

Supreme Court Holds that SEC Administrative Law Judges Are Unconstitutionally Appointed

June 26, 2018

On June 21, 2018, [the Supreme Court ruled in *Lucia v. SEC*¹](#) that Securities and Exchange Commission Administrative Law Judges (ALJs) are “officers” for the purposes of the Constitution’s Appointments Clause. Because, at the time he heard the case, the ALJ’s appointment was not consistent with that clause, it was deemed unconstitutional and the administrative proceeding void. *Lucia* is almost certainly not the last word on the constitutionality of the SEC’s ALJs. Indeed, another trip up to the Supreme Court on a related constitutional issue involving the ALJs’ civil service protections seems likely.

In the meantime, *Lucia* will require the SEC to, at minimum: (1) evaluate the efficacy of the Commission’s 2017 attempt to cure the constitutional infirmity of the ALJs’ appointment, (2) chart a course forward to achieve prompt and final resolution of the remaining constitutional issue, and (3) almost certainly face a host of related challenges to past and pending cases. And, of course, there are likely to be “spill-over” effects from *Lucia* that will force the other agencies that use ALJs to grapple with the legitimacy of their own administrative proceedings.

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¹ 585 U.S. __ (2018).



Background

In most instances, the SEC has discretion to file enforcement actions in either federal district court or in an administrative proceeding before an ALJ. After Dodd-Frank expanded the universe of cases the SEC could file in its administrative forum, the SEC began to bring more cases in Administrative Proceedings (APs).² Unlike federal court, these proceedings do not require the SEC to go through lengthy discovery, allow for a trial by jury, or subject the SEC to federal evidentiary and procedural rules more generally. ALJs are federal employees vetted through a merit-selection process, appointed by the chief ALJ, and ultimately approved by the Commission's Office of Human Resources.³

In July 2013, a SEC ALJ ruled that Raymond Lucia violated the federal securities laws, imposed a penalty, and barred Lucia from the securities industry for life.⁴ Lucia, among other arguments, asserted that the appointment of the ALJ violated the Constitution's Appointments Clause. The Appointments Clause requires that the President, "Courts of Law", or "Heads of Department" appoint inferior "Officers of the United States." Lucia argued the proceeding was invalid because ALJs are not just employees, as the SEC argued, but inferior officers requiring such an appointment by the Commission, as a "Head[] of Department"—which had not taken place. The Commission, on appeal, rejected Lucia's argument, reasoning that ALJs are "mere employees" not subject to the Appointments Clause because the Commission—not ALJs—has ultimate authority over all administrative proceedings.⁵

The D.C. Circuit affirmed the Commission's decision under a similar rationale. In comparison to the judges

of the Tax Court that the Supreme Court had deemed officers in *Freytag v. Commissioner*,⁶ the D.C. Circuit noted that ALJs do not issue binding final decisions because the Commission has to issue a finality order first.⁷ As such, the D.C. Circuit found ALJs to be mere employees rather than officers, and thus not subject to the Appointments Clause.

Before the D.C. Circuit reheard the case *en banc*, the Tenth Circuit set up a circuit split by determining that ALJs were in fact officers requiring such appointments in a separate proceeding. Specifically, the Tenth Circuit read *Freytag* differently, and held that the ALJs performed significant and important functions similar to judges of the Tax Court.⁸ After the D.C. Circuit evenly divided on the issue when sitting *en banc*,⁹ Lucia filed his cert. petition for Supreme Court review. Two developments followed.

First, the Solicitor General (SG) abandoned the defense of ALJs as mere employees, and joined with Lucia in asserting that ALJs were unconstitutionally appointed officers. The SG also asked the Court to hear a related constitutional separation of powers issue: whether the removal protections for ALJs prevent the President from faithfully executing the laws under *Free Enterprise Fund v. Public Co. Accounting Oversight Bd.*¹⁰ Under the Administrative Procedure Act, ALJs cannot be removed by the Commission at will, but rather, only for "good cause" found by the separate Merit Systems Protection Board.¹¹ This may improperly insulate them from presidential oversight. When the Court agreed to hear the case, it specifically did not ask the parties to address this second question and it also appointed an

² The Dodd-Frank Wall Street Reform and Consumer Protection Act expanded the SEC's ability to bring cases before administrative proceedings and seek a wider set of relief. *See, e.g.*, 15 U.S.C. § 77h-1, 78u-3, 80a-9(b), 80a-41(a), 80b-3(e), (f), and (k); 15 U.S.C. § 78d, 78o; 15 U.S.C. § 78d-1(a).

³ Division's Notice of Filing, *In the Matter of Timbervest, LLC*, No. 3-15519 (Jun. 4, 2015).

⁴ Slip Op. at 3.

⁵ *Id.* at 3-4.

⁶ 501 U.S. 868 (1991).

⁷ *Lucia v. SEC*, 832 F.3d 277, 283 (D.C. Cir. 2016).

⁸ *See Bandimere v. SEC*, 844 F.3d 1168, 1179 (10th Cir. 2016).

⁹ No. 15-1345, 2017 WL 2727079 (D.C. Cir. June 27, 2017)

¹⁰ 561 U.S. 477 (2010).

¹¹ 5 U.S.C. § 7521(d).

amicus for oral argument to argue in support of the D.C. Circuit opinion.¹²

Second, the day after the SG changed its position, the Commission issued an order ratifying the alleged prior appointment of its ALJs.¹³

Supreme Court Opinion

Justice Kagan's Majority Opinion

Justice Kagan wrote for a six-justice majority in deciding that SEC ALJs are officers rather than mere federal employees.¹⁴ The decision ultimately turned on whether the SEC's ALJs "exercise significant authority pursuant to the laws of the United States."¹⁵

Justice Kagan ruled that the ALJs did possess "significant authority" under *Freytag*, but was unwilling to go further to decide what is the minimum *necessary* to conclude that an employee has such significant authority. Justice Kagan observed that, just like the special Tax Court trial judges in *Freytag*, SEC ALJs "take testimony, conduct trials, rule on the admissibility of evidence, and have the power to enforce compliance with discovery orders" and exercise "significant discretion."¹⁶ Continuing down the list of similarities, ALJs "administer oaths", "shape the administrative record," may punish "contemptuous conduct" and finally, "at the close of those proceedings, ALJs issue decisions."¹⁷

In doing so, she rejected the argument that the judges in *Freytag* differed because (1) they issue contempt orders and (2) their findings were "presumed correct." She found the contempt distinction unimportant—the ALJs could "enforce their will through conventional weapons" such as suspending the lawyer from representing the client.¹⁸ Justice Kagan also explicitly

rejected Justice Sotomayor's argument that "significant authority" requires the ability for judges to enter final decisions in at least some instances, as only a "back-up" rationale of *Freytag*.¹⁹ However, she also noted that, as a practical matter, the Commission often defers to ALJ's factual findings.²⁰

After holding that the ALJ presiding over Lucia's case was improperly appointed, Justice Kagan also took the extra step to mandate that, on remand, Lucia's administrative re-hearing could not be heard by the same ALJ.²¹ The Court expressed no view on the Commission's attempt to ratify the prior ALJ appointments, or whether the Commission needs to take any other steps before Lucia's case can be reheard before a constitutionally-appointed ALJ.²² Finally, the Court noted that it was premature to address the *Free Enterprise Fund* issue regarding the constitutionality of the statutory removal protections for ALJs until lower courts addressed it first.²³

Justice Breyer's Concurrence

Justice Breyer would have avoided the constitutional question and found that SEC ALJs were wrongfully appointed under the technical provisions of the Administrative Procedure Act.²⁴

Justice Breyer identified the "embedded" question in the case as the "constitutionality of the statutory 'for cause'" removal protections that Congress provided for administrative law judges.²⁵ If ALJs are officers under the Appointments Clause, then the statutory protection under the Administrative Procedure Act might be unconstitutional per the Court's prior holding in *Free Enterprise Fund* that officers cannot have

¹² No. 17-130, 583 U.S. ___ (Jan. 12, 2018).

¹³ *Pending Administrative Proceedings*, Securities Act Release No. 10440 (Nov. 30, 2017).

¹⁴ Slip Op. at 5.

¹⁵ *Id.* at 6 (citing *Buckley v. Valeo*, 424 U.S. 1, 126 (1976) (*per curiam*)).

¹⁶ *Id.* at 7 (quoting *Freytag*, 501 U.S. at 881–882).

¹⁷ *Id.* at 9.

¹⁸ *Id.* at 10–11.

¹⁹ *Id.* at 8 n.4.

²⁰ *Id.* at 11.

²¹ *Id.* at 12.

²² *Id.* at 13 n.6.

²³ *Id.* at 4 n.1.

²⁴ Opinion of Breyer, J., concurring in the judgment and dissenting in part, at 1.

²⁵ *Id.*

“multilevel protection from removal” by the President.²⁶

Justice Breyer further expressed his concern that such a conclusion “threatens to change the nature of our merit-based civil service” system and “transform[]” independent ALJs into “dependent decision makers.”²⁷ Foreshadowing a likely future case, Justice Breyer said he would resolve this issue by looking to congressional intent. According to Justice Breyer, because the Appointments Clause requires that Congress establish the appointment of officers “by Law,” Congress can play a significant role in determining who is an officer.²⁸ He argued that Congress is restrained in its interpretation only to the extent that they attempt to create employees who exercise powers similar to one of the enumerated “principle Officers” of the Constitution (such as Cabinet secretaries or federal judges).²⁹

Justice Thomas’ Concurrence

Although he joined fully in the majority opinion, Justice Thomas’ concurrence, joined by Justice Gorsuch, would apply an originalist understanding to what it means to be an officer.³⁰ His originalist definition of officer would greatly expand the number of employees requiring appointment under the Appointments Clause even to include those individuals that “performed only ministerial duties.”³¹

Justice Sotomayor’s Dissent

Joined by Justice Ginsburg, Justice Sotomayor agreed with the D.C. Circuit and the Commission that SEC ALJs are not officers because they could not issue final, binding decisions on behalf of the government.³²

Conclusion

In the wake of *Lucia*, the Commission issued an order to stay all pending administrative proceedings for thirty days presumptively to consider the decision’s full impact and its next steps. During this time the agency will consider at least three immediate issues. First, it has to ensure its five current ALJs are validly appointed. The SEC’s attempted fix in 2017—to retroactively ratify the appointment of its ALJs in about 100 pending proceedings, including opening of their records for additional fact-finding and argument—has not been tested, but will certainly be challenged if not changed. The Court was silent on the question of whether the SEC’s ratification effort was permissible or whether all of the ALJs must now be “appointed” by the Commission pursuant to the Appointments Clause; but it is unlikely the Commission will rest on its prior ratification if it believes it can take additional steps to protect itself in future cases.

Second, the SEC likely will be forced to revisit all of its pending administrative cases as well as resolved cases where the respondent had preserved the Appointments Clause argument. Accordingly, the Commission may have to make some difficult decisions about which of these cases to re-litigate before a different, properly appointed ALJ.

Third, the Commission will need to decide how and whether to re-commence bringing substantial numbers of litigated cases in the administrative forum while questions remain about the *Free Enterprise Fund* removal issue. For more than a year now, the SEC has essentially frozen the filing of APs in all cases where it has the discretion to bring the same action in federal court while it awaited a determination of *Lucia*.³³ It seems likely that the SEC will remain reticent to bring

²⁶ *Id.* at 4 (citing *Free Enterprise Fund*, 561 U.S. at 495–98).

²⁷ *Id.* at 6.

²⁸ *Id.* at 12.

²⁹ *Id.*

³⁰ Opinion of Thomas, J., concurring at 1.

³¹ *Id.* at 3

³² Opinion of Sotomayor, J., dissenting at 1.

³³ There is a subset of cases under the federal securities laws and SEC’s own administrative rules that must be heard in an administrative proceedings (for example, cases to bar attorneys from practicing or appearing before the SEC). The future of those actions is likewise uncertain in light of *Lucia*.

large numbers of litigated APs given the remaining constitutional uncertainty. At the same time, the Commission will have to chart a strategy to find the right mechanism to get the *Free Enterprise Fund* issue before an appellate court, and then ultimately the Supreme Court—a task complicated by the fact that the Justice Department has already indicated in its briefings in *Lucia* that it believes this issue too presents a constitutional infirmity.

More broadly, the case poses some risk for the larger administrative state, which faces the same three issues, but on a greater scale: there are twenty-six federal agencies employing approximately 1,931 ALJs—over 1,600 of which work for the Social Security Administration.³⁴ While the Court did not determine what the bare minimum of “significant authority” would be to convert an “employee” to an “official”, it appears that such authority could be vested in the many other agency ALJs. For example, the D.C. Circuit had previously held that FDIC-employed ALJs are not officers under a similar challenge.³⁵ One wonders whether this precedent is now at odds with the Court’s pronouncements in *Lucia*. And outside of these ALJs under the Administrative Procedure Act, there are thousands of other employees in at least partly or fully adjudicative roles in the federal government that may be impacted.³⁶ One such example, where the D.C. Circuit has previously rejected an Appointments Clause challenge, are IRS “settlements” officers.³⁷ As the *Lucia* Court noted, it specifically designs Appointments Clause remedies “to create incentives to raise appointments clause challenges”³⁸ and such challenges to both formal ALJs and other similar employees will likely become routine.

Thus, these agencies too will have to evaluate their prior appointments, determine whether action is required in any pending cases, and consider how to

proceed with the removal protections question still unresolved.

Lucia also implicates larger fundamental issues. On the one hand, as Justice Breyer and other commentators have noted, the Administrative Procedure Act attempts to separate and preserve the independence of the investigatory and adjudicatory functions of agencies. On the other hand, as other commentators have pointed out, the double protection against removal that remains limits the political accountability that those commentators argue is essential in a democracy. The composition of the Supreme Court at the time the *Free Enterprise Fund* issue is ripe for review will shape which philosophy prevails.

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³⁴ Brief for Federal Administrative Law Judges Conference, as Amici Curiae Supporting Neither Party, *Lucia v. SEC*, 585 U.S. __ (2018) (No. 17-130).

³⁵ *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000).

³⁶ Kent Barnett et al., *Non-ALJ Adjudicators in Federal Agencies*, Administrative Conference of the United States

(Feb. 14, 2018)

https://www.acus.gov/sites/default/files/documents/Non-ALJ%20Draft%20Report_2.pdf.

³⁷ *Tucker v. Comm’r, Internal Revenue*, 676 F.3d 1129, 1132 (D.C. Cir. 2012).

³⁸ Slip. Op. at 12 n.5.