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CLIENT PUBLICATION

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D.C. Circuit Upholds Constitutionality of SEC Administrative Proceedings

On August 9, 2016, a three-judge panel of the United States Court of Appeals for the District of Columbia Circuit issued *Lucia v. SEC*,[1] a significant decision that holds that the Securities and Exchange Commission's ("SEC" or "Commission") use of administrative law judges ("ALJs") is constitutional. In so doing, the D.C. Circuit ruled that the SEC's use of ALJs does not violate the Appointments Clause of the Constitution because, rather than acting as officers of the United States, the SEC's ALJs act as employees who lack the authority to issue "final decisions." With at least one similar case pending in another Circuit,[2] and a number of appeals challenging the constitutionality of Administrative Proceedings (APs) pending before the Commission itself, *Lucia* is an important precedent-setting decision.

Background

In recent years, respondents have brought numerous challenges to the SEC's use of APs that asserted that the SEC's selective use of APs for some, but not all, litigated enforcement proceedings is inherently unfair. Specifically, numerous respondents filed actions in federal court seeking to preliminarily enjoin pending APs as unconstitutional before the cases were decided on the merits. While due process and equal protection challenges have generally been unsuccessful, respondents have achieved a measure of success in challenging APs on the ground that ALJs were not properly appointed pursuant to the Appointments Clause of Article II of the Constitution and, thus, could not issue decisions in APs. Under the Appointments Clause, "inferior officers," or government officials "exercising significant authority pursuant to the laws of the United States" must be appointed by the President, the federal courts or the heads of the federal departments.[3] SEC ALJs are however hired as though they are mere employees of the Commission.

Prior to 2015, district courts had uniformly rejected these petitions for injunctions, largely on the grounds that federal courts did not have jurisdiction to consider the applications because respondents would have a right to appeal any final determination of the Commission following the conclusion of an AP to a federal court of appeals. In June 2015, however, in *Hill v. SEC*, Northern District of Georgia Judge Leigh Martin May issued a preliminary injunction halting an AP against Charles Hill on the grounds that the manner in which the ALJ was appointed likely violated the Appointments Clause. In August 2015, Judge May enjoined a second AP for the same reasons in *Gray Financial Group v. SEC*.[4] Later that August, Judge Richard Berman of the Southern District of New York reached a similar conclusion in *Duka v. SEC*, holding not only that district courts had jurisdiction to consider applications for preliminary injunctions of APs, but also preliminarily enjoined the *Duka* AP.[5]

In the past two months, however, these successful challenges to the SEC's use of APs have been undone, although not on the merits. First, on June 1, 2016, in *Tilton v. SEC*, a divided Second Circuit panel affirmed the

dismissal of a constitutional challenge to an AP for lack of subject matter jurisdiction. *Tilton* appeared to conflict with Judge Berman's ruling in *Duka*, and shortly after *Tilton* was issued, the Second Circuit resolved the potentially inconsistent decisions by issuing an order that vacated and remanded *Duka* for further proceedings consistent with *Tilton*. On June 17, 2016, the Eleventh Circuit similarly reversed Judge May's decisions in *Hill* and *Gray Financial Group*,[6] citing D.C. Circuit,[7] Seventh Circuit[8] and Second Circuit[9] cases holding that the district court lacked subject matter jurisdiction.

While this string of Circuit court decisions appears to have resolved the jurisdictional question, at least three other cases involving constitutional challenges to APs have been brought by respondents as part of their appeal of final decisions in APs.[10] *Lucia v. SEC* is the first of these actions to reach a decision. The SEC had argued that ALJs were not required to be appointed pursuant to the Appointments Clause because they lack the authority to be "inferior officers." In other words, since SEC Commissioners review and finalize every ALJ decision, ALJs are mere SEC employees. Defendants challenging APs, on the other hand, contend that because the ALJs are primary fact finders whose decisions are reviewed deferentially by SEC Commissioners, the ALJs possess the decision-making authority to qualify as "inferior officers" under Article II, and because ALJs are not appointed by the President, SEC Commissioners, or a federal court, challengers argued that their appointment is unconstitutional.

The Facts of *Lucia v. SEC*

The *Lucia* decision centers on an SEC administrative enforcement action against Raymond J. Lucia and his investment company, Raymond J. Lucia Companies, Inc., for alleged violations of anti-fraud provisions of the Investment Advisers Act. Specifically, the SEC alleged that petitioners had deceptively presented their "Buckets of Money" retirement wealth-management strategy to prospective clients. As part of its enforcement action, on September 5, 2012, the SEC ordered an ALJ to conduct a public hearing on these allegations.[11] On July 8, 2013, the ALJ issued an initial decision finding Lucia and his company liable on one of the four misrepresentations.[12] The ALJ imposed a fine of $300,000 and a lifetime ban from the industry on Lucia. After Lucia and his company brought a motion to correct alleged factual errors by the ALJ, the ALJ conducted further fact finding and issued a revised initial decision on December 6, 2013.[13] Lucia and his company appealed this revised decision to the Commission, which conducted an independent review and found that Lucia and his company had violated the Investment Advisers Act and imposed the same sanctions as the presiding ALJ. The Commission also rejected petitioners' argument that the AP was unconstitutional because the appointment of the presiding ALJ did not comply with the Appointments Clause. The Commission relied on the D.C. Circuit's decision in *Landry v. FDIC*[14] in concluding that its ALJs are employees, not officers in a constitutional sense, and that their appointment is therefore not covered by the Appointments Clause.

The D.C. Circuit's Opinion

The D.C. Circuit affirmed the Commission's decision. Citing *Tucker v. Commissioner, Internal Revenue*,[15] the D.C. Circuit held that the primary criteria for distinguishing between inferior officers and employees not covered by the Appointments Clause are: "(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."[16] In *Tucker*, the D.C. Circuit held that an employee of the IRS Office of Appeals was not an officer because certain regulatory restraints resulted in a lack of discretion required by the second prong of the *Tucker* test. Similarly, in *Landry v. FDIC*,[17] the D.C. Circuit held that

ALJs at the Federal Deposit Insurance Corporation ("FDIC") were not Officers because FDIC regulations limited their ability to make final decisions, which failed the third prong of the *Tucker* test.

Though the *Lucia* court was careful to note that its decision in *Landry* did not resolve the constitutional status of ALJs for *all* agencies, it nonetheless relied heavily on the logic of that decision. The D.C. Circuit in *Lucia* analyzed the statutory and regulatory framework underpinning the powers of Commission ALJs, and came to the conclusion that Commission ALJs do not have the power to issue final decisions. Petitioners argued that because the delegating statute "contemplates that the ALJ's initial decision becomes final in at least some circumstances when Commission review is declined," Commission ALJs should therefore be viewed as having the authority to make final decisions.[18] The D.C. Circuit rejected this argument, noting that the same statutory provision on which petitioners relied also authorized the Commission to establish its delegation and review scheme through agency rulemaking.[19] Under the review scheme established by the agency's rules, "the initial decision [by the ALJ] becomes final when, *and only when*, the Commission issues the finality order," an affirmative act which must occur *in every case*.[20] The D.C. Circuit noted that "the Commission has retained full decision-making powers, and the mere passage of time is not enough to establish finality."[21] Furthermore, the court noted that "even when there is not full review by the Commission, it is the act of issuing the finality order that makes the initial decision the action of the Commission within the meaning of the delegation statute."[22]

What Is the Significance of *Lucia*?

As the first circuit court opinion to substantively address the constitutionality of the use of ALJs by the SEC, the D.C. Circuit's opinion in *Lucia* has the potential to be an important precedent-setting decision. In recent years, even as district courts have found more frequently that the Commission's use of ALJs violated the Appointments Clause, circuit courts addressing appeals from these decisions have reversed all decisions on jurisdictional grounds. This decision, however, is a clear statement supporting the constitutionality of the Commission's use of ALJs, a statement that is even stronger given that it emanates from the D.C. Circuit. The decision could also herald an increase in the use of APs by the SEC, even in the face of continued public criticism about perceived unfairness.

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1 No. 15-1345, slip op. (D.C. Cir. Aug. 9, 2016).

2 *Bandimere v. SEC*, No. 15-9586 (10th Cir. filed Dec. 22, 2015).

3 *Freytag v. C.I.R.*, 501 U.S. 868, 881 (1991), *citing Buckley v. Valeo*, 424 U.S. 1, 126, n.162 (1976).

4 *Gray Financial Group v. SEC*, No. 15-cv-0492-LMM (N.D. Ga. Aug. 5, 2015).

5 *Duka v. SEC*, 124 F. Supp. 3d 287 (S.D.N.Y. 2015).

6 *Hill v. SEC*, No. 15-12831, slip op. (11th Cir. June 17, 2016).

7 *See Jarkesy v. SEC*, 803 F.3d 9 (D.C. Cir. 2015).

8 *See Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015).

9 *See Tilton, et al. v. SEC*, No. 15-2103, 2016 WL 3084795 (2d Cir. June 1, 2016).

[10] *Timbervest LLC v. SEC*, No. 15-1416 (D.C. Cir. filed Nov. 13, 2015); *Bandimere v. SEC*, No. 15-9586 (10th Cir. filed Dec. 22, 2015).

[11] *Raymond J. Lucia Cos., Inc.*, Exchange Act Release No. 67781, 2012 WL 3838150 (Sep. 5, 2012).

[12] *Raymond J. Lucia Cos.*, Inc., Initial Decision Release No. 495, 2013 WL 3379719 (July 8, 2013).

[13] *Raymond J. Lucia Cos., Inc.*, Initial Decision Release No. 540, 2013 WL 6384274 (Dec. 6, 2013).

[14] 204 F.3d 1125 (D.C. Cir. 2000).

[15] 676 F.3d 1129 (D.C. Cir. 2012).

[16] *Id.* at 1133.

[17] 204 F.3d at 1134.

[18] No. 15-1345, *slip* op. at *11 (D.C. Cir. Aug. 9, 2016).

[19] *Id.* at 11-12.

[20] *Id.* at *13 (emphasis added).

[21] *Id.*

[22] *Id.*

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