ALERT MEMORANDUM

Appellate Courts Split Over Constitutionality of SEC Administrative Proceedings

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On Tuesday, the United States Court of Appeals for the Tenth Circuit in *Bandimere v. S.E.C.*[1] found that the Securities and Exchange Commission's ("SEC") use of administrative law judges ("ALJs") violated the U.S. Constitution. While the court's opinion relies on a somewhat arcane question of administrative law—whether the hiring of SEC ALJs must comply with the Appointments Clause of the Constitution—its decision to set aside an SEC order imposing sanctions for securities laws violations raises significant questions about future SEC claims brought before ALJs rather than in federal courts, as well as prior adjudications. With the D.C. Circuit currently considering whether to grant rehearing *en banc* on its recent holding that these same SEC proceedings were constitutional,[2] the Tenth Circuit's decision is sure to draw considerable scrutiny in the months ahead and may well give rise to Supreme Court review of the issue.

[1] No. 15-9586, 2016 WL 7439007 (10th Cir. Dec. 27, 2016), *slip op. available at* https://www.ca10.uscourts.gov/opinions/15/15-9586.pdf.

[2] *Raymond J. Lucia Cos. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016), *petition for reh'g filed* No. 15-1345 (D.C. Cir. Sept. 23, 2016) (Document #1637313).

The SEC's Use of Administrative Law Judges

Since the 2010 Dodd-Frank Act expanded the jurisdiction of SEC ALJs and authorized them to impose new penalties, the SEC Division of Enforcement has increasingly chosen to bring claims through internal proceedings rather than in federal civil courts.[3] Whereas the SEC brought more than 65% of its enforcement actions against public company defendants in federal civil court between 2010 and 2013, the proportions have since inverted.[4] In 2015, 76% of actions against such defendants were brought before ALJs.[5]

While decisions by SEC ALJs are not necessarily binding, they exercise considerable power and discretion in carrying out their duties. In order to conduct hearings on alleged securities violations brought by the SEC, an ALJ can administer oaths, examine witnesses, issue subpoenas, order depositions, rule on evidentiary issues and dispositive motions, regulate the course of the hearing, and "do all things necessary and appropriate to discharge [their] duties."[6] After the hearing, the ALJ prepares an initial decision containing factual findings and legal conclusions, along with an appropriate order.[7] The SEC can then either review the initial decision (on its own initiative or upon a petition by a party or intervener) or adopt the initial decision as final. Once final, the respondent can seek review of the order in a federal court of appeals.[8]

SEC ALJ proceedings offer streamlined procedures compared to federal courts, but critics have complained that speed comes at the expense of fairness to respondents[9] and that ALJs are more likely than federal courts to find in the SEC's favor.[10] Apparently responding to these procedural concerns, the SEC recently amended its hearing rules to make ALJ proceedings more closely resemble federal civil court proceedings,[11] but litigants have nonetheless pursued numerous challenges to the validity of SEC ALJ proceedings, primarily by attacking their constitutionality under the Appointments Clause.[12] Courts have rejected separate federal lawsuits brought to enjoin such SEC proceedings on the grounds that constitutional challenges must first be raised before the SEC. If the SEC rejects the challenge—as it has done repeatedly—the final order can then be appealed in federal court.[13] Indeed, several respondents found liable for violating securities laws notwithstanding their constitutional objections are now bringing appeals in federal court. To date, two circuit courts have addressed the issue: on August 9, 2016, the D.C. Circuit found that the SEC ALJs were constitutional in *Raymond J. Lucia Cos. v. SEC*,[14] and on December 27, 2016, the Tenth Circuit disagreed, finding them unconstitutional in *Bandimere*.

The Constitutionality of SEC Administrative Law Judges

The constitutionality of SEC ALJs rests on the Appointments Clause, which empowers Congress to determine whether the power to appoint so-called "inferior officers" should be vested "in the President alone, in the Courts of Law, or in the Heads of Departments."[15] By limiting the power to appoint inferior officers to these enumerated offices, the Appointments Clause "promotes public accountability by identifying the public officials who appoint

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[3] *See* 15 U.S.C. §§ 78u, 78u–2, 78u–3, 78v (2012); *see also id.* §§ 77h–1, 77t(b), 80b–9 (2012) (permitting SEC to bring claims by filing civil suit in federal district court or by instituting a civil administrative action).

[4] CORNERSTONE RESEARCH & NYU POLLACK CENTER FOR LAW & BUSINESS, SEC ENFORCEMENT ACTIVITY AGAINST PUBLIC COMPANY DEFENDANTS: FISCAL YEARS 2010-2015, at 6 (2016), http://www.cornerstone.com/Publications/Reports/SEC-Enforcement-Activity-Against-Public-Company-Defendants.

[5] *Id.*

[6] *Bandimere*, 2016 WL 7439007, at *7 (citing statutes and regulations).

[7] *Id.*

[8] 15 U.S.C. §§ 77i(a), 78y(a)(1).

[9] Breon S. Peace, Elizabeth (Lisa) Vicens, and Daniel D. Queen, *Fighting the SEC On Its Home Turf*, LAW360 (Oct. 28, 2016), http://www.law360.com/articles/854404/fighting-the-sec-on-its-home-turf.

[10] Jean Eaglesham, *SEC Wins with In-House Judges*, WALL ST. J. (May 6, 2015), http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

[11] Peace et al., *supra* note 9.

[12] U.S. CONST. art II, § 2, cl. 2.

[13] *See Bandimere*, 2016 WL 7439007, at *1 n.2.

[14] 832 F.3d 277 (D.C. Cir. 2016).

[15] U.S. CONST. art II, § 2, cl. 2.

officers."[16] But while inferior officer appointments must comply with the Appointments Clause, the selection of "employees or other lesser functionaries" need not follow those rules.[17] That is to say, if SEC ALJs are inferior officers, they must be appointed pursuant to the Clause, otherwise their exercise of authority is unconstitutional.

But SEC ALJs are not appointed by the President, a court, or a department head. Instead, they are selected through a "merit-selection process" involving the executive branch and the SEC's Chief ALJ.[18] While *employees* may be hired through such a process, *inferior officers* may not.

An appointee is an officer, as opposed to an employee, if he or she exercises "significant authority pursuant to the laws of the United States."[19] For instance, the Supreme Court found in *Freytag v. Commissioner*[20] that "special trial judges" appointed by the Tax Court were inferior officers based on three characteristics: (i) the position was "established by Law"; (ii) the "duties, salary, and means of appointment . . . [were] specified by statute"; and (iii) they "exercise[d] significant discretion [in] carrying out . . . important functions."[21] Focusing on the third element, the Court found that the special trial judges were inferior officers in light of "the significance of the duties and discretion" that they exercised in hearings and their authority to enter final decisions in certain types of cases.[22]

Here, respondents challenging the constitutionality of SEC proceedings argued that the ALJs are inferior officers, just like the special trial judges in *Freytag*, given their substantial powers to conduct proceedings. The SEC has conceded that unlike in *Freytag*, where the Supreme Court found that the special trial judges were properly appointed inferior officers, the selection of ALJs does not comply with the Appointments Clause. Accordingly, the question is whether the ALJs exercise significant discretion: if so, they are inferior officers serving in contravention of the Appointments Clause. Respondents argued that SEC ALJs exercise considerable power and discretion in shaping the administrative record by ruling on motions, making credibility findings, and issuing initial decisions that declare respondents liable and impose sanctions for securities law violations.[23] The SEC contended in response that the ALJs' discretion is limited because their initial decisions only become final after the SEC—whose Commissioners are appointed pursuant to the Appointments Clause—either delivers its own decision or declines to review, and thus adopts, the ALJ's initial decision.

The first appellate court to address this question was the D.C. Circuit, which sided with the SEC in *Raymond J. Lucia Cos*. Relying on that circuit's precedent, the court held that SEC ALJs are employees—and not inferior officers—because they lack the power to issue final decisions. After finding that SEC ALJs met the first two requirements of inferior officers—that the position and its duties were specified by statute—the D.C. Circuit addressed the third requirement of "significant authority" by looking to the circuit's three factor test: "(1) the significance of the matters resolved by the officials, (2) the discretion they exercise in reaching their decisions, and (3) the finality of those decisions."[24] Relying on its decision in *Landry v. FDIC*,[25] which held that ALJs of the Federal Deposit Insurance Corporation were employees rather than officers because they lacked the power to issue final decisions, the D.C. Circuit concluded that that SEC ALJs were likewise employees because their decisions did not become final unless or until "the politically accountable Commissioners have determined that an ALJ's initial decision is to be the final action of the Commission."[26]

Just four months after *Raymond J. Lucia Cos.*, however, a split panel of the Tenth Circuit reached the exact opposite conclusion in *Bandimere*. Rejecting the D.C. Circuit's premise that final decision-making power is an essential characteristic of inferior officers,

[16] *Bandimere*, 2016 WL 7439007, at *3.
[17] *Raymond J. Lucia Cos.*, 832 F.3d at 284.
[18] *Bandimere*, 2016 WL 7439007, at *6.
[19] *Buckley v. Valeo*, 424 U.S. 1, 126 (1976).
[20] 501 U.S. 868 (1991).
[21] *Bandimere*, 2016 WL 7439007, at *8 (citing *Freytag*, 501 U.S. at 881–82).
[22] *Freytag*, 501 U.S. at 873.
[23] *Bandimere*, 2016 WL 7439007, at *8–9.
[24] *Raymond J. Lucia Cos.*, 832 F.3d at 284 (quoting *Tucker v. Comm'r*, 676 F.3d 1129, 1133 (D.C. Cir. 2012)).
[25] *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000).
[26] *Raymond J. Lucia Cos.*, 832 F.3d at 286.

Bandimere noted that the Supreme Court "has not equated significant authority with final decision-making power."[27] Instead, the Tenth Circuit found that SEC ALJs "exercise significant discretion in performing 'important functions' commensurate with the [special trial judges'] functions described in *Freytag*,"[28] and thus held that ALJs were inferior officers rather than mere employees. As Judge Briscoe wrote in concurrence, final decision-making power "might be *sufficient* to make an employee an Officer, [but] that does not mean such authority is *necessary* for an employee to be an officer."[29]

In a cautionary dissent, Judge McKay warned that the majority opinion "carries repercussions that will throw out of balance the teeter-totter approach to determining which of all the federal officials are subject to the Appointments Clause."[30] Supporting an interpretation of *Freytag* similar to the D.C. Circuit's in *Landry* and *Raymond J. Lucia Cos.*, Judge McKay expressed concern that the majority's interpretation of the Supreme Court's precedent put "all federal ALJs," such as the 1,537 Social Security Administration ALJs, "at risk of being declared inferior officers."[31]

The Future of Administrative Law Judges in the SEC and Beyond

The *Bandimere* decision is a significant one, but it may not be the final word: the SEC can—and likely will—petition the Tenth Circuit for rehearing or rehearing *en banc* or seek Supreme Court review. While petitions for both rehearing *en banc* and certiorari are granted sparingly, Judge McKay's dissent may draw attention to the circuit split and encourage further review. Indeed, a petition for rehearing *en banc* in *Raymond J. Lucia Cos.* is currently pending before the D.C. Circuit, and the respondent just yesterday submitted a letter informing the court of the *Bandimere* decision.[32] Given the D.C. Circuit's frequent encounters with administrative law issues, the court may be inclined to grant rehearing in order to defend its Appointments Clause jurisprudence and address the Tenth Circuit's analysis in anticipation of future Supreme Court review. Particularly given the similarities between SEC ALJs and other administrative law judges elsewhere in the executive branch, a circuit split on this issue could create considerable uncertainty in the myriad proceedings conducted by administrative agencies throughout the country, making Supreme Court review more likely.

Even if the Tenth Circuit's interpretation of the Appointments Clause prevails, the long-term effects of the decision could still be relatively minor. As in recent successful challenges to the constitutionality of the Public Company Accounting Oversight Board[33] and the Consumer Financial Protection Bureau,[34] the Supreme Court will likely seek the "minimum relief necessary to bring administrative overreach in line with the Constitution."[35]

In the coming months, however, *Bandimere* will likely spur more resistance to SEC proceedings, encouraging more respondents to object to the use of ALJs and to appeal any unfavorable adjudications. As these challenges proceed through the courts, it remains to be seen whether the SEC will choose to pursue future securities laws violations in administrative proceedings at the same rate as in the past several years, or whether this decision presages the SEC's return to the federal courts for the majority of its cases. Indeed, the SEC's direction may be changed even more significantly by President-elect Donald Trump. Notably, House Republicans have opposed the use of SEC ALJs in the past, proposing legislation to provide respondents in SEC administrative proceedings an automatic right of removal to federal court.[36] We will

[27] *Bandimere*, 2016 WL 7439007, at *12.
[28] *Id.* at *8 (citing *Landry*, 204 F.3d at 1134).
[29] *Bandimere*, 2016 WL 7439007, at *19 (Briscoe, J., concurring) (emphasis in original).
[30] *Id.* at *21 (McKay, J., dissenting).
[31] *Id*. at *25 (McKay, J., dissenting).
[32] Letter from Raymond J. Lucia Cos., *Raymond J. Lucia Cos. v. SEC*, No. 15-1345, 832 F.3d 277 (D.C. Cir. Dec. 29, 2016) (Document #1653283).
[33] *Free Enterprise Fund v. Public Co. Accounting Oversight Bd.*, 561 U.S. 477 (2010)
[34] *PHH Corp v. Consumer Fin. Protection Bureau*, 839 F.3d 1 (D.C. Cir. 2016).
[35] *Bandimere*, 2016 WL 7439007, at *17 (Briscoe, J., concurring).
[36] *See* HOUSE COMMITTEE ON FINANCIAL SERVICES, THE FINANCIAL CHOICE ACT: A REPUBLICAN PROPOSAL TO REFORM THE FINANCIAL REGULATORY SYSTEM at 96 (2016), http://financialservices.house.gov/uploadedfiles/

have to wait and see if Mr. Trump's SEC appointees share a similar view.

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