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EXPERT ANALYSIS

10th Circuit Ruling on SEC's Use of Administrative Law Judges Creates Circuit Split

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The recent string of successes by the Securities and Exchange Commission in administrative proceedings may have just hit a roadblock.

In 2010, the Dodd-Frank Act greatly expanded the SEC's authority to pursue enforcement actions in-house. Since then, the agency has brought the vast majority of its cases in administrative courts.

The SEC's ability to bring a case in its administrative forum is widely viewed as giving its staff several advantages, especially against individuals. Moreover, the forum decision is left solely to the SEC's discretion.

Seeking to curb any home-field advantage enabled by this practice, defense attorneys have brought numerous constitutional challenges to the commission's use of administrative proceedings. Until recently, both the SEC and federal courts have consistently rejected their arguments.

However, the 10th U.S. Circuit Court of Appeals' decision in *Bandimere v. SEC*, 844 F.3d 1168 (2016), holding that the SEC's use of administrative law judges violates the appointments clause of the Constitution, has provided reason to hope that at least one such argument may ultimately prevail.

Bandimere has significant implications for the SEC and other federal agencies that use in-house administrative judges, and it sets the stage for a potential Supreme Court showdown regarding the use of administrative courts.

This analysis provides a detailed discussion of the *Bandimere* decision and also offers a more general overview of the recent constitutional challenges brought against the SEC's in-house tribunals.

THE SEC'S IN-HOUSE TRIBUNALS

The SEC may bring civil enforcement actions in one of two forums: federal court or internal administrative proceedings. These forums are subject to different rules.

Enforcement targets generally prefer adjudication in federal courts, where they have the benefit of a number of substantive and procedural mechanisms that have traditionally been unavailable in the administrative realm. These include the right to a jury trial, application of the Federal Rules of Evidence, and the ability to subpoena witness testimony.

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Moreover, administrative proceedings are generally subject to tighter deadlines that may compound the difficulty of mounting a successful defense — particularly given that the commission typically gathers a substantial amount of evidence over multiple years before bringing the case and triggering the relevant clock.

Finally, some enforcement targets have questioned the impartiality of a system in which they are investigated, prosecuted and judged all by officials of the same agency.[1]

Historically, the practical impact of the differences between administrative and federal court proceedings has been mitigated by restrictions limiting the types of cases that the SEC could bring on its home turf.

For much of its history, the commission could bring administrative enforcement actions only against individuals or entities registered with the SEC and affiliated with SEC-regulated industries — and even then, there were limitations on the remedies the SEC could seek.

The SEC was required to proceed in federal court if it sought civil monetary penalties from nonregulated parties or a permanent ban preventing an individual from serving as an officer or director of a public company.

In effect, this meant that federal courts had exclusive jurisdiction over most insider trading, public company accounting or offering fraud, as well as claims related to unregistered securities. Administrative proceedings were largely reserved for cases involving regulated entities such as exchanges, utilities, and registered broker-dealers or investment advisors.

Dodd-Frank ushered in a new era of enforcement by giving the commission authority to bring nearly any case before an ALJ. Specifically, the act expanded the commission's jurisdiction to include nonregulated entities in addition to those registered with the agency.

It also gave the agency the power to seek most forms of remedies in administrative proceedings. As a result, the SEC can now seek monetary penalties against any individual or entity and impose industry-wide suspensions through an order from an ALJ.

Additionally, the commission has virtually unfettered discretion to choose the forum where an action will be brought.

The SEC was initially slow to take full advantage of this new freedom. But under the hand of the most recent SEC chair, Mary Jo White, who pursued an aggressive enforcement agenda, the staff began bringing substantially more cases via administrative proceedings in 2014 — so much so that that the head of the SEC's foreign corrupt practice unit described the shift to administrative proceedings as "the new normal."[2]

The commission has justified its increased use of administrative proceedings by noting that they "produce prompt decisions," "have the benefit of specialized fact finders" and allow for the inclusion of all "relevant evidence."[3]

Perhaps not surprisingly, critics have denounced these purported justifications as mere pretext, arguing that the agency is focused on exploiting its "'home court' advantage before its own judges."[4] They have pointed to the SEC's high success rate as evidence of its bias: For example, over the same five-year period, the commission had an overwhelming 90 percent win rate in administrative proceedings as compared with a 69 percent win rate in federal court.[5]

The SEC attempted to mollify critics by modifying its procedural rules in July 2016. Among other things, the agency extended certain deadlines and permitted parties to take depositions as part of discovery.[6] However, such measures have largely been viewed as insufficient.

CONSTITUTIONAL CHALLENGES

Against this backdrop, defense attorneys have brought numerous challenges to the SEC's use of administrative proceedings in an attempt to level what many see as an uneven playing field.

Beginning in 2011 — and escalating in frequency since 2014 — such challenges have primarily been brought on four separate constitutional grounds: due process, equal protection, separation of powers and the appointments clause.

First, defense attorneys have argued that administrative proceedings deprive their clients of a full and fair opportunity to be heard before an impartial adjudicator in violation of the due process guarantees of the Fifth Amendment.

In support of this argument, they have pointed to the lack of procedural safeguards, including the ability to subpoena witnesses and sufficient time to prepare a meaningful defense, and a perceived agency bias.[7]

Second, defense attorneys have asserted that the SEC's decision to bring an administrative proceeding (rather than to file suit in federal court) amounts to irrational discrimination in violation of the equal protection clause of the 14th Amendment.

They note that similarly situated defendants receive markedly different treatment merely by virtue of the forum in which their cases are adjudicated.[8] These substantive challenges have been largely unsuccessful, as courts have generally held that they have jurisdiction to hear such challenges only on appeal from that proceeding.[9]

The SEC has virtually unfettered discretion to choose the forum where an action will be brought.

Third, defense attorneys have brought structural challenges to the SEC's use of administrative proceedings based on separation-of-powers concerns.

Specifically, they have argued that such proceedings are per se unconstitutional because ALJs are executive officers but are not subject to presidential oversight as required by Article II because they can be removed only for good cause and by commissioners who are themselves protected by tenure.[10]

This challenge has not gained much traction. In any event, even if a defendant successfully mounts an Article II removal claim, the consequences are limited because any constitutional defect can be easily remedied simply by removing the grant of tenure to ALJs without striking down the entire administrative enforcement process.[11]

Fourth, defense attorneys have argued that the hiring process for ALJs is unconstitutional because the ALJs are treated like any other SEC employee and are not appointed by the president, courts of law or heads of department (i.e., the five commissioners who run the SEC) as required by the appointments clause of Article II.

In relevant part, the appointments clause reads:

> [The president] shall nominate, and by and with the advice and consent of the Senate, shall appoint ... officers of the United States, whose appointments are not herein otherwise provided for, and which shall be established by law: but the Congress may by law vest the appointment of such inferior officers, as they think proper, in the president alone, in the courts of law, or in the heads of departments.

Defense attorneys argue that ALJs fall squarely within the ambit of the appointments clause because they are "inferior officers."[12] Although the SEC vigorously disputes this classification, and at least one appellate court has specifically rejected the argument, this argument has gained surprising traction with the recent decision in Bandimere.

WHAT IS A CONSTITUTIONAL APPOINTMENT?

The Supreme Court provided the basic framework for analyzing constitutional appointments in *Freytag v. Commissioner of Internal Revenue*, 501 U.S. 868 (1991). In *Freytag*, the high court held that the U.S. Internal Revenue Service's special trial judges were inferior officers requiring appointment per constitutional guidelines.

Bandimere's impact has been immediate, halting SEC administrative proceedings in the six states subject to the 10th Circuit's jurisdiction.

In deciding whether an appointee is an inferior officer for purposes of Article II, *Freytag* evaluated the creation, duties and functions of the judges. It then concluded that the judges' office was established by law and that the judges' duties, salary and means of appointment are specified by statute.

The court made it clear that courts must also assess whether the appointee "exercise[s] significant authority pursuant to the laws of the United States."[13]

Ultimately, the court concluded that special trial judges do exercise such "significant authority" because they perform "more than ministerial tasks," "exercise significant discretion," and render final decisions in declaratory judgment proceedings and limited-amount tax cases.

The District of Columbia U.S. Circuit Court of Appeals was the first appellate court to consider whether ALJs are inferior officers for purposes of the appointments clause. In *Raymond J. Lucia Cos. v. SEC*, initially decided in August 2016, the court considered an appeal from a commission decision rejecting a constitutional objection based on a claim that ALJs exercise the requisite "significant authority" to qualify as inferior officers under the appointments clause.[14]

In its analysis, the court inexplicably narrowed the analytical framework set forth in *Freytag* to a single determining factor — whether the SEC's ALJs have "authority to issue final decisions in at least some cases" — and concluded that they did not.

Specifically, the court reasoned that the commission, rather than the ALJ, retains "full decision-making powers" because it must affirmatively act in every case to issue a final order.

Furthermore, the court explained that the commission reviews an ALJ's decision de novo and may affirm, reverse, modify or set aside the initial decision in whole or in part. On the basis of this reasoning, *Lucia* initially held that ALJs are employees rather than inferior officers and that there is therefore no constitutional defect in the manner of their appointment.[15]

THE *BANDIMERE* DECISION

On Dec. 27, 2016, the second federal appellate court to consider the issue of whether ALJs are inferior officers for purposes of the appointments clause rendered a decision that is in direct conflict with the earlier D.C. Circuit ruling in *Lucia*.

In *Bandimere v. SEC*, the 10th Circuit overturned the commission's decision that the ALJ who presided over the underlying administrative proceeding was a "mere employee" as opposed to an inferior officer, and was therefore not subject to the appointments clause.

As a preliminary matter, the court noted that the term "inferior officer" has an unusually "broad sweep," as evidenced by the multiple and varied examples of inferior officers in Supreme Court decisions spanning more than 150 years.[16]

Next, the court explicitly disagreed with *Lucia*'s determination that the question of whether an ALJ possesses final decision-making authority is dispositive for purposes of determining inferior officer status.

The court noted that no Supreme Court decision equates the concept of "significant authority" (as articulated in *Freytag*) to "final-decision making power."

To the contrary, Supreme Court cases make it clear that inferior officers are frequently subject to supervision by superior officers. As such, the court concluded that, while "final decision-making power is relevant in determining whether a public servant exercises significant authority, ... that does not mean *every* inferior officer *must* possess final decision-making power" (emphasis in original).

Rather than the final decision-making power test, then, the *Bandimere* court focused its analysis on three factors set forth in *Freytag*:

- Whether the position was established by law.

- Whether the duties, salary, and means of appointment are specified by statute.
- Whether the judges exercise significant discretion in carrying out important functions.

The circuit court found that SEC ALJs meet all three factors. While the first two factors have straightforward statutory bases, the third required the court to engage in lengthy analysis.

After carefully charting out dozens of ALJ duties and powers, the court found that ALJs enjoy significant discretion to shape the administrative record and issue initial decisions that declare respondents liable and impose sanctions.

This discretionary authority extends to the power to enter default judgments and otherwise steer the outcome of the proceedings via settlement conferences, as well as to set aside, make permanent, limit or suspend temporary sanctions that the SEC itself has imposed.

Accordingly, the court found that the SEC ALJs "closely resemble the STJs [special trial judges] described in *Freytag*" and are therefore "inferior officers who must be appointed in conformity with the appointments clause."

BANDIMERE'S FAR-REACHING IMPLICATIONS

Bandimere's impact has been immediate, halting SEC administrative proceedings in the six states subject to the 10th Circuit's jurisdiction (Colorado, Kansas, New Mexico, Oklahoma, Utah and Wyoming). However, the full implications of *Bandimere* have yet to be revealed.

In the wake of the *Bandimere* decision, the D.C. Circuit granted a petition for rehearing en banc, therefore vacating its August ruling in *Lucia* and agreeing to issue a new decision from a full panel of appeals judges.

The en banc proceeding only further contributes to the turmoil and uncertainty surrounding the appointments clause issue.

On the one hand, the panel could maintain the initial conclusion regarding the constitutionality of SEC judges, and therefore recreate a tense circuit split with the 10th Circuit.

On the other, if the panel changes course and issues an opinion more in line with *Bandimere*'s reasoning, then the SEC's administrative proceedings will be severely stymied in D.C. as well.

In the 10th Circuit, the SEC on March 13 also filed a petition for rehearing en banc, and there is at least a possibility that the panel's decision will be reversed, thus curing the present freeze on SEC administrative proceedings within the 10th Circuit's jurisdiction.

If, however, the rehearing petition is denied, or if an en banc panel confirms the original panel's decision, then the SEC will continue to be hamstrung.[17]

If the Supreme Court were to address the question of whether the SEC's ALJ are inferior officers, its decision could have implications beyond the SEC. Specifically, if the Supreme Court were to hold that SEC ALJs are not constitutionally appointed, such a holding would at least call into question the constitutional validity of ALJs used by other administrative agencies.

Indeed, the sole dissenting opinion in *Bandimere* warned that "all federal ALJs are at risk of being declared inferior officers" and provided as an example the 1,537 Social Security Administration ALJs that, like SEC ALJs, are hired via a "competitive service" system for civil service employees and share similar duties.

NOTES

[1] As expressed by U.S. District Judge Jed Rakoff, a prominent critic of the SEC's increased use of administrative proceedings, ALJs "are inevitably are a product of the milieu in which they operate." Stephanie Russell-Kraft, *Rakoff Hopes SEC Will 'Think Twice' About Using Admin Court,* Law 360 (Mar. 3, 2015, 4:42 PM), https://www.law360.com/articles/627028/rakoff-hopes-sec-will-think-twice-about-using-admin-court. Consistent with these concerns, enforcement targets have suggested that there is no meaningful appeals process for administrative proceedings. In the first instance, an ALJ

decision must be appealed to the SEC itself, which already reviewed the relevant facts and the charged party's defenses, and expressed its opinion on the need for a case by granting its staff the authority to initiate the administrative action in the first place. A party then has the option of appealing to a federal appellate court, but the applicable standard of review is deferential to administrative decisions on law and leaves little chance of success.

[2] Jean Eaglesham, SEC Is Steering More Trials to Judges It Appoints, Wall St. J., Oct. 21, 2014; *see* Peter K.M. Chan et al., *There's No Place Like Home: SEC Increasingly Uses Administrative Proceedings,* Nat'l Law Rev. (Dec. 22, 2014), http://bit.ly/2pvyzDl; *see also* Jean Eaglesham, *SEC Wins With In-House Judges,* Wall St. J., May 6, 2015.

[3] Andrew Ceresney, Dir., SEC Div. of Enf't, Remarks to the American Bar Association's Business Law Section Fall Meeting (Nov. 21, 2014), *available at* http://bit.ly/2ph9FX4.

[4] Peter J. Henning, *S.E.C.'s In-House Judges Face Supreme Court Scrutiny,* N.Y. Times, Jan. 3, 2017, http://nyti.ms/2pef9jC; Gretchen Morgenson, *Crying Foul on Plans to Expand the S.E.C.'s In-House Court System,* N.Y. Times, June 26, 2015, http://nyti.ms/2oGuzv0.

[5] *See* Eaglesham, supra note 2.

[6] *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Proposes to Amend Rules Governing Administrative Proceedings (Sept. 24, 2015), http://bit.ly/1LiiiXZ.

[7] *See, e.g., Chau v. SEC,* 72 F. Supp. 3d 417, 426-29 (S.D.N.Y. 2014), *aff'd sub nom. Chau v. SEC,* No. 15-461, 2016 WL 7036830 (2d Cir. Dec. 2, 2016) (arguing that the time constraints set forth in the SEC's rules of practice hampered the defendant's ability to adequately prepare for a hearing); *Bebo v. SEC,* 799 F.3d 765 (7th Cir. 2015) (arguing that the defendant did not receive a fair hearing because she could not subpoena foreign witnesses critical to her defense); Brief for Appellants at 34-46, *Jarkesy v. SEC,* 803 F.3d 9 (D.C. Cir. 2015) (arguing that the SEC engaged in impermissible "prejudgment" and deprived the defendant of a fair trial when the commission issued an ex parte order finding the respondent guilty months before the actual fact-finding administrative hearing).

[8] *See, e.g., Chau,* 72 F. Supp. 3d at 430 (identifying three other "nearly identical" cases that were brought in federal courts rather than administrative courts and claiming that defendants were "intentionally treated differently from others similarly situated and there is no rational basis for the difference in treatment").

[9] *See, e.g., Jarkesy v. SEC,* No. 14-cv-114, 2014 WL 2584403, at *4 (D.D.C. June 10, 2014) (noting that administrative proceedings should generally adhere to the following four-step process: "charges are brought by the SEC's enforcement division before an ALJ," "the plaintiffs have the opportunity to be heard and present evidence challenging the charges," "the plaintiffs may appeal an adverse ALJ decision to the SEC commissioners," and "if the plaintiffs are aggrieved by the resulting final order, the plaintiffs may appeal to a federal court of appeals"). The sole exception is *Gupta v. SEC,* 796 F. Supp. 2d 503 (S.D.N.Y. 2011), in which Judge Rakoff allowed the plaintiff's equal protection claim to survive a motion to dismiss. The claim was settled shortly after that ruling, with the SEC agreeing to sue Gupta in federal court.

[10] *Hill v. SEC,* 825 F.3d 1236 (11th Cir. 2016); *Bebo v. SEC,* 799 F.3d 765.

[11] *Cf. Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.,* 561 U.S. 477 (2010) (holding that oversight structure of the Public Company Accounting Oversight Board, which is under the direct supervision of the SEC, was defective but not a separation-of-powers violation because the unconstitutional tenure provision of the statute could simply be severed).

[12] *See, e.g., Tilton v. SEC,* 824 F.3d 276, 279-80, (2d Cir. 2016), *petition for cert. filed, Tilton v. SEC,* No. 16-906 (U.S. Jan. 19, 2017).

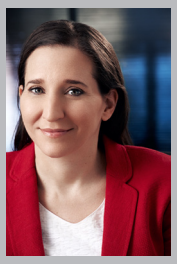
[13] *Freytag v. Comm'r of Internal Rev.,* 501 U.S. 868, 881 (1991) (quoting *Buckley v. Valeo,* 424 U.S. 1, 126 (1976)).

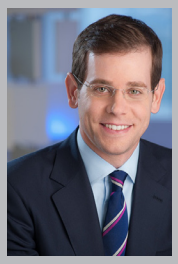
[14] *Raymond J. Lucia Cos. v. SEC,* 832 F.3d 277 (D.C. Cir. Aug. 9, 2016), *reh'g en banc granted, judgment vacated* (D.C. Cir. Feb. 16, 2017).

[15] *Id.* at 289 ("[H]aving failed to demonstrate that commission ALJs perform such duties as would invoke [the appointments clause] requirement, this court could not cast aside a carefully devised scheme after years of legislative consideration and agency implementation.").

[16] These examples include a district court clerk; an "assistant surgeon"; "thousands of clerks in the Department of the Treasury, Interior and the othe[r]" departments; an election supervisor; a federal marshal; a "cadet engineer" appointed by the secretary of the Navy; a postmaster first class; Federal Election Commission commissioner; Tax Court special trial judges; and military judges.

[17] Lynn Tilton, a high-profile private equity investor, recently filed a petition for certiorari in her long-running appointments clause challenge to the SEC's administrative court structure. *Tilton v. SEC*, No. 16-906 (Jan. 19, 2017). To the extent the 10th Circuit does not reverse the original panel's decision in *Bandimere*, this makes it far more likely that the Supreme Court will grant Tilton's petition in order to address the constitutional infirmities raised by the *Bandimere* panel opinion.





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