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Supreme Court: SEC ALJs Are Officers Subject to Constitution's Appointments Clause

Respondents in pending or future proceedings should carefully assess their options until several key legal questions are resolved.

The United States Supreme Court recently issued its ruling in *Lucia v. Securities and Exchange Commission*,[1] concluding that Administrative Law Judges (ALJs) at the Securities and Exchange Commission (SEC, or the Commission) are "Officers of the United States" and thus must be appointed consistent with the Constitution's Appointments Clause.[2] The Court concluded that SEC ALJs are "near-carbon copies" of other officers whom precedent made plain were also Officers of the United States.[3] But the Court's ruling, issued on June 21, 2018, left open several legal questions that will take time to resolve and that are relevant to ongoing and future enforcement proceedings before SEC ALJs and other agencies. Respondents in pending or future proceedings should carefully assess their options and preserve a variety of constitutional challenges for judicial review.

Background: *Lucia v. Securities and Exchange Commission*

Petitioner Raymond Lucia (and respondent before the SEC) marketed retirement savings strategies. According to the SEC, he "used misleading slideshow presentations to deceive prospective clients" in violation of the antifraud provisions of the Investment Advisers Act.[4] The SEC commenced an administrative proceeding against Lucia before an ALJ who ultimately issued an initial decision sanctioning Lucia and ordering US$300,000 in civil penalties and a lifetime bar from the investment industry.[5] On appeal to the Commission, Lucia argued, among other points, that the administrative proceeding was invalid because the ALJ was unconstitutionally appointed by "SEC staff members" instead of by the Commission.[6] The Commission rejected the challenge, holding that SEC ALJs are not "Officers of the United States" subject to any Constitutional appointment considerations because they "do not exercise significant authority." A unanimous panel of the D.C. Circuit affirmed, concluding that an ALJ is not an "Officer of the United States" unless the ALJ can issue final decisions — something the court determined the SEC's ALJs could not do.[7] The full Circuit granted *en banc* review, but split evenly 5-5, resulting in a *per curiam* affirmance.[8] That resulted in a Circuit split with the Tenth Circuit (which had held that SEC ALJs *are* Officers of the United States)[9] and teed up the issue for Supreme Court review. There, the US Department of Justice took the unusual approach of reversing its previous defense of the government's position and aligning itself with the petitioner.[10] The Supreme Court accordingly appointed an *amicus curiae* to defend the D.C. Circuit's judgment.[11]

Justice Kagan issued a succinct opinion for six members of the Court reversing the D.C. Circuit and holding that SEC ALJs are "Officers of the United States." The Court concluded that one of its precedents — *Freytag v. Commissioner of Internal Revenue* — was dispositive on the "Officer" question: "[O]ur analysis there (sans any more detailed legal criteria) necessarily decides this case."[12] That is because the SEC ALJs wield materially all of the same authority that rendered the United States Tax Court's "special trial judges" (STJs) Officers of the United States in the *Freytag* case.[13] As in *Freytag*, the SEC's ALJs "hold a continuing office established by law," and essentially have "all the tools of federal trial judges" such as to take testimony, conduct trials, rule on the admissibility of evidence, and enforce compliance with discovery orders.[14] Further, whereas in *Freytag* an appointed Tax Court judge was *required* to review certain STJ orders before they took effect, the SEC was free to decline review of ALJ orders altogether, thus allowing them to become final and binding in their own right.[15] The Court-appointed *amicus* attempted to distinguish *Freytag* by arguing that SEC ALJs lacked the same capacity to enforce compliance with discovery orders (such as with fines or imprisonment) and that the Tax Court was more deferential to STJ factual findings.[16] But the Court held that these "distinctions make no difference for officer status"; although their mechanisms were not the same, SEC ALJs still possessed power to enforce compliance with discovery orders, and the Commission often accords similar deference to ALJ findings as the Tax Court did with STJs.[17]

The Court remanded for a new hearing before a properly appointed ALJ.[18]

Ramifications for SEC Administrative Enforcement Actions

When the Commission initiates an enforcement action, it proceeds either in federal court or in an administrative proceeding.[19] In a litigated (as opposed to settled) administrative proceeding, an ALJ ordinarily presides.[20] The Dodd-Frank Act dramatically expanded the types of actions that the SEC may adjudicate administratively,[21] and since then, the Commission has increasingly used the administrative forum to litigate enforcement actions. Thus, *Lucia* will have substantial, immediate impacts on litigated administrative proceedings.

Shortly after Dodd-Frank was enacted in 2010, the SEC's Director of Enforcement Division acknowledged that the Commission was steadily using its discretion to shift more proceedings into the administrative tribunal.[22] In 2014, for example, the SEC initiated more than 610 administrative proceedings — nearly double its number in 2005.[23] The data regarding enforcement actions against public companies that are not financial institutions is particularly profound; in 2010, the SEC initiated 27 such cases in federal court and only nine in administrative proceedings, but by 2015, those numbers virtually reversed to nine and 16, respectively.[24] Some have noted that the SEC has shifted gears more recently in response to substantial public criticism by filing a greater percentage of *litigated* cases in federal court. Administrative proceedings are still the norm in settled cases: 71% of settled cases took place in administrative proceedings in the second half of 2017.[25] And nothing in *Lucia* will likely change the administrative proceeding as the forum of choice for settlements.

Lucia does, however, raise substantial considerations for litigated SEC administrative enforcement proceedings in the past, present, and even the future. For the time being, the SEC has stayed ALJ proceedings,[26] but when proceedings resume, a variety of unsettled legal questions will arise that should generate further litigation.

The precise impact *Lucia* may have on an SEC administrative enforcement proceeding depends on where it falls in a chronological timeline. The four relevant temporal categories are:

(1) Past actions that have become final and for which the time to seek judicial review has expired

(2) Actions in which a petition for review had been filed by November 30, 2017 — the date the SEC issued an order "ratifying" its "prior appointment" of the agency's five ALJs[27]

(3) Actions that were pending before an ALJ or the Commission when the SEC issued its ratification order

(4) Actions that had not yet commenced when the SEC issued its ratification order

Parties in category (1) will have the most difficulty invoking *Lucia* to change their circumstances. The Court noted 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," and so it is plausible that if a challenge was made during the proceedings of an order that is otherwise final, that order may be open to renewed attack.[28] However, *res judicata* considerations will likely make courts especially wary of such challenges unless the SEC itself opts to reopen the proceedings.[29]

Parties in category (2) were not affected by the SEC's ratification order. For these cases, *if* the respondent in the SEC enforcement proceedings raised a timely challenge to the ALJ non-appointment, the *Lucia* opinion provides that the SEC must provide "a new hearing before a properly appointed official."[30] The ALJ who presided over the initial hearing cannot preside over the hearing on remand — even if the ALJ is properly appointed.

Parties in category (3) are subject to the ratification order, which directed the same ALJ who conducted the proceedings in the first instance to "[r]econsider the record," permit "any new evidence the parties deem relevant," and then determine whether to revise the previous order.[31] The *Lucia* opinion suggests this procedure was defective for two reasons. First, the *Lucia* Court held that a *different* ALJ must conduct the new proceeding. Second, it is questionable whether a paper review, along with the consideration of new evidence, suffices to satisfy the *Lucia* Court's requirement of a "new hearing." If, after its stay expires, the Commission does not order new hearings in these matters before a *different* ALJ, then parties in this category who preserved their Appointments Clause challenge will likely have strong arguments on judicial review.

Parties in category (4) are unaffected by *Lucia*, but they may nonetheless be able to bring an identical challenge. That is because it is unclear whether the SEC's ratification order is a constitutionally permissible way to appoint an Officer of the United States. The Constitution requires that such officers take an oath of office, and that there be a signing and delivery of a commission.[32] The Commission can avoid this problem with a more formal appointment, but until it does so this uncertainty will linger.

Ramifications for Administrative Law Judges

Lucia raises questions about ALJs more generally.

Which ALJs are Officers of the United States?

Among the more than 1,900 ALJs in the country, spread across more than 30 different agencies,[33] are *all* Officers of the United States, as President Trump's July 10, 2018 Executive Order suggests?[34] Are *some*? Or could the Supreme Court's opinion be cabined so as to apply only to SEC ALJs?

For at least some agencies, this question will be less important. In *Lucia,* the trigger for the appointment problem was that SEC *staff*, and not the SEC *itself*, made the appointments. The Appointments Clause provides that "Heads of Departments" may lawfully appoint certain officers (such as ALJs),[35] and so *Lucia* is unlikely to directly impact those agencies where the head actually did appoint the ALJs. Other

agencies, such as the Labor Department, have sought to get ahead of this question by ratifying the appointment of its ALJs.[36] Although, as noted, that may not be a constitutionally permissible remedy.

There may also be bases for distinguishing certain agency ALJs from the SEC ALJs and the *Freytag* STJs. For example, the vast majority of the federal government's ALJs (more than 1,500) reside in the Social Security Administration. At oral argument, counsel for Lucia contended that these ALJs were materially different from the SEC's because "the vast majority of [their] determinations" have to do with "a citizen voluntarily go[ing] to the agency and seek[ing] benefits from the government" as opposed to situations such as Lucia's, in which the agency is imposing penalties for wrongdoing.[37] Whether this distinction (or others) will have meaningful weight in future cases is unclear. Although the *Lucia* majority used the *Freytag* similarities as a reason to deliberately refrain from addressing any further qualities of an Officer of the United States, Justice Thomas — in a concurrence joined by Justice Gorsuch — expressed a view of the Appointments Clause that would likely sweep in *all* ALJs. As Justice Thomas noted, the Court's "precedents in this area do not provide much guidance," but original understanding of the term "Officers of the United States" likely "encompass[ed] *all* federal civil officials who perform an ongoing, statutory duty — no matter how important or significant the duty."[38] Accordingly, the clause would cover even individuals tasked "only with ministerial duties — including recordkeepers, clerks and tidewaiters."[39]

Even if Justice Thomas' concurrence does not guide further development in this area of law, the fact that Supreme Court precedent provides little guidance here will likely lead to deep uncertainty over which ALJs are most clearly affected by *Lucia*. Some have advanced the view that the touchstone will be whether the ALJ can issue "final" determinations,[40] yet the Fifth Circuit recently held that Federal Deposit Insurance Corporation ALJs are Officers of the United States even though they do *not* have "final decision-making authority."[41] Others have singled out specific agency ALJs, such as those at the Federal Energy Regulatory Commission, on the basis that they closely resemble the SEC's ALJs.[42] But because the *Lucia* majority reasoned that its holding followed "*a fortiori*" from *Freytag*,[43] the agencies in future cases will likely seek to feature any colorable difference as a significant one for the Officer analysis, and the law will develop on a case-by-case basis until the Supreme Court speaks again.

Do SEC ALJs now enjoy unconstitutional dual-layer removal protection?

The *Lucia* opinion may have solved one constitutional problem only by immediately creating another. In *Free Enterprise Fund v. Public Co. Accounting Oversight Board*, the Supreme Court held that "dual for-cause limitations on the removal" of certain Officers by the President is unconstitutional.[44] There, "with th[e] understanding" that SEC Commissioners are only removable for cause, the Court addressed whether the for-cause removal protection for Officers at the Commission's subsidiary Public Company Accounting Oversight Board (PCAOB) was constitutional.[45] The Court held that this dual-layer of protection was unconstitutional.

The *Lucia* Court has teed up a re-run of this problem with its holding that SEC ALJs are Officers of the United States. Under the Administrative Procedure Act, ALJs are only removable for cause.[46] And, although the President's July 10, 2018 Executive Order amended regulations governing ALJ hiring,[47] the statutory for-cause *removal* provision remains operative. That cause must be "established and determined by the Merit Systems Protection Board" (MSPB) whose members are *also* removable only for cause.[48] Thus, as Justice Breyer put it in his *Lucia* partial concurrence, the Court has arguably created a situation akin to "just what *Free Enterprise Fund* interpreted the Constitution to forbid."[49]

The Justice Department requested that the Court address this problem, but only Justice Breyer did so.[50] To Justice Breyer it was not clear whether *Free Enterprise Fund* would apply to ALJs; for one, they — unlike PCAOB members — "perform adjudicative rather than enforcement or policymaking functions" and,

two, the PCAOB members enjoyed "*significant and unusual* protections from Presidential oversight"[51] (in particular, they were removable only for willful violations of law, willful abuse of authority, or failure to enforce compliance with rules or standards without "reasonable justification or excuse").[52] Even in Justice Breyer's opinion, the legal significance that these distinctions bear is unclear.

Furthermore, what should happen in a successful, future challenge to the new dual-layer removal protection for SEC ALJs is unclear. At least three options are possible:

(1) The ALJs — the second layer of the two removed from the President — might simply lose their for-cause removal protection. That is precisely what the *Free Enterprise Fund* Court did with the PCAOB members.[53] But *Free Enterprise Fund* did not deem this the *exclusive* remedy and, sure enough, the Justice Department proposed an alternative in its *Lucia* briefing.

(2) The Justice Department proposed that the dual-removal protection problem could be remedied by allowing "the Commission itself" to remove ALJs whenever they "fail[] to follow lawful instructions or perform adequately," subject only to MSPB review of the Commission's factfinding, *not* MSPB review of "whether the facts (as found) count as 'good cause' for removal."[54]

(3) A Tenth Circuit judge opined that the dual-removal problem could be remedied by making the *MSPB* members "removable by the President at will."[55]

In short, this is another question that will likely remain unresolved pending future judicial review and possibly Supreme Court review.

Conclusion

Individuals or entities subject to SEC enforcement actions, (or even administrative proceedings before other agencies), should consider several key takeaways and ongoing questions from *Lucia*.

(1) Respondents in SEC administrative enforcement actions should preserve challenges to ALJ appointments. An ALJ who reviewed the same proceeding after the SEC's ratification order has likely not complied with the *Lucia* remedy. Furthermore, even today, whether the SEC's ALJs have been validly appointed remains unclear.

(2) Litigants before federal ALJs more broadly should carefully assess their options for a constitutional challenge. The *Lucia* holding is likely to extend to many ALJs — not only the SEC's — and so they will require valid appointments in order to conduct administrative proceedings. So too, any ALJ deemed an Officer of the United States will by that very fact enjoy dual-layer removal protection, which tees up another ground for constitutional challenge.

(3) Although the *Lucia* opinion does not directly impact the Commission's discretion to proceed with administrative enforcement instead of in federal court, stakeholders should watch to see whether the continued legal uncertainty will trigger a change in the SEC's practice. Another important legal question to consider is whether the subject of an SEC investigation can leverage that legal uncertainty to force a proceeding in federal court instead of before an ALJ.

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Endnotes

1 No. 17-130.

2 U.S. Const. Art. II, § 2, cl. 2, 3.

3 *See* Slip Op. at 6 (citing *Freytag v. Commissioner*, 501 U.S. 868 (1991).

4 *Id.* at 2.

5 *Id.* at 2-3.

6 *Id.* at 3-4 (quotations omitted).

7 *See* 832 F.3d 277, 284-87 (D.C. Cir. 2016) (applying *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000).

8 *See* 868 F.3d 1021 (D.C. Cir. 2017) (en banc).

9 *Bandimere v. Securities and Exchange Commission*, 844 F.3d 1168, 1191 (10th Cir. 2016).

10 Slip Op. at 4.

11 *Id.* at 4 n.2.

12 *Id.* at 6.

13 *Id.* at 8-10.

14 *Id.* at 8-9.

15 *Id.* at 9-10.

16 *Id.* at 10.

17 *Id.* at 10-11.

18 *Id.* at 12.

19 15 U.S.C. §§ 78u, 78u-2, 78v.

20 17 C.F.R. § 201.110.

21 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

22 Andrew Ceresney, Director, SEC Division of Enforcement, Keynote Speech at New York City Bar Fourth Annual White Collar Institute (May 12, 2015), available at https://dart.deloitte.com/USDART/resource/d88a91ae-3f1d-11e6-95db-a3115b8d09bf ("The Commission is ... bringing more litigated cases in administrative proceedings than it did in the past."); *see also Chau v. SEC*, No. 14-cv-1903 LAK, 2014 WL 6984236, at *13-14 (S.D.N.Y. Dec. 11, 2014) (noting "legitimate" concerns about "the growth of administrative adjudication" in SEC enforcement actions).

23 Ryan Jones, *The Fight Over Home Court: An Analysis of the SEC's Increased Use of Administrative Proceedings*, 68 S.M.U. L. Rev 507, 509 (2015).

24 Stephen J. Choi & A.C. Pritchard, *The SEC's Shift to Administrative Proceedings: An Empirical Assessment*, 34 Yale J. Reg. 19 (2017).

25 Urska Velikonja, *Behind the Annual SEC Enforcement Report: 2017 and Beyond* 10-11 (2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3074073.

26 Order, *In re: Pending Administrative Proceedings*, Securities Act Release No. 10510 (June 21, 2018).

27 Order, *In re: Pending Administrative Proceedings*, Securities Act Release No. 10,440 (Nov. 30, 2017) (Ratification Order).

28 Slip Op. at 12 (quotations omitted).

29 *See Travelers Indem. Co. v. Bailey*, 557 U.S. 137, 154 (2009).

30 Slip Op. at 12.

31 *See* Ratification Order.

32 U.S. Const. Art. II, § 3 (commission); Art. VI, cl. 3 (oath).

33 *See* https://www.opm.gov/services-for-agencies/administrative-law-judges/#url=ALJs-by-Agency.

34 *See* Executive Order Excepting Administrative Law Judges from the Competitive Service § 1 (July 10, 2018) (July 10 EO) ("[A]t least some – and perhaps all – ALJs are 'Officers of the United States' and thus subject to the Constitution's Appointments Clause."); *see also Bandimere*, 844 F.3d at 1199 (McKay, J., dissenting) (posing this question).

35 U.S. Const. Art. II, § 2, cl. 3.

[36] *See* Erin Mulvaney, *U.S. Labor Department, Eyeing SCOTUS Case, Moves to Shield In-House Judges*, NATIONAL LAW JOURNAL (Jan. 22, 2018), https://www.law.com/nationallawjournal/sites/nationallawjournal/2018/01/22/us-labor-department-eyeing-scotus-case-moves-to-shield-in-house-judges/.

[37] *See* Oral Arg. Tr. at 12: 14-17.

[38] Concurring Op. of Thomas, J., at 2.

[39] *Id.* at 3.

[40] *See* BNA, *Supreme Court Leaves In-House Judges in Limbo Governmentwide* (June 21, 2018), https://www.bna.com/supreme-court-leaves-n73014476762/.

[41] *See Burgess v. FDIC*, 871 F.3d 297, 303 (5th Cir. 2017).

[42] *See* BNA, *Supreme Court Leaves In-House Judges in Limbo Governmentwide* (June 21, 2018), https://www.bna.com/supreme-court-leaves-n73014476762/.

[43] Slip Op. at 10.

[44] 561 U.S. 477 (2010).

[45] *Id.* at 487.

[46] 5 U.S.C. § 7521(a).

[47] *See* July 10 EO §§ 2, 3.

[48] 5 U.S.C. § 1202(d).

[49] Concurring Op. of Breyer, J., at 5.

[50] Slip Op. at 4.

[51] Concurring Op. of Breyer, J., at 7 (emphasis added).

[52] *Free Enterprise Fund*, 561 U.S. at 486.

[53] *Id.* at 509.

[54] Concurring Op. of Breyer, J., at 8 (characterizing government argument).

[55] *Bandimere*, 844 F.3d at 1191 (Briscoe, J., concurring).