Docket No. 24-1899

In the

United States Court of Appeals

for the

Ninth Circuit

THOMAS JOSEPH POWELL, et al.,

Petitioners,

v.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for Review from the United States Securities and Exchange Commission, No. 4-733

BRIEF OF ATLANTIC LEGAL FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS AND REVERSAL

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PRELIMINARY STATEMENT

This amicus brief in support of Petitioners is being filed in accordance with Federal Rule of Appellate Procedure 29(a) and Circuit Advisory Committee Note 29-3.

Petitioners and Respondent have consented to the filing of this brief.

Pursuant to Federal Rule of Appellate Procedure 29(a)(4)(E), no party's counsel authored this brief in whole or part, and no party or party's counsel, and no person other than the *amicus curiae*, its supporters, or its counsel, contributed money that was intended to fund preparing or submitting the brief.

INTEREST OF THE *AMICUS CURIAE*

Established in 1977, the Atlantic Legal Foundation ("ALF") is a national, nonprofit, public-interest law firm whose mission is to advance the rule of law by advocating for individual liberty, free enterprise, property rights, limited and efficient government, sound science in judicial and regulatory proceedings, and effective education. With the benefit of guidance from distinguished legal scholars, corporate legal officers, private practitioners, business executives, and prominent

scientists who serve on its Board of Directors and Advisory Council, the Foundation pursues its mission by participating as *amicus curiae* in carefully selected appeals before the Supreme Court of the United States, federal courts of appeals, and state supreme courts.

* * *

This case implicates one of ALF's fundamental concerns: checking the power and autonomy of the federal administrative state—the de facto "fourth branch" of government. As a steadfast advocate for limited and responsible government, civil justice, and due process of law, ALF urges the Court to grant the petition and direct the SEC to engage in rulemaking that respects the public's right to oversee those enforcing the law. This brief provides a bird's eye view of the SEC's opaque enforcement practices and how its "Gag Rule" fits into that schema.

SUMMARY OF ARGUMENT

Because of the Gag Rule, 17 C.F.R. § 202.5(e), it is impossible to determine whether the SEC's Enforcement Division is seeking civil justice or its own ends. Like a defendant without an alibi, there simply is no information on vast swaths of SEC's enforcement activity. As an integral and significant part of this dearth of information, the "Gag

Rule" severely limits SEC civil enforcement targets' ability to shed light on the merits of SEC's enforcement actions.

The Gag Rule sets forth the SEC's policy preventing the Commission from settling claims without compelling an agreement "to avoid creating, or permitting to be created, an impression that a decree is being entered or a sanction imposed, when the conduct alleged did not, in fact occur." 7 C.F.R. §202.5(e). This vague gag on the accused's speech does more than prevent an individual from vindicating themself, but also prevents the public from being "their own governors" because "knowledge will always govern ignorance." James, *James Madison to W. T. Barry*, (August 4, 1822.)[1] No one else has access to the information that the accused holds and SEC will not distribute it any other way. Although many parts of SEC enforcement are hidden from public view, its pre-enforcement decisions are particularly immune to review.

The public has a right to know. The public needs to know. Law enforcement in secret is a gateway to fascism. Our federal government must be better than that.

[1] Available at https://tinyurl.com/356hmcef.

ARGUMENT

SEC's Gag Rule is Part of a Scheme of Secrecy That Permits Unjust Civil Enforcement

The SEC claims that it created the Gag Rule in 1972 to solve a problem. But the justification to which it points is misleading.

> Over fifty years ago, the "Wells Committee" examined the Commission's enforcement practices. The committee produced a report in September 1972, and shortly thereafter, the Commission issued a policy regarding settlements. . . . It reflects the Commission's view that in any civil lawsuit or in any administrative proceeding of an accusatory nature, "it is important to avoid creating, or permitting to be created, an impression that a decree is being entered or a sanction imposed, when the conduct alleged did not, in fact occur." 17 C.F.R. 202.5(e).

ER 56 (SEC letter of Jan. 30, 2024 to New Civil Liberties Alliance denying rulemaking petition) at 9 (internal citations omitted).

The Commission points to the Wells Committee's recommendations as its motive for creating the Gag Rule. But the Commission does not cite to the Wells Committee's recommendations. Instead, the Commission cites to a document establishing the Committee. *Id.* This might be because the Wells Committee's recommendations (i) uniformly encouraged more transparency, and (ii) said *absolutely nothing* about preventing defendants from discrediting the claims against them. *See, e.g.*, John A. Wells, Chairman, Advisory Committee on Enforcement

Policies and Practices, Report of the Advisory Committee on Enforcement Policies and Practices (June 1, 1972)[2] ("Wells Report"), (Recommendation 4—"The Commission should publish periodically a summary of significant interpretative positions taken by the staff," Recommendation 11—"A procedure should be established for auditing investigative practices and techniques of enforcement personnel on a continuing basis," Recommendation 19—"In the ordinary case the staff should exhibit a draft of the proposed order for proceedings to the adverse party or his attorney.").

Despite this lack of authority or justification, the SEC keeps as much of its enforcement activity out of the public eye as possible. The most guarded part of that process is what happens before a case is opened, an area called pre-enforcement. In addition to denying FOIA requests on investigations and obscuring outcome statistics, the SEC, under the Gag Rule, forces all defendants who settle judicial or administrative civil enforcement actions to agree not to make statements casting doubt on their culpability. In effect, this prevents defendants (or

[2] Available at tinyurl.com/2p8scsk2.

administrative enforcement respondents) from sharing any negative details from their experience, closing another window into the SEC's pre-enforcement behavior. The SEC has power and perverse incentives, and it largely operates in secrecy—the perfect trifecta for a threat to civil liberty.

A. SEC wields broad, discretionary enforcement and pre-enforcement power

Although the SEC may not employ police officers, carry guns, or put people in prison (directly), it absolutely engages in law enforcement activities. And, just like all law enforcement, it can call upon the force of the federal government to ensure that its decisions take effect. *See, e.g.*, Frédéric Bastiat, *The Law* (FEE ed.), Foundation for Economic Education (1998), pp. 3-4, (explaining that government and law are the "substitution of a common force for individual forces"); Thomas Hobbes, *Leviathan* (1909 ed.) Clarendon Press, 1651, pp. 135-90 (explaining that the covenant between the government and the governed is only as powerful and as binding as it is backed by the "publique Sword"). If anyone doubts that force is behind all government actions, let them refuse to pay a fine levied by "civil" enforcement, ignore orders of a judge

in a "civil" case, or attempt to withhold real estate found to be another's property, and see what consequences knock at their door. The SEC acknowledged this functional force when it compared the settlements at issue in Petitioners' renewed rulemaking petition to a criminal plea bargain. ER 59.

The SEC has broad discretion concerning where it directs the enforcement authority it has been given. This starts when it chooses what laws to emphasize, what market segments to monitor, what tools to use to enforce laws, and even how it reports the outcomes of its decisions. *See Molchatsky v. United States*, 713 F.3d 159, 162 (2d Cir. 2013) ("[T]he SEC retains complete discretion over when, whether and to what extent to investigate and bring an action against an individual or entity."); Stephen J. Choi, *Measuring the Impact of SEC Enforcement Decisions*, 89 Fordham L. Rev. 385 (2020) ("Today, the SEC enjoys wide discretion in its enforcement decisions, including decisions on whether to bring an action at all, against whom to bring the action, the timing of the initiation and resolution of the action, the venue of enforcement (civil court or an administrative proceeding), and the remedy sought from enforcement."). Only after the enforcement process reaches a late stage and someone is

accused does the Commission make its actions public. But everything that happens before then which led to that step is inaccessible. What type of regulated entities received the most scrutiny, whether the increased attention led to more enforcement actions, and if that resulted in positive effects for the public are all questions for which the SEC does not provide answers. Only occasionally will an SEC publication disclose even the raw number of matters investigated, or number of actions recommended to the Commission. *See, e.g.*, SEC, Select SEC And Market Data Fiscal 2015, at 24, tbl. 4 (2016)[3] (reporting aggregate information on investigations). It is not reported in their annual reports.

And it is not only the public that is kept in the dark by SEC enforcement. From investigation to initiating the case, all disclosure to the accused is discretionary. *See,* e.g., SEC Enforcement Manual, § 2.3.4.2 (2017) ("Manual")[4] ("[A] copy of the formal order shall not be furnished to that person for their retention without the express approval of a Division official at the level of Assistant Director or higher. 17 C.F.R. § 203.7(a)."); *id.* § 2.4 (discussing what the subject of an

[3] Available at https://tinyurl.com/5yvetyf7.

[4] Available at https://tinyurl.com/bdcs7efa.

investigation may be told about the investigation and how to decide whether to notify them). There is some mandatory transfer of information when an order requiring a witness or subject to produce documents is issued, but they may never get a copy of a document with that information.

> Rule 7(a) of the SEC's Rules Relating to Investigations provides that a person who is compelled or requested to furnish documentary evidence or testimony at a formal investigative proceeding shall, upon request, be shown the Commission's formal order. However, a copy of the formal order shall not be furnished to that person for their retention without the express approval of a Division official at the level of Assistant Director or higher. 17 C.F.R. § 203.7(a).

Manual, § 2.3.4.2 (2017). Without copies of several iterations of these documents, it is impossible to identify any type of trend or normative analysis to SEC's investigative decisions. Although this idea of pre-charge secrecy is not unique to SEC enforcement, it is taken to an extreme by the SEC. *See, e.g.*, Lauren M. Ouziel, *supra.* Both the person accused and the public are kept in the dark. In a traditional criminal investigation, the defendant at least has a constitutional right to discovery under *Brady v. Maryland*, 373 U.S. 83 (1963), which guarantees production of exculpatory evidence in a timely manner. SEC proceedings provide no such access.

The movement from investigation to charge, which occurs via formal recommendation to the Commission, also is opaque. Manual, § 2.5. The only way an investigation matriculates to an enforcement action is through a recommendation, which might be paired with a statement opposing the recommendation by the accused party. In 1972, the SEC made some non-binding policy recommendations that allowing the accused party to argue against enforcement when the Commission is deciding how to allocate resources would be advantageous. *See* Securities Act of 1933 Release No. 5310, "Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations";[5] *see also* Wells Report at 28-33.

To allow the accused to write such an argument, he must have some idea of what he is suspected of doing wrong. This led to the development of the "Wells Process." Manual, § 2.4. This process allows, but does not require, the SEC Enforcement Division to disclose to an entity against whom it is recommending instituting an action (i) that the recommendation is coming, (ii) what laws the recommendation alleges were violated, and (iii) that they may write or video record a counter

[5] Available at https://tinyurl.com/39hwv6sd.

argument to present to the Commission. This does not include a full disclosure of the case file, a description of the facts underlying the alleged violations, or even a timeframe in which the illegal activities were alleged to occur. For that, the recipient of the notice must make a special request for portions of the Enforcement Division's investigative file which staff "has discretion to allow." *Id.*

Neither Formal Orders of Investigation, which start the enforcement process, *see* Manual, § 2.3.4, nor Matters Under Inquiry, the initial fact-finding phase of SEC review, are produced to the public via FOIA requests. The Commission claims that disclosure would make its practices too vulnerable to exploitation by regulated parties, appealing to FOIA exemptions 7(a) & 7(e). This claim has the convenient side-effect of preventing criticism.

The SEC will not even describe its investigations in a statistical manner. This is particularly disturbing given the SEC's penchant for deleting the files after the fact, making long term trend analysis impossible. *See* Matt Taibbi, *Is the SEC Covering Up Wall Street Crimes, Rolling Stone (2011).*[6]

[6] Available at https://tinyurl.com/57j6ymz.

There occasionally are some publications on specific types of investigations, if the Commission deems it appropriate and in the public interest to issue a Report of Investigation under Section 21(a) of the Exchange Act.[7] These disclosures are meant to educate the public on risks from market players, however, not to clarify the agency's workings.

This is where the "Gag Rule" really bears fruit for the Commission. While the lack of disclosure prevents trend-based review of investigative decisions, the Gag Rule is a tool to prevent piecemeal review. Settlements are supposed to balance the strength of the case against the effort of defense. Wells Report at 34. But with SEC civil enforcement cases the accusation is the ball game. No matter how flimsy the evidence in the allegation, the cost of defense inflicts catastrophic harm, in and of itself. *See, e.g.*, Brief of Mark Cuban, Phillip Goldstein, Elon Musk, Nelson Obus, and Investor Choice Advocates Network as Amicus Curiae in Support of Petitioner at 4-6, *Romeril v. SEC* (U.S. 21-1284) (describing the Hobson's Choice defendants face when the cost of being investigated is so high).[8] If win or lose, the defendant loses millions, the only option

[7] *See, e.g.*, https://tinyurl.com/28pyrmwa.

[8] Available at https://tinyurl.com/4j5x6b5j.

to mitigate what is likely a bankrupting cost is to settle.

So, the rational decision is to settle, regardless of guilt or strength of evidence. These settlements are not real victories for the SEC. These are not victories for the public's goal in regulating this field. They are only self-serving victories for SEC personnel.

This is an inequitable arrangement and its impact on transparency is evident in that almost all SEC enforcement actions settle. *See* Commissioner Luis A. Aguilar, "A Stronger Enforcement Program to Enhance Investor Protection" (20th Annual Securities and Regulatory Enforcement Seminar, Oct. 25, 2013),[9] (noting that SEC settles approximately 98 percent of its enforcement cases). And almost all of those settle immediately upon filing of the enforcement action, indicating prior communication between the defendant and the Commission. There is no reported information on what that communication was, whether there were defects in the investigation, or if any undue pressure was applied to the defendant. And settling defendants cannot speak out against any shortcomings because that would be attacking the proceeding against them, violating the Gag Rule. It is even unclear if

[9] Available at https://tinyurl.com/5n8ucdtu.

defendants could publish information about the investigation against them without commentary. As Commissioner Pierce noted,

> What is an action that "create[s] the impression" that the complaint lacks a factual basis? A defendant looking at this language is not going to have any idea where it ends[…] What if she publishes a book with additional facts that were not included in the complaint, and those facts cast the entire case in an entirely different light? Has she then "create[d] the impression" that the complaint lacked a factual basis?

ER 64.

On a more generalized level, if a defendant had reason to believe they were targeted for their race, religion or protected speech—such as criticism of the SEC or the current president—they probably would not disclose that information after a gag order. With so many actions settling, it is impossible to know if the enforcers are using the power of the people in a constitutional or ethical manner. The SEC believes it has the right to prevent anyone from examining how it goes about using the people's power and the public purse.

B. SEC's Enforcement Division has strong incentives to pursue its own agenda and no reason to consider the public's opinion of its decisions

Making and enforcing law is an activity that can and has been misused. *See, e.g.*, Bastiat, *supra* at xii ("As long as it is admitted that the law may be diverted from its true purpose — that it may violate property instead of protecting it — then everyone will want to participate in making the law, either to protect himself against plunder or to use it for plunder."). Whether for personal advancement, prejudice or for institutional gain, there are reasons the SEC's behavior may not live up to its constitutional, statutory, or ethical obligations. The SEC and its personnel have the motive, or at least the temptation, to place their own interests ahead of the public interest. From the oft-maligned "revolving door" issue to the desire to increase the agency's funding, there are many reasons the SEC's and the public's interests might diverge. *See, e.g.*, Ed deHaan et al., T*he Revolving Door and the SEC's Enforcement Outcomes: Initial Evidence from Civil Litigatio*n, 60 J. Acct. & Econ. 65, 66 (2015) (discussing the flow from SEC enforcement attorney to defense attorney for regulated party and relating it to enforcement outcomes); SEC, FY 2020 Congressional Budget Justification and Annual Performance Plan,

FY 2018 Annual Performance Report (2019), (presenting enforcement statistics and "successes" as part of SEC's congressional budget request and justification).[10]

Many researchers have attempted to use the available data to reverse engineer how the SEC makes pre-enforcement decisions each year. All have been stymied by the poor reporting and lack of transparency. For example, Professor Urska Velikonja compiled all the SEC's then-public reports in 2016 and outlined several flaws and under-disclosures. Professor Velikonja suggests that better enforcement statistics for its congressional budget request "likely influence what types of actions SEC brings." Urska Velikonja, *Reporting Agency Performance: Behind the SEC's Enforcement Statistics*, 101 Cornell L. Rev. 901, 969-970 (2016).

Some scholars suggest a political or ideological motive for uneven enforcement and uneven reporting. *See, e.g.*, Stephen J. Choi, *supra.* Professor Choi points to the change in number of enforcement actions in the last year of the Obama administration and the first year of the Trump

[10] Available at https://tinyurl.com/2mj8n54m.

administration as a change in ideology. Professor Choi added that the change in enforcement actions did not correlate with a change in number of securities class actions, indicating that it was not a change in behavior by regulated parties, but a change in enforcement decision-making.

C. A secret process with perverse incentives does not inspire or deserve public trust

The Gag Rule both advances and is advanced by self-serving interests of SEC personnel. Others will no doubt describe the value of free and open debate to creating public trust; this brief primarily speaks to the importance of public access for trust. *See, e.g.*, Rodney A. Smolla, *Why the SEC Gag Rule Silencing Those Who Settle SEC Investigations Violates The First Amendment,* 29 Widener L. Rev. 1, 18 (2023) (describing the First Amendment's role as a manifestation of the public's mistrust of government and desire to hold it in check). Because of the Gag Rule, defendants who settle cannot discuss the SEC's behavior during the investigation, preventing review of the investigator's behavior.

The SEC wants to settle as many cases as possible, rather than litigate, producing higher enforcement statistics at lower cost. For

example, the SEC claimed in its 2020 budget request that by litigating certain cases, it was able to pressure other regulated parties into settling because it had "demonstrate[ed] that it will pursue litigation and trial, if necessary[…]" *See* SEC, FY 2020 Congressional Budget Justification and Annual Performance Plan, *supra*, at 123. Perhaps this was good management of resources, or perhaps it was an agency padding its stats and silencing potential critics in one move. Commissioner Pierce noted SEC incentives to settle in her dissent from denial, pointing out that "forgoing its day in court yields great benefits to the commission. When it settles, the commission does not need to prove the allegations in court – which is expensive, time-consuming, and difficult[.]" ER 63. Statistical and FOIA obfuscation hides agency-wide shortcomings. The Gag Order prevents demonstrating that the agency failed to live up to its constitutional or ethical standards in any one case.

Of particular concern in the Gag Rule scenario, pre-enforcement choices are easily manipulated. Whether and whom to investigate is a decision ripe for abuse, whether that is by targeting based on the resources available to the accused to defend against a claim, targeting based on protected class, or by targeting investigations against regulated

parties who are critical of the agency. Lauren M. Ouziel, *Prosecution in Public, Prosecution in Private,* 97 Notre Dame L. Rev. 1071 (2022) (describing the secrecy surrounding pre-charging decisions in typical criminal investigations and its deleterious effect on perceived and actual justice). But with the SEC the decision on who to investigate happens without public review.

The SEC has lost public trust by hiding. Narratives of bad behavior and continuing mistrust surround the Commission. *See,* e.g., David Michaels, *SEC Says Employees Improperly Accessed Privileged Legal Records*, Wall St. J. (Apr. 6, 2022); Jean Eaglesham, Fairness of SEC Judges Is in the Spotlight, Wall St. J. (Nov. 22, 2015); Kent Barnett, *Against Administrative Judges*, 49 U.C. Davis L. Rev. 1643 (2016) (discussing the inherent unfairness of ALJ proceedings, with data from SEC actions); Chris Prentice, *Wall Street enforcement to get tougher as SEC's new top cop gets to work*, Reuters (July 26, 2021).

The SEC has the opportunity to rebuild public confidence by supplementing the existing narrative with real data, open disclosure, and the abolition of gag orders. But today the agency is committing the

unforced error of letting speculation fill the void left by its silence and suppression. Frank D. LoMonte, *Rebuilding Trust through Government Transparency and Accountability*, 46 Hum. Rts. 18 (2021) (explaining the value of disclosure to public image).

CONCLUSION

The petition for review should be granted, the Gag Rule should be vacated, and the Commission ordered to commence rulemaking in accordance with the Petitioners' request.

Respectfully submitted,

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June 24, 2024

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