A Key Victory For SEC In Battle Over Administrative Courts

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The U.S. Securities and Exchange Commission scored a significant victory last week when a three-judge panel of the U.S. Court of Appeals for the D.C. Circuit ruled in Raymond J. Lucia Cos. Inc. and Raymond J. Lucia v. SEC that the appointment of the SEC's administrative law judges does not violate constitutional requirements.[1] This case was a matter of high stakes for the agency as an adverse ruling could have compromised a large part of the SEC's enforcement program.

In recent years, the SEC's Enforcement Division has increased its use of administrative actions. This increased use, particularly for litigated actions against individuals not working in the securities industry, has triggered considerable criticism from the defense bar and commentators about the perceived unfairness of the SEC's administrative proceedings. Lawyers and commentators have pointed to many factors contributing to the alleged unfairness, including the fast pace of the proceedings (often going to trial in only four months), the lack of significant discovery for litigants, the use of in-house judges, the lack of a jury trial right, and having to appeal ALJ decisions first to the commission (the very body that approved bringing the action in the first place).[2] In response to the uptick in litigated administrative proceedings, resourceful defense lawyers began advancing arguments that the ALJs were unconstitutionally appointed in violation of the appointments clause of Article II of the U.S. Constitution.[3]

Notably, Lucia is the first time a circuit court of appeals has decided this constitutional question.

Previously, many litigants raised the constitutional arguments through injunctive actions in federal district courts seeking to enjoin ongoing SEC administrative proceedings. This strategy had some success at the district court level.[4] However, the SEC was able to stem the tide by successfully arguing on appeal that federal courts lacked subject matter jurisdiction to hear the constitutional arguments until litigants exhausted the administrative process. To date, the circuit courts to decide this jurisdictional question have agreed with the SEC.[5] Because of this jurisdictional hurdle, the constitutional question has been slow to reach judicial review by the circuit courts, until now.

The appeal in Lucia involved a review of a commission opinion upholding an ALJ's initial decision that found San Diego-based investment adviser Raymond J. Lucia and his entities liable for misleading statements under the Investment Advisers Act of 1940. In its opinion, the commission rejected Lucia's arguments that the administrative hearing was unconstitutional because the ALJ presiding over the matter was unconstitutionally appointed. The key question at issue was whether the ALJ was simply an employee of the SEC, or rather whether he should be considered an "inferior officer" of the United States, subjecting his appointment to the

requirements of the appointments clause. If deemed an inferior officer, the ALJ's appointment would be unconstitutional since the ALJs are not appointed by the president, the courts or the commission by delegated authority, but rather are hired through a federal government hiring process for ALJs. Not surprisingly, the commission found that the ALJ was an employee, not an inferior officer, and therefore not subject to the appointments clause.[6] Lucia subsequently appealed to the D.C. Circuit.

On appeal, the appointments clause issue was squarely teed up for the circuit panel. In its briefs, the SEC staff conceded that the ALJ was not appointed in compliance with the appointments clause and that the commission's opinion and sanctions could not stand if the D.C. Circuit found that the ALJ was an inferior officer subject to the appointments clause.

In answering the central question of whether the ALJs are "inferior officers," the three-judge panel focused on an ALJ's authority to issue final decisions of the agency. The panel noted they were bound by the circuit's prior precedent, Landry v. Federal Deposit Insurance Corp., where the D.C. Circuit had held that ALJs of the FDIC were not inferior officers primarily because they lacked final decision-making authority.[7] Significantly, the panel stated that their analysis of the constitutional question "begins, and ends" with this consideration. The parties were in dispute on this issue, with petitioners arguing that the ALJs had the ability to issue final decisions under certain circumstances and the SEC staff arguing that only the commission itself could render final decisions.

In siding with the SEC, the three-judge panel found it critical that under SEC rules an ALJ's initial decision could only become final upon order of the commission itself through a so-called "finality order." Additionally, the panel noted that prior to issuing a finality order, the commission retains the power to conduct a review of an ALJ's initial decision in every case regardless of whether an appeal is filed. The panel also found it convincing that the commission reviews an ALJ's initial decision de novo and "may affirm, reverse, modify [or] set aside" the initial decision "in whole or in part ...." Based on these considerations, the panel held that the ALJs were employees of the SEC and not inferior officers, and thus an ALJ's appointment was not subject to the requirements of the appointments clause.

Undoubtedly, this decision will bolster the SEC's use of its administrative forum even in the face of continued criticism that the forum gives the agency an unfair advantage. Individuals suspected of securities law violations will have to remain prepared to defend themselves in administrative proceedings even if they are not employed in the securities industry. The battle on this issue is likely not over, however. SEC enforcement cases are pending on appeal in other circuits where the appointments clause issue may be considered.[8] Additionally, litigants in administrative proceedings will continue to raise the constitutional arguments in proceedings outside of the D.C. Circuit. If a circuit split develops, this issue ultimately may have to be decided by the U.S. Supreme Court.

The probability of a circuit split is difficult to handicap. On the one hand, other circuit courts are not bound by Landry, which the D.C. Circuit heavily relied upon in rendering its decision in Lucia. On the other hand, the D.C. Circuit has significant expertise in interpreting administrative law and procedures, so other courts may give Lucia and Landry considerable weight. In any

event, the next circuit-level decision will be crucial. A consistent decision could spell the demise of the appointments clause argument while a contrary decision would give the argument new life.

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[1] Raymond J. Lucia Cos. Inc. and Raymond J. Lucia v. SEC, --- F.3d ---, 2016 WL 4191191 (D.C. Cir. Aug. 9, 2016).

[2] The SEC recently amended its Rules of Practice in July 2016. While the amended rules are an improvement, they do not go far enough to eliminate the unfairness arguments.

[3] The appointments clause provides that the president:

> shall nominate, and by and with the Advice and Consent of the Senate, shall appoint ... Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law; but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.

U.S. Const. art. II, § 2, cl. 2.

[4] Duka v. SEC, 124 F. Supp. 3d 287, 289 (S.D.N.Y. August 12, 2015) (ALJs found to be inferior officers); Gray Financial Group Inc. v. SEC, 2015 WL 10579873, at *13-14 (N.D. Ga. August 4, 2015) (same); Timbervest LLC v. SEC, 2015 WL 7597228, at *11-12 (N.D. Ga. Aug. 4, 2015) (same); Hill v. SEC, 114 F. Supp. 3d 1297, 1319 (N.D. Ga. June 8, 2015) (same).

[5] Hill v. SEC, --- F.3d ---, 2016 WL 3361478, at *13 (11th Cir. June 17, 2016); Tilton v. SEC, --- F.3d ---, 2016 WL 3084795, at *11 (2d Cir. June 1, 2016); Jarkesy v. SEC, 803 F.3d 9, 30 (D.C. Cir. 2015); Bebo v. SEC, 799 F.3d 765, 775 (7th Cir. 2015).

[6] Raymond J. Lucia Cos., Exchange Act Release No. 75837, 2015 WL 5172953, at *21-23 (Sept. 3, 2015).

[7] Landry v. FDIC, 204 F.3d 1125, 1134 (D.C. Cir. 2000).

[8] See e.g., David F. Bandimere, Exchange Act Release No. 76308, 2015 WL 6575665, at *19 (Oct. 29, 2015), petition for review filed, No. 15-9586 (10th Cir. Dec. 22, 2015); Duka v. SEC, 124 F. Supp. 3d 287, 289 (S.D.N.Y. August 12, 2015) (mandate not yet issued in Tilton v. SEC, --- F.3d ---, 2016 WL 3084795, at *11 (2d Cir. June 1, 2016)).