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SEC Update

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Supreme Court Rules SEC ALJs Are Officers, Subject to the Appointments Clause

On June 21, 2018, the Supreme Court issued its decision in *Lucia v. SEC*.[1] Securities and Exchange Commission (SEC) administrative law judges (ALJs) have traditionally been appointed by SEC Staff members, not the Commission. In *Lucia*, the Court held that SEC ALJs were "Officers of the United States" subject to the Appointments Clause of the US Constitution and, therefore, had to be appointed by the President, "Courts of Law," or "Heads of Departments" (as relevant here, the Commission).

The SEC previously sought to mitigate and preempt any fallout from an adverse decision in this case by issuing an order in November 2017 ratifying the agency's prior appointments of its current sitting ALJs and directing each of the SEC's five ALJs to reconsider and review the record in pending proceedings before him/her.[2] However, as discussed below, the remedy granted by the Court in *Lucia* calls into question the effectiveness of the SEC's proactive measure. And the *Lucia* decision calls into question the constitutionality of administrative proceedings before other agencies that historically have followed similar ALJ appointment procedures—in the financial services context, the Federal Deposit Insurance Corporation (FDIC) and the Consumer Financial Protection Bureau (CFPB).

Background

The SEC instituted administrative proceedings against a registered investment adviser and its owner, Raymond Lucia, in connection with their marketing of a retirement savings strategy called "Buckets of Money." The SEC's Order Instituting Administrative Cease-and-Desist Proceedings alleged that Mr. Lucia and his company committed securities fraud by making materially misleading statements in slideshow presentations to prospective investors. The case was tried before ALJ Cameron Elliot, who issued an initial decision concluding that the investment adviser had violated Sections 206(1), (2), and (4) of the Investment Advisers Act of 1940 and that Lucia had aided and abetted and caused those violations.[3] ALJ Elliot ordered Lucia and his company to cease and desist from further violations of the Advisers Act; imposed $300,000 in civil penalties ($250,000 against the investment adviser and $50,000 against Lucia); barred Lucia from associating with an investment

adviser, broker, or dealer; and revoked Lucia's and his company's investment adviser registrations.

Lucia appealed the decision to the Commission, arguing that the administrative proceeding was invalid because ALJ Elliott had not been constitutionally appointed.[4] The Division of Enforcement argued that SEC ALJs were ordinary "employees" and thus not subject to the Appointments Clause. The SEC rejected Lucia's arguments, and Lucia appealed to the D.C. Circuit. The D.C. Circuit agreed with the SEC, and Lucia requested a hearing *en banc*. The *en banc* court was evenly divided, resulting in a *per curium* order denying Lucia's claim. That decision conflicted with the Tenth Circuit's decision in *Bandimere v. SEC*,[5] and Lucia petitioned the Supreme Court for a *writ of certiorari* to resolve the circuit split.

Until this point, the Department of Justice, which had assumed responsibility for representing the SEC, had defended the SEC's position. But in response to Lucia's petition for *certiorari* (and following the change in administration), the Department of Justice changed its position and asked the Court to address a second question: whether the statutory restrictions on removing the SEC's ALJs were constitutional. The Court granted Lucia's petition but declined to address the second question raised by the government. The Court appointed an attorney to defend the judgment of the D.C. Circuit.

Decision

The Court made short work of the argument that the ALJs were constitutionally appointed, relying on *Freytag v. Commissioner*[6] to hold that SEC ALJs were inferior officers subject to the Appointments Clause. In *Freytag*, the Court held that special trial judges (STJ) of the US Tax Court were "officers" subject to the Appointments Clause. The Court saw no reason to distinguish SEC ALJs—who, like the STJs, receive a career appointment to a position created by statute and have "significant discretion" to ensure fair and orderly adversarial proceedings (for example, by receiving evidence, examining witnesses, conducting trials, ruling on motions and enforcing discovery orders) and to render decisions that are afforded deference by the SEC—from the STJs at issue in *Freytag*.

The only real issue left for the Court was the question of remedy. Relying on *Ryder v. United States*[7] the Court concluded that "'one who makes a timely challenge to the constitutional validity of the appointment of an officer who adjudicates his case' is entitled to relief." That relief—"a new 'hearing before a properly appointed' official"—could not be satisfied in this case by a hearing before ALJ Elliott, even assuming that the SEC had now properly appointed him (pursuant to the November 2017 order). Because ALJ Elliott had already heard Lucia's case and issued an initial decision on the merits, the Court concluded that he could not "be expected to consider the matter as though he had not adjudicated it before." At the same time, the Court made clear that a hearing before a different ALJ was not constitutionally required; rather, it was the preferable remedy in Lucia's case because other ALJs unfamiliar with the case were available, and remanding to one of them was a more equitable solution than remanding the case back to ALJ Elliott—the remedy suggested by Justice Breyer in his concurring opinion. In different circumstances, necessity could justify remand to either the Commission (or similar agency head) or the same ALJ.

Impact

While at first blush the Court's decision may appear to have a far-reaching impact on cases tried before SEC ALJs, the impact of the *Lucia* decision is limited in one important respect:

- *Timely Objection*. The Court's decision suggests that only those who timely challenged the constitutionality of the ALJ in their proceeding will be entitled to relief. Thus, the Court's decision does not affect settled actions (not before ALJs) or decided cases where the litigant failed to timely challenge the constitutionality of the ALJ.

The Court's directive that Lucia be granted a new hearing before a different ALJ, however, does call into question the effectiveness of the SEC's November 2017 order to ALJs to review and reconsider the record in their pending cases.

- *Cases Reviewed After Initial Decision Issued*. Given the Court's directive in *Lucia*, it seems unlikely that the proactive review by the ALJ who issued an initial decision would cure the constitutional defect. Rather, the Court's reasoning suggests that the appropriate relief would have been review and reconsideration by a different ALJ.
- *Cases Reviewed Prior to Decision*. In cases where an ALJ had not rendered an initial decision prior to the SEC's November 2017 order, the impact of *Lucia* is less clear. To explain why it was requiring a trial before a different ALJ in *Lucia*, the Court noted that ALJ Elliott both had already heard Lucia's case and had issued an initial decision on the merits.

The SEC sought to cure any Appointments Clause defect going forward with its November 2017 order but, in light of the *Lucia* decision, issued an order staying all pending administrative proceedings for 30 days or until further order from the SEC.[8] While the Court did not specifically address the effectiveness of the November 2017 order, it did note that "[b]oth the Government and Lucia . . . acknowledge that the Commission, as a head of department, can constitutionally appoint [ALJs]." On July 10, 2018, President Trump issued an executive order in response to the *Lucia* decision excepting ALJs from the competitive examination and service selection procedures and giving the agency heads (political appointees) more discretion in the ALJ hiring process.[9] One major purpose of the order is to "mitigate concerns about undue limitations on the selection of ALJs, reduce the likelihood of successful Appointments Clause challenges, and forestall litigation in which such concerns have been or might be raised." Following President Trump's executive order, the SEC may choose to rely on the November 2017 order to cure the Appointments Clause defect or undertake further action, such as having pending cases reviewed by different ALJs (the remedy chosen in *Lucia*). Given the uncertainty caused by the Court's decision not to directly address the effectiveness of the November 2017 order or the removal question, it is unclear whether the SEC will return to pursuing more cases administratively. The SEC had reduced its reliance on its administrative forum for contested matters while this case was pending.

Going forward, the greatest impact of *Lucia* will likely be felt outside the SEC—at other agencies that rely on ALJ proceedings and have employed similar appointment procedures. In particular, the Court's opinion calls into question the constitutionality of the FDIC's ALJs and CFPB's ALJs.

- Like the SEC, the FDIC's ALJs have previously been challenged, and circuits are split on this issue.[10] Notably, the Court's opinion in *Lucia* specifically rejects the notion that, in order for an ALJ to be an "officer," he/she must have the authority to issue at least some "final decisions"—that rationale underpinned the D.C. Circuit's *Landry* decision finding that FDIC ALJs were not "officers" subject to the Appointments Clause.
- The CFPB currently uses a single ALJ for its administrative hearings. Challenges to the CFPB's ALJ will likely raise the question of whether the CFPB's director qualifies as a "Head of Department" because the CFPB operates as an independent bureau within the Federal Reserve. Challengers seeking relief will also have to address the "rule of necessity" exception that the Court suggested would permit the same, originally improperly appointed ALJ to rehear a case on remand.

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NOTES

1 Slip Op. No. 17-130.

2 *See* In re Pending Administrative Proceedings, SEC Release No. 34-82178 (Nov. 30, 2017).

3 The Commission remanded the case on its own initiative following the initial decision because ALJ Elliott had failed to address three theories of liability that the Division of Enforcement had presented in connection with the slideshow presentations. On remand, ALJ Elliott issued a revised initial decision that imposed the same sanctions. *See* In the Matter of Raymond J. Lucia Companies, Inc., Initial Decision Release No. 540 (Dec. 6, 2013).

4 The SEC Division of Enforcement cross-appealed ALJ Elliott's finding that the company did not violate, and Lucia did not aid or abet or cause a violation of, Rule 206(4)-1(a)(5) under the Advisers Act. On appeal, the Commission agreed with the Division of Enforcement and found an additional violation of Rule 206(4)-1(a)(5). *See* In the Matter of Raymond J. Lucia Companies, Inc., SEC Release No. 34-75837 (Sep. 3, 2015).

5 844 F.3d 1168 (2016).

6 501 US. 868 (1991).

7 515 U.S. 177 (1995).

8 *See* In re: Pending Administrative Proceedings, SEC Release 34-10510 (Jun. 21, 2018).

9 Available at https://www.whitehouse.gov/presidential-actions/executive-order-excepting-administrative-law-judges-competitive-service/.

10 *Compare* Burgess v. FDIC, Slip Op. No. 17-60579 (5th Cir. Sept. 7, 2017) (finding FDIC ALJs were unconstitutionally appointed), *with* Landry v. FDIC, 204 F.3d 1125 (DC Cir. 2000) (finding FDIC ALJs were not "officers" subject to the Appointments Clause).