 1996), or

(ii) the nature of a potential litigant, that is, whether the litigant has the financial resources and political contacts to effectively contest the agency in court, thereby draining disproportionately the agency's limited resources (*see* Howard 2001; and Howard and Nixon 2002).

A logical progression after linking the concepts above is to test whether bureaucrats are aware of the ideology of relevant members of the judiciary and adapt their behavior in anticipation of how a judge with a certain ideology will respond in order to avoid being reversed ultimately by the courts. The Canes-Wrone article takes this next logical step.

While the Canes-Wrone study establishes empirically some links between the theories described above, it remains unclear whether its findings can be generalized to pertain to agency decision making in circumstances that are substantially different from those in the Army Corps process. Thus, this paper analyzes whether bureaucratic decision making is influenced by the ideological composition of the lower federal courts when the decisions relate to policy that helps define the mission of the agency and the decision making process includes substantive review and input from high levels of the bureaucracy. Neither of these elements exists in the Army Corps decision making process.

The 38 district offices of the Army Corps produced the 18,331 decisions comprising the data base used in the Canes-Wrone analysis, for an annual average of about 54 cases per office. The two-to-three-month lifespan of a wetland permit case passes entirely within an Army Corps district office; there is no formal review process of the decision making at a higher level of the bureaucracy. Since the relevant land-use

regulations took effect in 1979, only 11 of the approximately 150,000 cases have percolated up the procedural ladder to be reversed by the Environmental Protection Agency (EPA), which has statutory authority to review Army Corps decisions (Canes-Wrone 2003, 207 (citing the EPA web site, www.epa.gov). So, the typical permitting decisions used to identify the impact of judicial ideology on bureaucracies appear to be rendered in bulk at a relatively low bureaucratic level.

In this context, it is conceivable that the lower-level bureaucrat in the Army Corps focuses primarily on the short-term, individual permitting decision rather than the macro-level legal process and agency mission. This paper therefore tries to advance the literature by analyzing the influence of judicial ideology on bureaucratic decision making when (i) the policy or activity that is the subject of the bureaucratic decision making is material to or, preferably, helps define the overall mission of the agency and (ii) the decision making process includes substantive review and input from high levels of the bureaucracy. The paper builds on the Canes-Wrone innovation to determine whether the ideology of the lower federal courts may have an impact on the broader mission and high-level decision making of a federal agency that has recently experienced intense scrutiny in the popular media¹ – the U.S. Securities and Exchange Commission (SEC).

This paper proceeds as follows. The next section explains why the SEC is appropriate for this analysis. The paper then discusses the data and methods used in the analysis. This section starts by stating the hypothesis and explaining the assumptions that underlie it. It then describes the development of the data set and the regression method used to evaluate the data. The paper then describes in detail each of the variables and the

¹ See, e.g., Charles Gasparino. 2005. *Blood on the Street*. New York: Free Press; and Mark Maremont and Deborah Solomon. 2003. “Missed Chances – Behind SEC’s Failings: Caution, Tight Budget, ‘90’s Exuberance.” *Wall Street Journal*, December 24, p. A1.

reasons each was used in the analysis. The paper finally discusses the results of the analysis and offers detailed conclusions which suggest other potential influences on bureaucratic decision making that may be more important than the ideology of courts under certain conditions.

Why the U.S. Securities and Exchange Commission?

The process of decision making in the SEC about whether it will file enforcement actions against defendants in federal district court or through administrative proceedings before an administrative law judge (ALJ) includes a combination of factors that makes it ideal for this analysis. First, like the wetland permitting process, the SEC process culminates in a choice of two options that can be built into a data base and tested. Second, unlike the wetland permitting process, this SEC decision making process involves (i) a policy and activity that helps define the mission of the agency and (ii) includes substantive review and input from the highest levels of the bureaucracy.

Enforcement Actions Help Define Mission of Agency

The stated mission of the SEC is to protect investors and maintain the integrity of U.S. capital markets (Securities and Exchange Commission 2003a, 1). Congress created the SEC in 1934 following hearings of the Senate Banking and Currency Committee into stock exchange practices that led to the stock market crash in October 1929 (Seligman 2003, 1 - 3). The Committee uncovered rampant stock market manipulation, insider trading and breaches of fiduciary duty by directors and officers who controlled publicly traded corporations (Karmel 1982, 39).

Prior to the market crash, U.S. securities markets were governed by state “blue sky” laws, which varied across states and consisted of a potpourri of basic antifraud and

licensing laws (Keller and Gehlmann 1988, 331). States enforced these laws unevenly and, as the Senate hearings revealed, the laws were ineffective deterrents to fraud (Keller and Gehlmann 1988, 332; Khademian 1992, 24). The hearings prompted Congress to devise a regulatory safety net to prevent a similar market crash in the future (Aggarwal 2003, 584), so it passed six major acts to protect investors and restore public confidence in the capital markets. This legislation included the two primary acts administered by the SEC, the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act), which established the SEC and transferred to it from the Federal Trade Commission the power to oversee and enforce the new federal securities laws (Karmel 1982, 41; Aggarwal 2003, 585).

Since its earliest grants of authority from Congress, the SEC has focused much of its efforts and resources on its prosecutorial role and, under the SEC's modern structure, the Enforcement Division has consistently been the largest of the SEC's five operating divisions (Bealing 1994, 557). Over time, the reputation of the SEC has become tied closely to its highly visible and successful enforcement activities (Pitt and Shapiro 1990, 155-56) and the enforcement role continues to help define its agency mission. This is evident from the fact that the SEC chooses every year to begin the *Annual Report of the U.S. Securities and Exchange Commission* with a thorough review of its enforcement activities prior to discussing results from its other areas of responsibility. This placement sends a signal to Congress and the general public about the priorities of the SEC, which may in part reflect what the agency believes Congress will focus on during the annual budget process.

Decision Making Process Includes Substantive Review and Input from Highest Levels of Bureaucracy

The material differences between the enforcement options available to the SEC in federal district court compared to those available in the administrative setting before an ALJ, as explained below, compel the agency to make a series of substantive decisions before initiating a case against a defendant. For example, the SEC bureaucrats must determine whether the nature of the evidence warrants the enhanced expenditure of agency resources in pursuit of a more severe penalty against a defendant in federal district court. Moreover, the bureaucrats must decide in each matter whether the marginal benefits of filing a suit in federal district court over administrative proceedings outweigh the increased risk of going to federal court over “the home court advantage” of a proceeding before an ALJ (Mahoney Interview, 9 December 2003).

Division of Enforcement Initiates Process

The SEC initiates the decision making process through the Division of Enforcement (Division). The Division was established in 1972 as the result of a reorganization of the SEC to consolidate the enforcement functions of the agency that had previously been spread throughout the bureaucracy (Karmel 1982, 96). The Division is now involved in virtually all of the enforcement activities of the SEC (Securities and Exchange Commission 2003a, 25). It investigates leads about violations of securities laws, interviews witnesses and develops evidence in support of enforcement filings (*see, e.g.,* McLucas, Taylor and Mathews 1997, 56 – 58). The Division is based in SEC headquarters in Washington, D.C., but also maintains offices in the five regional and six local SEC offices.

The Enforcement Action Process

Since the decision making process leading to an enforcement action is carefully designed to include substantive review and input from the highest levels of the bureaucracy, it can be long (Davis 2001, 99). Depending on the geographic origins of a lead about a securities violation, a member of the Division staff of one of the SEC offices can open an informal investigation with the approval of a branch chief (Mahoney, Walker, Schwartz and Greenstein 2004, A - 11).

If the results of the ensuing review warrant further investigation, the local Division staff submits a written recommendation to the SEC Office of General Counsel. These recommendations often incorporate local agency biases (Mahoney Interview, 9 December 2003) and knowledge (*see* Canes-Wrone 2003, 207), but are reviewed by high-level bureaucrats in SEC headquarters early in the process. If approved by the General Counsel, the recommendation for an informal inquiry will be forwarded to the offices of the SEC chairperson and each of the four other commissioners for review and approval. It is noteworthy that although at this early stage in the enforcement process the staff cannot issue subpoenas to compel the production of documents or testimony from targets of the investigation (SEC Informal and Other Procedures, Rule 5(a), 17 C.F.R. § 202.5(a)), the investigation will not proceed without the approval of the commissioners representing the highest level of the bureaucracy.

In the absence of a settlement, the matter will evolve into a formal investigation. The timing of when the SEC initiates this stage varies across regional offices since some enforcement staff members will wait until a key witness refuses to cooperate any further prior to taking this advanced step (Mahoney Interview, 9 December 2003). Nonetheless,

the enforcement staff repeats essentially the same process to obtain approval for a formal investigation as it does to start an informal inquiry. Initially, it submits a revised “action memorandum” to the General Counsel that makes its case for a formal investigation (Mahoney, Walker, Schwartz and Greenstein 2004, A - 15). The memorandum must argue successfully that the staff needs subpoena power to further the investigation.

Next, the General Counsel forwards the revised memorandum to the five commissioners. From there, a formal order authorizing the filing of an action in federal district court or an administrative proceeding may be issued in one of three ways. First, one 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 a majority of the commissioners agreeing together to do so in a closed-door meeting (Mahoney, Walker, Schwartz and Greenstein 2004, A - 15 – A-16).

As the description of this lengthy process makes evident, although it may start at a local or regional level and incorporate relevant knowledge and professional judgments from the branch offices, the repeated high-level review of the matters ensures ultimately that the decisions reflect the bureaucratic mission and macro policy positions of the SEC. As a result, any discernible impact of the ideology of the federal courts on this decision making process would affect significantly the functioning of the SEC.

Data and Methodology

Hypothesis

This analysis tests the following *hypothesis*: once the SEC decides to pursue a potential securities violation through an enforcement action, the ideological composition

of the federal district courts affects the decision making of the bureaucracy as to whether to bring that action in federal district court or through an administrative proceeding before an ALJ.

Assumptions Underlying Hypothesis

The assumption underlying this hypothesis is that a federal district court with a more conservative ideological composition is less likely to favor regulators such as the SEC. In general, the conservative political attitude favors reducing the size of bureaucracy and taking a more laissez-faire approach to financial market regulation with an emphasis on self-regulation by capital markets (which are also referred to as SRO's, or self-regulatory organizations (*see, e.g.,* Khademian 1992, 107)).

The hypothesis thus implies that, when confronting an ideologically conservative federal district court, the SEC may prefer to trade off the potential benefits of bringing an enforcement action in federal district court, as explained in detail below, for the opportunity to bring the proceeding before an ALJ in an environment that is more favorable to the agency (*see* Committee on Federal Regulation of Securities 1992, 1734 (the SEC prevailed in 58 out of 62 administrative proceedings reviewed by the Committee in the period 1983 through 1988)). This is consistent with the results of an empirical study by New York University Law School Dean Ricky Revesz that found federal judges with Republican affiliations were less likely than those with Democratic affiliations to defer to the EPA when industry challenged EPA policy in federal court (Revesz 1997).

This hypothesis also assumes that a liberal district court would be more likely to view SEC enforcement actions positively because of its attitude that government plays a

key role in preventing the perpetration of fraud by corporate entities and their agents on vulnerable investors in the securities markets. The Revesz study also found that federal judges with Democratic affiliations were, in turn, less likely to defer to industry when it challenged EPA policy in federal court (Revesz 1997). The federal judges in that study who had been Democrats assumed an ideologically liberal stance on the cases.

Also, the SEC chairperson for most of the period covered in this study (he served from 1993 to 2001) was Arthur Levitt, who was appointed by President Bill Clinton. Levitt became known as an activist² and was ultimately identified with politically liberal attitudes by members of Congress during the Clinton years (*see* Seligman 2003, 630). He added to this perception when he quoted former SEC chairperson and renowned liberal William O. Douglas on the cover of the *U.S. Securities and Exchange Annual Report for FY 1999* (“We are the investor’s advocate”). So, this study assumes, in order to test the hypothesis, that federal district court judges who are affiliated with the Democrats are more likely than their Republican counterparts to defer to SEC positions in enforcement proceedings.

A note of caution, however, is appropriate here. In their study demonstrating that Internal Revenue Service (IRS) audit policy is responsive to political controls, Scholz and Wood (1999) 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, based on the argument that each political party will favor its dominant coalition when promoting public policy, is that Republican principals would promote efficient tax collection for lower and middle income returns and Democrats, in

² Michael Schroeder. 2000. “Levitt Will End 8 Activist Years as SEC Chief Early in 2001.” *The Wall Street Journal*, December 21, p. C1.

contrast, would emphasize equity between the amounts of tax dollars collected from individuals and from corporations. This assumption seemed to hold prior to 1981. But during the Reagan Administration, Republicans criticized the negative elements of tax collection as part of their political attacks on big government and promoted legislation that would establish a taxpayers' bill of rights (Scholz and Wood 1999, 1175). And Democrats, responding to budget shortfalls triggered by Reagan Administration tax cuts, began to defend the need for efficient IRS enforcement practices to collect more revenues to reduce the deficit. This role reversal changed the direction of partisan policy effects on the IRS after 1981.

A similar blurring of the “dominant coalition” effects described above may have occurred over the last few years with regards to SEC policy in the wake of the unprecedented levels of financial fraud that have been uncovered in public companies during this decade³ and the success of the subsequent prosecutions of many high-level offenders.⁴ Attacking financial wrongdoing is now good politics regardless of whether the offender is an individual or a corporation. The passage of the Sarbanes-Oxley Act in 2002, which provided the SEC a panoply of new enforcement tools, was the initial political response to this situation. Yet, it is possible that federal judges from both ends of the ideological spectrum may now be, at least in the short-term, more deferential to SEC enforcement positions in court. This trend would theoretically affect the data from the last two fiscal years in this study because most of the relevant political response occurred after the steep market decline in March 2000. Therefore, although there may not be a full ‘partisan reversal’ in the relevant data, there may be some mitigation of

³ See discussion in “‘Real Time’ Enforcement: Recent Trends in SEC Enforcement Actions.” 2004. Gibson Dunn & Crutcher LLP for The SEC Institute’s 19th Midyear SEC Reporting Forum, pp. 10-78.

⁴ See, e.g., “Ebbers is Convicted in Massive Fraud.” *Wall Street Journal*, March 16, 2005, p. A1.

partisan effects. This is something to consider when analyzing the results of the regression below.

Data

This analysis uses a modestly sized, originally developed data set derived from a sample of 100 enforcement actions selected from all of the enforcement actions brought by the SEC in FY 1993 through FY 2002. The SEC fiscal year ends on September 30th. *Table 1* shows the annual levels of those actions over this period.

Table 1: Number of SEC Enforcement Actions brought in Federal District Court and through Administrative Proceedings, FY 1993 through FY 2002

<u>Fiscal Year</u>	<u>Federal District Court</u>	<u>Administrative Proceedings</u>
1993	172	229
1994	196	268
1995	171	291
1996	180	239
1997	189	285
1998	214	248
1999	198	298
2000	223	244
2001	205	248
2002	270	281
	<u>Total: 2,018</u>	<u>Total: 2,631</u>

Source: *U.S. Securities and Exchange Commission Annual Report, Fiscal Years 1993 – 2002*

Data Set Starts in FY 1993

The analysis uses data starting in FY 1993 for two reasons. First, as *Table 1* shows, the data from the latest fiscal years after and including FY 1993 provides a sufficiently large pool of enforcement actions for testing the hypothesis. Second, the Securities Law Enforcement Remedies Act of 1990 (the Remedies Act) provided the SEC with new administrative enforcement remedies and expanded substantially the universe of potential defendants against whom the SEC could bring an administrative proceeding (see McLucas, DeTore and Colachis 1991, 831).

Prior to the Remedies Act, the SEC was authorized to bring administrative enforcement proceedings only against industry participants such as investment advisors and broker-dealers. The Remedies Act empowered the SEC to bring its new array of administrative enforcement remedies against all persons with respect to all provisions of federal securities laws (Martin, Mirvis and Herlihy 1991, 20). Although it took the SEC some time to incorporate these new powers into its enforcement arsenal (Mahoney Interview, 9 December 2003), for the first time ever in FY 1993 the number of administrative enforcement proceedings that the SEC filed surpassed the number of federal court cases the agency brought. And as *Table 1* reveals, the SEC has since filed more enforcement actions through administrative proceedings than in federal district court in every successive fiscal year. Thus, this legislative change may represent an exogenous shock that changed some of the influences on the decision making of the SEC regarding whether to file an enforcement action in federal district or through an administrative proceeding.

Data Set Continues Through FY 2002

The data used in the analysis continues through FY 2002 for similar reasons.

The Sarbanes-Oxley Act includes two provisions that increase significantly the scope of proceedings the SEC can bring before an ALJ. First, 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 (*see Baker and Campbell 2003, 4*). Many participants in the securities industry view this sanction as one of the harshest because it essentially ends the defendant's career and current livelihood. Previously, the SEC was empowered to bring such actions only in federal district court.

Second, the Sarbanes-Oxley Act lowers the legal standard of proof for instituting such bars (*see Mahoney, Walker, Schwartz and Greenstein 2004, A-84*). In 2002, prior to the implementation by the SEC of its new powers, the agency sought orders barring 126 defendants from serving as officers or directors of public companies.⁵ The record of success of the SEC was mixed in these proceedings, according to the SEC, largely because the prior legal standard of proof was too high.⁶ Congress listened to the arguments of the SEC bureaucrats when drafting the Sarbanes-Oxley Act.

The data from FY 2003 and FY 2004 demonstrate the effect of these new provisions on the filing of SEC enforcement actions. From FY 2002 to FY 2003, the first fiscal year of implementation of these new provisions, while the number of enforcement actions filed by the SEC in federal district court remained flat (270 in FY 2002 to 271 in FY 2003), the number of actions brought through administrative proceedings increased

⁵ Richard Hill. 2003. "SEC Enforcement Staff Says O & D Bars, Subpoenas, Insider Case Fines to be Focus." *BNA Securities Law Daily*, March 4.

⁶ Stephen M. Cutler, Director of SEC Enforcement Division. 2002. Remarks at the Glasser LegalWorks 20th Annual Federal Securities Institute, February 15.

approximately 30%, from 281 in FY 2002 to 365 in FY 2003 (Securities and Exchange Commission 2003b, 17). Although the SEC has not yet released data for FY 2004, the SEC Public Affairs Office confirmed that the FY 2004 numbers are similar to FY 2003: in FY 2004 the SEC filed 639 total enforcement actions, with a ratio of actions filed in federal district court to actions brought through administrative proceedings comparable to FY 2003, when the SEC filed a total of 636 enforcement actions.⁷ Again, this legislative change may also represent an exogenous shock that changes some of the influences on the decision making of the SEC.

Comparing Apples to Apples/Random Selection

So, by utilizing cases from this time period to create a data set, this analysis compares enforcement actions that the SEC brought within a similar legal and regulatory framework. The 100 individual cases were selected randomly. *Mathematica 5.0* was used to generate one random set of 50 numbers between 1 to and 2,018 (inclusive) to represent the 50 federal court cases to be used in the analysis and a second set between 1 and 2,631 to represent the 50 administrative proceedings. Each of the 100 cases that corresponded to the random numbers were then retrieved from SEC sources, which include both (i) the weekly *SEC Docket*, which contains a summary of each major event that occurred at the SEC the previous week, including the filing of each suit in federal district court and the initiation of each administrative proceeding, and (ii) SEC litigation releases and descriptions of administrative proceedings listed by fiscal year on the SEC web site, www.sec.gov.

⁷ Telephone interview with chief of SEC Public Affairs Office, Washington, D.C., March 23, 2005.

Regression Method and Variables

The analysis uses a basic logit regression because the dependent variable is dichotomous. This assumes that the errors have a standard logistic, rather than a normal, distribution. The full model that the regression tests is:

$$enforce = \alpha + \beta_1 courtcon + \beta_2 numdefs + \beta_3 corpcase + \beta_4 djia + \beta_5 income + \varepsilon$$

Dependent Variable

The dependent variable (*enforce*) is whether the SEC filed the enforcement proceeding in federal district court or in an administrative proceeding before an ALJ. This variable has the value of 0 if it was filed in district court and 1 if it was initiated before an ALJ.

1. Why Compare Filings in Federal District Court to Administrative Proceedings?

As explained below, the stakes for both the SEC and defendants are higher in federal district court than they are in administrative proceedings. Thus, as the SEC readily concedes (Securities and Exchange Commission 2003a, 9), and as was described in detail during a lengthy interview with a former Deputy Director of the Division of Enforcement and Acting General Counsel of the SEC (Mahoney Interview, 9 December 2003), the SEC employs tactical and strategic decision making when determining how to pursue a particular enforcement action. It is within this strategic decision making process that the SEC would be influenced, if at all, by the ideological composition of the federal district courts. Therefore, it is logical to investigate this process.

2. *The Different Scope of Authority of the SEC to Bring Charges against a Defendant in Federal District Court Compared to Administrative Proceedings before an ALJ*

The SEC has access to a larger and more potent array of sanctions in federal court than it does through administrative proceedings. Since a defendant is exposed to much 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 the protections offered through the SEC Rules of Practice, which govern discovery in SEC administrative proceedings. Its own Rules of Practice severely limit the information that the SEC has to provide to a defendant through discovery and do not provide for standard techniques of developing potentially exculpatory facts such as interrogatories and depositions. As a consequence, a defendant in an enforcement action in federal court will have a better idea of the evidence that the SEC has early in the process. Complying with enhanced discovery requirements and preparing a case for trial in federal court consume the time and resources of the SEC. So, the bureaucracy must weigh these added costs against the potential benefits of prosecuting an enforcement action in federal district court.

Table 2 summarizes the enhanced sanctions available to the SEC when filing an enforcement action in federal district court as compared to an administrative proceeding:

Table 2: Enforcement Action Sanctions Available to the SEC in Federal District Court as Compared to Those Available through Administrative Proceedings

<u>Federal District Court</u>	<u>Administrative Proceedings</u>
SEC must meet lower “reasonable likelihood” standard of proof to obtain temporary or permanent injunction.	SEC must meet higher “irreparable injury” or “inadequate legal remedy” standard to obtain temporary or permanent injunction
SEC can seek either temporary or permanent injunction against <i>any</i> person or entity	SEC has authority to seek temporary injunction against only a limited number of categories of participants in the securities industry
No statute of limitations for actions	Statute of limitations exists, varies depending on sanction SEC seeks
SEC has broad authority to seek monetary penalties against <i>any</i> violator of federal securities laws	Authority of SEC to impose administrative fines limited to actions against categories of securities professionals specified in federal statutes
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	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
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	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
Court can permanently bar a defendant from serving as officer or director of publicly traded company	After passage of Sarbanes-Oxley in 2002, SEC can also permanently bar a defendant from serving as officer or director of publicly traded company (but not relevant to data set for this paper)

Primary Independent Variable

The primary independent variable (*courtcon*) in this analysis is a measure of the ideological composition of the federal district courts. The measure ascends in value as the court grows more ideologically conservative. For each of the 50 enforcement actions that the SEC filed in federal district court, the analysis uses a measure of the ideology of the court in which the SEC actually filed the action on the date filed. And for each of the

50 enforcement actions that the SEC initiated through administrative proceedings, the analysis uses the measure of the ideology of the court in which the SEC would have filed the action had it decided to bring the action in federal district court on the date that the administrative proceeding was filed. The federal district court “in which the SEC would have filed the action” is defined, as appropriate, as either the district court for the area (i) where an individual defendant resides or (ii) where a corporate defendant has its principal place of business. This definition is based on a standard statutory provision of jurisdiction used in these types of cases (Mahoney, Walker, Schwartz and Greenstein 2004, A-4 (citing federal law 15 U.S.C. § 78y(a)(1))).

The measure of the ideology of an individual federal district court judge, designed originally for this paper, is based on two inputs: (i) the President who appointed the judge to the federal bench (*see* Canes Wrone 2003, 208 – 209) and (ii) the political party affiliation of the judge at the time that he or she was appointed to the bench. These inputs were weighted for each judge as follows:

<u>Score</u>	<u>Party of Nominating President</u>	<u>Party of Judge When Nominated</u>
0	Democrat	Democrat
.25	Democrat	Unknown
.5	Democrat	Republican
.5	Republican	Democrat
.75	Republican	Unknown
1.0	Republican	Republican

The measure of the ideological composition of each federal district court was determined by summing these values for each judge in the particular district (the number of judges ranged from 26 on the largest court in the sample (Southern District of New York, 1995) to 2 on the smallest court (Middle District of Louisiana, 1999) and dividing the sum by the number of judges on the court. This value provides an average measure of the relative conservatism of a district court.

The data for these measurements was available through a combination of the reference source, *The American Bench – Judges of the Nation* for calendar years 1992 through 2002, and a database developed under the guidance of Professor Wendy L. Martinek of the Department of Political Science at Binghamton University (SUNY). The database contains extensive data on each of the approximately 1,600 nominations made to the lower federal courts from 1977 through 2002.

It is noteworthy in this context that the analysis does not use as an independent variable a measure of the ideology of the ALJ's because it would be neither relevant nor measurable. The SEC, like all other federal bureaucracies, appoints its own ALJ's subject to the approval of the federal Office of Personnel Management (OPM) (5 United States Code § 3105 (statute); 5 Code of Federal Regulations § 930.201 (regulation) (these federal laws establish the regime for the selection of ALJ's)). The OPM establishes salary levels for ALJ's independent of ratings or recommendations from federal agencies (Hoffman and Cihlar 1995, 865). And in contrast to federal judges who have lifetime tenure, ALJ's can be removed by the OPM pursuant to federal reduction-in-force procedures (Verkuil 1992, 783).

Although the selection process for ALJ's is public, it is not political. The SEC selects ALJ's on the basis of technical expertise rather than a candidate's political preferences. And the OPM renders approvals for these selections based on the same criteria; it views ALJ's as "quasi-judicial officers" within the federal bureaucracies. Moreover, the ALJ's operate under authority delegated by the SEC (Exchange Act, 15 U.S.C. § 78d-1, § 4A). And the SEC is authorized to actually reverse a decision of an ALJ that went contrary to the enforcement position of the SEC in the administrative proceeding (Committee on Federal Regulation of Securities 1992, 1732; 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...")). So a particular bias of an ALJ, ideologically or otherwise, can be offset through subsequent action by the SEC Commissioners. Thus, the political ideology of an ALJ is materially relevant to neither the selection process of the ALJ nor the ALJ's performance of his or her duties within the bureaucracy.

Control Variables

numdefs

Since this analysis focuses on the nature of the enforcement actions (*i.e.* the forum in which the SEC brings the actions), two of the independent variables control for specific characteristics of these actions. The first such control variable (*numdefs*) is the number of defendants charged in the action. This provides a sense of whether the complexity and potential cost of the action affects the decision making process of the SEC. Specifically, it shows whether the SEC prefers to bring cases that emerge from more complicated frauds involving larger numbers of persons and entities in federal

district court to take advantage of the enhanced efficiency of the court proceedings. On the other hand, the SEC might have a preference to file complicated enforcement actions in administrative proceedings because ALJ's have more experience in handling these actions and technical expertise in securities fraud.

Also, a case with multiple defendants requires the SEC to negotiate potential charges and settlement agreements with numerous defendants, most of whom have interests that conflict not only with the SEC but also with the other defendants. The SEC must develop evidence supporting the charges against each separate defendant, identify appropriate penalties for each defendant and maintain parallel negotiations with the legal representatives for each defendant during the course of the investigation and subsequent enforcement action. The SEC uses substantial resources in these efforts. During its decision making process, therefore, the SEC might consider having recourse to the more onerous threat of the sanctions available in federal court to use as leverage against the multiple defendants to avoid an impasse in the progress of complicated and costly negotiations, or it may decide that the friendlier confines of an administrative proceeding provide the appropriate leverage. The control variable provides some data on these difficult choices.

corpcase

The second variable (*corpcase*) controls for the type of defendant in an enforcement action. This dummy variable has the value of 0 if the primary defendant in an action is a corporation and 1 if it is an individual. The use of this variable is motivated by the study of IRS audit policy by Scholz and Wood (1999) described on pages 11-12 above. Building on the rationale of Scholz and Wood, the SEC might be more confident

to bring an enforcement action against an individual defendant rather than a corporate defendant in a federal district court that has a conservative ideological composition. Similarly, if faced with an ideologically liberal district court, the SEC might prefer to bring the action in an administrative proceeding.

Two noteworthy issues apply, however, to this variable. First, the analysis must remain conscious of the concept of a national ‘partisan reversal’ and a possible blurring of the ‘dominant coalition’ effects identified by Scholz and Wood. Thus, in light of the unprecedented levels of financial fraud that have occurred recently and the successful prosecutions of many high-level offenders, attacking financial wrongdoing is now good politics for both political parties regardless of whether the offender is an individual or a corporation. So, it is possible that federal judges from both ends of the ideological spectrum may now be, at least in the short-term, more deferential to SEC enforcement positions in court. Second, this independent control variable might serve as a useful independent variable in an additional model in a future analysis pursuant to this same rationale. As a dependent variable, it could test further the Scholz and Wood concepts and also help reveal whether the SEC considers the ideology of the federal district courts when making decisions about tactics in an enforcement action against individual defendants as compared to actions against corporate entities.

djia and income

The analysis also uses two economic control variables. The first (*djia*) is the level of the Dow Jones Industrial Average (DJIA) on the date that an enforcement action is filed. The DJIA is the oldest and most widely quoted indicator of stock market performance in the world. It is an index of 30 blue chip U.S. stocks that is now selected

by the editors of the *Wall Street Journal*. The historical daily levels of this index are available from Dow Jones at www.djindexes.com. The second variable (*income*) is the average per capita income in the U.S. on the date of the filing of an enforcement action. This variable or one of its derivatives is commonly used as an indicator of the vitality of the U.S. economy (*see, e.g.*, Erikson, MacKuen and Stimson 2003, 244). The data is available from the Bureau of Economic Analysis of the U.S. Department of Commerce at www.bea.doc.gov.

These variables show whether the SEC is less confident about filing an enforcement action in federal district court, where the outcome is less predictable for the agency than in an administrative proceeding, when the economy and the stock markets are performing poorly. These controls are motivated by literature asserting that bureaucracies are more likely to regulate when the economy is performing well and less eager to regulate during a weak economy in order to permit needed economic growth (*see, e.g.*, Krause 1996). Others argue that causality flows in the other direction, particularly when the SEC is involved.⁸

Lastly, the analysis does not include a control variable for Congressional ideology. If this value had been calculated, it would have been derived from the ideological compositions of the respective Senate and House committees that have responsibility for overseeing the SEC. Under *Rule XXV* of the *Standing Rules of the U.S. Senate*, the Senate Banking, Housing and Urban Affairs Committee has this responsibility (*see* www.senate.gov). In the House, *House Rule X* mandates that the House Committee on Financial Services oversees the SEC (*see* www.house.gov). These

⁸ Mark Maremont and Deborah Solomon. 2003. "Missed Chances – Behind SEC's Failings: Caution, Tight Budget, 90's Exuberance." *Wall Street Journal*, December 24, p. A1 (quoting Seligman, "The greatest enemy of effective securities regulation and corporate accountability is a sustained bull market").

values were not used here, however, because they would not have added significantly to the analysis. If this analysis were to be expanded to track each enforcement action filing that the SEC made over the last ten fiscal years and compare the ratio of the number of actions filed in federal district court to the number of administrative proceedings, then this measurement might be valuable. The analysis here, in contrast, tries to elicit meaningful data from the individual cases to explain some material factors of the SEC decision making process.

Results and Conclusions

Results

Table 3 shows the standard logit regression estimates results for both the full model and the reduced form of the model.

Table 3: Logit Regression Analysis Comparing Full and Reduced Models

<u>Variables</u> Dependent Variable = <i>enforce</i> (federal court = 0, administrative proceeding = 1)	<u>Model 1 : Full Model</u> Logit Coefficients (Standard Error)	<u>Model 2: Reduced Model</u> Logit Coefficients (Standard Error)
Ideology of Federal District (<i>courtcon</i>)	1.489 (1.556)	1.828 (1.305)
Number of Defendants (<i>numdefs</i>)	-.779 * (.229)	-.784 * (.229)
Defendant Individual Person or Corporate Entity (<i>corpcase</i>)	-.219 (.490)	-.217 (.488)
Level of Dow Jones Industrial Average (<i>djia</i>)	-.118 (.294)	_____
Level of Average Per Capita Income (<i>income</i>)	.066 (.270)	_____
Constant	.132 (5.334)	.821 (.869)
Observations	100	100

* Statistically significant at 1%.

In Model 1, one of the five independent variables, the number of defendants per enforcement action (*numdefs*), is statistically significant. The other four, including the ideological composition of the federal district courts, are not significant at $\alpha = .05$. The sign for *numdefs* is negative, indicating that as the number of defendants in an enforcement action increases, it becomes more likely that the SEC will bring the action in federal district court rather than before an ALJ. This provides support for the theory that the SEC prefers to bring cases that emerge from more complicated frauds involving larger numbers of persons and entities in federal district court to take advantage of the enhanced efficiency of the court proceedings. It also supports the concept that the SEC utilizes the more onerous threat of the sanctions available in federal court as leverage against multiple defendants to avoid, where possible, an impasse in the progress of complicated and costly negotiations in enforcement actions.

Although the variable *courtcon* is not statistically significant, its sign is strongly positive. This would have provided support for the theory that as the ideological composition of the federal district courts grew more conservative, the SEC would be more likely to bring an enforcement action through an administrative proceeding than in an ideologically conservative court. Importantly, this result would have supported the hypothesis and the conclusions of Canes-Wrone.

The variable *corpcase* is not statistically significant, but its negative value shows that it would have supported the notion that the SEC is more likely to bring enforcement actions against individual persons in federal district court and pursue actions against corporations in administrative proceedings. Also, the signs of the two economic control

variables, *djia* and *income* are different and the sizes of their coefficients are relatively small. A subsequent analysis would likely employ only one economic control variable.

Model 2 excludes these economic variables. In this reduced model, *numdefs* remains statistically significant and its sign remains positive. Its standard error is the same as the standard error in Model 1, however, and the size of its coefficient is slightly larger. Neither *courtcon* nor *corpcase* becomes significant in the reduced form of the model. It is noteworthy that *courtcon* is much closer to being statistically significant in Model 2 than in the full model (.161 for Model 2 compared to .338 in Model 1). Also, its sign remains positive, its coefficient increases in size and its standard error is somewhat reduced. Further, the sign and size of the coefficient, and the standard error, are virtually identical for *corpcase* in Models 1 and 2.

Increasing the sample size of the data set would likely decrease the large standard errors in these regression results. And perhaps one or more of the independent variables would become statistically significant if the data base comprised 1,000 or more enforcement actions as compared to 100. Moreover, a subsequent analysis with a larger data set would include a computation of the marginal effects of each variable to determine exactly how much the probability of the SEC filing an enforcement action through an administrative proceeding would increase or decrease depending on a one-unit increase in the specific independent variable. Finally, a subsequent analysis would add estimates of the log likelihood for successive models to determine whether different models have better predictive value.

Conclusions

The analysis does not support a conclusion that the SEC considers the ideological composition of the federal district courts when making a strategic decision about whether to file an enforcement action in federal court or through administrative proceedings. This result is not necessarily surprising despite findings generally to the contrary in the recent work by Canes-Wrone (2003). It is unclear whether the support underlying the Canes-Wrone conclusion that the ideological composition of the federal courts affects the decisions of the Army Corps can be generalized to more high-level decision making processes in other federal bureaucracies. It does not appear that they can be applied to the SEC.

The questions about this innovative approach to thinking about the relationship between federal courts and bureaucracies arise from its assumptions. First, to make the connection between the potential bias of an ideologically conservative or liberal federal court and the decision making process of a bureaucracy, an analysis must assume that the agency knows the ideological proclivities of the federal judge who will preside over an agency matter, such as an enforcement action, filed in federal court. As described by a former bureaucratic leader of the Division (Deputy, second in the chain of command) who reviewed hundreds of potential enforcement actions a year originating from the eleven SEC regional offices, even though the SEC may be aware of the general ideological composition of the district courts that handle many securities cases (for example, the Southern District of New York and the District Court for the District of Columbia), it is impossible for the agency to determine in advance which specific judge

from a district will be assigned to an action (Mahoney interview, 9 December 2003). So, the general awareness is largely negated by uncertainty.

This makes other, more mundane factors become relatively more important in the decision making process. Such factors might include whether the evidence and facts place a case within the clearly defined elements of a federal statute that warrants a court proceeding and potential higher penalty for the defendant, or whether the alleged offense is covered only by administrative penalties and is appropriate for a proceeding before an ALJ. Another factor is the level of cooperation by defendants with the SEC staff in its investigation. Also, in its role as a regulator of U.S. capital markets, the SEC will sometimes consider the adverse effect its choice of forum decision would have on public shareholders (innocent victims who would be collaterally affected) of the company if the SEC were to pursue more harsh sanctions against members of management, or the corporation itself, in federal court. This decision making, which takes the public interest into account, is not the purview of a typical prosecutor, such as a U.S. Attorney's Office, but is relevant to the process of a federal agency such as the SEC that must balance its various responsibilities to the public.

It is reasonable, then, to think critically about the ability to extend the Canes-Wrone theory to assert that a bureaucracy weights heavily its speculation about the consequences of judicial assignment when making high-level decisions about how to proceed in a policy area that defines the mission of the agency. In the case of the SEC, enforcement actions have traditionally defined the mission of the agency. Moreover, the SEC decision making process regarding where and how to bring an enforcement action is

multi-tiered and reaches the highest levels of the agency – twice – before the SEC files an action in federal district court or initiates an administrative proceeding.

As a consequence, the many bureaucratic sources of comment from within the SEC on an enforcement action consider the tangible factors described above during the decision making process. Moreover, higher level bureaucrats, including the five SEC commissioners, consider the broader policy implications of the enforcement actions and whether the actions reflect accurately the mission of the agency and help it achieve its enforcement goals for the fiscal year. Often, the five commissioners do not agree on how best to pursue the mission of the SEC, so their inputs may at times confound SEC policy implementation and enforcement strategies.⁹ Some scholars theorize further that the enforcement role of the SEC legitimizes the agency's existence and its federal budget allocation to Congress (*see, e.g.*, Bealing 1994, 555 – 556). If this is accurate, the high levels of the SEC bureaucracy focus on ensuring that the enforcement actions filed during a year add to the perception that the SEC is carrying out its duties so as to maintain a base of support within the Congressional budget process.

In the context of these myriad factors that comprise the substance of the SEC decision making process, speculation about the ideology of a judge who may – or may not – preside over an enforcement action appears relatively unimportant.

⁹ Deborah Solomon. 2005. "SEC's Top Enforcer Plans to Move On; 'It's a Grueling Job.'" *Wall Street Journal*, April 15, p. C1 (article states five-member commission was divided over last three-and-a-half years).

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