

## Outside Counsel

## Expert Analysis

# D.C. Circuit Upholds Constitutionality Of SEC Administrative Proceedings

The Securities and Exchange Commission's (SEC) selective use of administrative proceedings (AP) for some, but not all, litigated enforcement actions has been the subject of significant public criticism in recent years. Respondents have brought numerous challenges to the SEC's use of APs arguing that the SEC's selective use of the proceedings is inherently unfair. Respondents achieved a measure of success in 2015 by challenging APs on the ground that administrative law judges (ALJs) were not properly appointed pursuant to the Appointments Clause of Article II of the Constitution and, thus, could not issue decisions in APs.<sup>1</sup>

On Aug. 9, 2016, however, a three-judge panel of the U.S. Court of Appeals for the District of Columbia Circuit issued *Lucia v. SEC*,<sup>2</sup> which roundly rejected the respondent's

By  
**Claudius O.  
Sokenu**



challenge and held the SEC's use of ALJs constitutional. As the first appellate decision to address the constitutionality of the SEC's appointment of ALJs, the D.C. Circuit's opinion could embolden the

---

The D.C. Circuit's opinion in 'Lucia' could embolden the SEC to continue its use of administrative proceedings in litigated enforcement actions.

commission to continue its use of APs in litigated enforcement actions.

### Petitions for Injunctions

Prior to 2015, district courts had uniformly rejected petitions for injunctions of APs on due process and equal protection grounds. These courts held 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.

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.<sup>3</sup> SEC ALJs, however, are hired as though they are employees of the commission. In *Hill*, Judge May first held that a district court had jurisdiction to consider the plaintiffs' petition for an injunction, and later concluded that ALJs were improperly acting as inferior officers without having been appointed by the commission itself as required by

---

CLAUDIUS O. SOKENU is a partner at Shearman & Sterling and a former senior counsel with the U.S. Securities and Exchange Commission, Division of Enforcement. JON WEINGART and BRITTANY BRUDNICKI, litigation associates at Shearman in the Washington, D.C., and New York offices, respectively, assisted in the preparation of this article.

the Appointments Clause. In August 2015, May enjoined a second AP for the same reasons in *Gray Financial Group v. SEC*.<sup>4</sup> Later that August, Judge Richard Berman of the Southern District of New York reached a similar conclusion in *Duka v. SEC*.<sup>5</sup>

These successful challenges to the SEC's use of APs were subsequently 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 consideration consistent with *Tilton*.

On June 17, 2016, the U.S. Court of Appeals for the Eleventh Circuit similarly reversed Judge May's decisions in *Hill* and *Gray Financial Group*,<sup>6</sup> citing D.C. Circuit,<sup>7</sup> U.S. Court of Appeals for the Seventh Circuit<sup>8</sup> and U.S. Court of Appeals for the Second Circuit<sup>9</sup> cases holding that district courts lack subject-matter jurisdiction to consider preliminarily enjoining APs given that the AP respondents would have a right to circuit court review following any final determination by the commission.

### Addressing Constitutionality

While these appellate decisions appear to have resolved the jurisdictional question, *Lucia v. SEC* is the first appellate opinion to

substantively address the constitutionality of the SEC's appointment of ALJs. The SEC had argued that ALJs are 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 merely SEC employees. Respondents challenging APs, on the other hand, characterized ALJs as primary factfinders whose decisions are reviewed deferentially by SEC commissioners and thus possess the decision-making authority to qualify as "inferior officers." Because ALJs are not appointed by the president, SEC commissioners or a federal court, the respondents argued that their appointment is unconstitutional.

The *Lucia* decision arises out of 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 of 1940 (the Advisers Act). After conducting a public hearing, the presiding ALJ imposed a fine of \$300,000 and a lifetime industry ban 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.

Lucia and his company appealed to the commission, which conducted an independent review and found that Lucia and his company had violated the Advisers Act and imposed the same sanctions as the presiding ALJ. Relying on the D.C. Circuit's

opinion in *Landry v. FDIC*,<sup>10</sup> the commission rejected the petitioner's argument that the AP was unconstitutional because the appointment of the presiding ALJ did not comply with the Appointments Clause.

The D.C. Circuit affirmed the commission's decision. Citing *Tucker v. Commissioner, Internal Revenue*,<sup>11</sup> the court 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."<sup>12</sup> In *Tucker*, the court 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*,<sup>13</sup> the D.C. Circuit held that ALJs at the Federal Deposit Insurance Corporation (FDIC) were not inferior 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 court 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.<sup>14</sup> 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.<sup>15</sup>

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*.<sup>16</sup> 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.”<sup>17</sup> Furthermore, the court noted that “even when there is [no] 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.”<sup>18</sup>

## Amendments

The SEC’s increased use of APs in litigated enforcement actions has been subject to strong public criticism. The commission’s overwhelming record of success in APs, combined with a former ALJ’s claim that she had been pressured to favor the SEC, has only fueled claims that the SEC prefers APs because ALJs favor the commission. After a former SEC ALJ claimed in

a May 6, 2015, Wall Street Journal article that she felt pressured by the chief ALJ to favor the commission, the SEC’s Office of Inspector General (OIG) investigated these claims.<sup>19</sup> The OIG report, released on Jan. 21, 2016, found no bias by ALJs. Nevertheless, respondents have continued to challenge the constitutionality of APs on equal protection and other grounds.

Even though legal challenges to the commission’s AP process have been largely unfruitful for respondents, the robust criticism of, and repeated constitutional challenges to, APs appears to have affected the SEC’s forum selection process for litigating contested enforcement actions. Cornerstone’s Securities Enforcement Empirical Database, a public online resource that provides data on SEC actions filed against defendants that are public companies and their subsidiaries, suggests that the commission is bringing fewer contested actions before ALJs. The agency also recently announced changes to the AP process.

Specifically, on July 13, 2016, the SEC announced that it had adopted amendments to its Rules of Practice governing APs that were originally promulgated to “modernize” the AP process. The amendments, among other things, adjust the deadlines by which an ALJ must issue an initial decision, which allow respondents more time for discovery and hearing preparation, and give the parties discretion to take limited depositions during the discovery period.

The Lucia decision is unlikely to quell public criticism of the SEC’s use of APs, and the commission will likely continue its efforts to reform the process. Nonetheless, the Lucia decision represents a clear statement supporting the constitutionality of the commission’s use of ALJs, and as a result could herald an increase in the use of APs by the SEC.



1. Order, *Hill v. SEC*, No. 15-cv-1801-LMM (N.D. Ga. June 8, 2015), ECF No. 28; Order at 35-36, *Gray Financial Group v. SEC*, No. 15-cv-00492 (N.D. Ga. Aug. 4, 2015), ECF No. 56; see also *Ironridge Global IV v. SEC*, No. 1:15-CV-2512-LMM (N.D. Ga. Nov. 17, 2015).

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

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 (SDNY 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 v. SEC*, No. 15-2103, 2016 WL 3084795 (2d Cir. June 1, 2016).

10. 204 F.3d 1125 (D.C. Cir. 2000).

11. 676 F.3d 1129 (D.C. Cir. 2012).

12. *Id.* at 1133.

13. 204 F.3d at 1134.

14. No. 15-1345, slip op. at \*11 (D.C. Cir. Aug. 9, 2016).

15. *Id.* at 11-12.

16. *Id.* at \*13 (emphasis added).

17. *Id.*

18. *Id.*

19. SEC Office of Inspector General, Report of Investigation, Case No. 15-ALJ-0482-I, (Jan. 21, 2016), <https://www.sec.gov/oig/reportspubs/Final-Report-of-Investigation.pdf>.