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PERSPECTIVE

DC Circuit ruling confirms split on SEC's use of in-house judges

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On June 26, an en banc panel of the U.S. Court of Appeals for the D.C. Circuit denied the petition for review in *Raymond L Lucia Cos. v. SEC*, a case that involved a constitutional challenge to the Securities and Exchange Commission's administrative proceedings. In a per curiam decision, the panel split 5-5, resulting in the petition's denial and effectively affirming the lower court's ruling upholding the constitutionality of the SEC's administrative forum. This decision confirms a circuit split between the D.C. Circuit and the 10th Circuit (*Bandimere v. SEC*) over the legality of the SEC's administrative proceedings under the appointments clause in Article II of the Constitution. That split makes it likely that the Supreme Court will examine the issue, possibly in its fall term.

The appointments clause states that Congress may confer appointment power over "inferior officers" to the president, courts or heads of departments. The SEC contends that its administrative law judges are merely "employees" of the federal government and therefore are not subject to the requirements of the appointments clause.

The circuit split has resulted from the appellate courts' differing interpretations of *Freytag v. Commissioner of the IRS*, a 1991 decision in which the Supreme Court held that special trial judges in the U.S. Tax Court were subject to the appointments clause even if they preside over a case in which a Tax Court judge issues the final decision. In considering the status of ALJs at the Federal Deposit Insurance Corporation in 2000 (*Landry v. FDIC*), the D.C. Circuit, applying Freytag, found those judges to be employees. The court considered dispositive the FDIC ALJs inability to render final decisions.

In *Lucia*, originally decided by a three-judge panel in August 2016, the D.C. Circuit similarly focused its analysis on whether SEC ALJs have "final decision-making power." If the ALJs had such authority, they would be inferior officers subject to the appointments clause. If not, they would be considered employees. The D.C. Circuit concluded that SEC ALJs merely render initial decisions that the SEC commissioners can review de novo. According to the D.C. Circuit, because SEC ALJs are unable to issue final decisions, they were not inferior officers subject to the appointments clause. As the D.C. Circuit held, "the Commission's ALJs neither have been delegated sovereign authority to act independently of the Commission nor, by other means established by Congress, do they have the power to bind third parties, or the government itself, for the public benefit."

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In December 2016, *in Bandimere v. SEC*, the 10th Circuit reached the opposite result. It held that SEC ALJs are "inferior officers" who assumed their position in violation of the appointments clause. In evaluating whether an SEC ALJ is an inferior officer, the 10th Circuit looked to three characteristics it identified from *Freytag*: (1) the ALJ position was "established by Law," as required by the appointments clause, (2) "the duties, salary, and means of appointment ... are specified by statute," and (3) SEC ALJs "exercise significant discretion" in "carrying out ... important functions." The 10th Circuit found that the SEC ALJs easily satisfied the first two elements and focused its analysis on whether the ALJs exercise significant discretion to carry out their duties.

The 10th Circuit concluded that SEC ALJs exercise significant discretion in a number of ways. Among other things, they take testimony, regulate document production and depositions, issue subpoenas, rule on the admissibility of evidence, decide dispositive and procedural motions, preside over trial-like proceedings, make credibility findings to which the SEC affords "considerable weight" during agency review and issue initial decisions that declare respondents liable and impose sanctions.

Based on these findings, the 10th Circuit ultimately concluded that SEC ALJs "closely resemble" the special trial judges described in *Freytag*. The court, citing *Freytag*, held that both sets of judges "exercise significant discretion while performing 'important functions' that are 'more than ministerial tasks.'" As a result, SEC ALJs are inferior officers who must be appointed in conformity with the appointments clause.

In reaching this conclusion, the 10th Circuit rejected the SEC's position that its ALJs do not issue final decisions. The court noted that that these initial decisions can declare respondents liable and impose sanctions. And, if a respondent does not seek review of the initial decision, the decision becomes final. Moreover, even if a respondent seeks review, the SEC may decline to review the initial decision, which would also render the initial decision a final decision. The 10th Circuit also added that SEC ALJs have the authority to enter default judgments and set aside, make permanent or suspend temporary sanctions that the SEC itself has imposed against respondents.

On May 22, following the 10th Circuit's *Bandimere* decision, the SEC issued an order staying "all administrative proceedings assigned to an administrative law judge in which a respondent has the option to seek review" in the 10th Circuit of a final order under certain provisions of the federal securities laws. The stay is effective until a Supreme Court petition is resolved or on further order of the SEC.

The circuit split, until it is resolved by the Supreme Court, creates additional uncertainty for the SEC in the other appellate circuits that have not yet confronted the appointments clause issue. Although decisions issued by the D.C. Circuit typically have persuasive impact in other circuits, the 10th Circuit's rejection of *Lucia*, provides a reasonable roadmap and interpretation of precedent that other circuits may adopt.

Regardless of how the courts ultimately parse this issue, Congress is currently considering legislation that may moot this debate. The Financial CHOICE Act of 2017, which passed the House on June 8, contains two provisions likely to suppress the SEC's appetite for administrative proceedings. First, Section 823 would raise the standard of proof required in an SEC administrative proceeding to "clear and convincing evidence" and allow a respondent to remove the proceeding to federal court. Second, Section 825 would forbid the SEC from seeking officer and director bars in administrative proceedings.

Although it remains to be seen whether these provisions will survive the Senate — or even its Committee on Banking, Housing, and Urban Affairs — the fact that even Congress is willing to wade into this debate speaks volumes about the shaky Constitutional foundation for the SEC's current administrative proceedings.

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