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SEC ALJs continue to draw scrutiny

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Recent years have witnessed a dramatic increase in the number of enforcement actions brought by the U.S. Securities and Exchange Commission in its administrative forum, where the commission enjoys a decisive home-court advantage. While early constitutional challenges to these proceedings appeared promising for respondents, more recent decisions from the U.S. Courts of Appeals for the 2nd, 7th, 11th and D.C. Circuits have handed a string of victories to the SEC. Nevertheless, amendments to the rules of practice that were adopted by the SEC this past week suggest that it may finally be getting serious about addressing the fairness concerns that have dogged these proceedings since their inception. While the amendments represent an important first step in resolving these issues, they fall far short of the changes necessary to level the administrative playing field.

In defense of its "in-house" courts, the commission has sought to characterize administrative bodies as highly specialized tribunals that provide for the efficient resolution of complex securities matters. But administrative proceedings lack several key safeguards that are critical to respondents' ability to mount an effective defense. Chief among these is the absence of the right to trial by jury. Instead, administrative cases are tried before administrative law judges — or ALJs — who are both employed by the commission and housed in its offices. The close ties between the ALJs who preside over these cases and the agency that prosecutes them raise serious concerns about the constitutionality of these proceedings.

A survey of enforcement actions brought by the commission confirms that these concerns are well founded. According to a study conducted by the Wall Street Journal, the commission prevailed against 90 percent of respondents in administrative proceedings from October 2010 through March 2015. The remarkably high success rate enjoyed by the SEC leaves little doubt that, with respect to administrative proceedings, the deck is stacked in its favor.

Faced with these odds, a number of respondents have brought constitutional challenges against these proceedings in federal court. While respondents have long cited due process as grounds to attack the constitutionality of the administrative forum, more recent challenges have focused on the appointments clause of Article II of the Constitution. The appointments clause provides that Congress may vest the appointment of inferior officers "in the President alone, in the Courts of Law, or in the Heads of Departments."

Respondents have argued that the ALJs are "inferior officers" of the executive branch because they exercise broad enforcement powers. On that basis, respondents contend that their appointment violates Article II because ALJs are appointed by neither the president nor the SEC commissioners.

While early challenges gained traction at the district level, recent opinions issued by courts of appeals across the country have favored the SEC. Just last month, both the 11th and 2nd Circuits ruled that respondents cannot attack the constitutionality of administrative proceedings by bringing a collateral action in federal district court.

In *Hill v. SEC*, the 11th Circuit concluded that, through the Securities Exchange Act of 1934, Congress authorized the SEC to bring cases in the forum of its choosing. The court reasoned, "Congress intended the respondents' claims to be resolved first in the administrative forum, not the district court, and then, if necessary, on appeal to the appropriate federal court of appeals. We see no indication that Congress intended to exempt the type of claims the respondents raise here from the review process it created."

The 11th Circuit's ruling came on the heels of a similar opinion out of the 2nd Circuit. In *Tilton v. SEC*, the 2nd Circuit held that "[b]y enacting the SEC's comprehensive scheme of administrative and judicial review, Congress implicitly precluded federal district court jurisdiction over the [respondents'] constitutional challenge."

The Court of Appeals evaluated the factors enumerated by the Supreme Court in *Thunder Basin Coal Co. v. Reich*, 510 U.S. 200 (1994), which offers guidance on federal court jurisdiction over matters that have been designated for administrative review. The 11th Circuit rejected the respondent's contention that requiring her constitutional claim to be heard through administrative channels would deprive her of access to meaningful judicial review. Likewise, the court found that the respondent's claims were not wholly collateral to the SEC's administrative scheme, and that the SEC may bring its expertise to bear on the respondent's constitutional challenge, while acknowledging that these latter two issues presented "closer questions."

The *Hill* and *Tilton* opinions followed similar rulings from the 7th and D.C. Circuits that came down last year. Both courts held that respondents must await a final order from the SEC's in-house courts before having their constitutional challenges heard in federal court.

Despite these victories, the SEC has faced mounting criticism not only from the securities defense bar, but also from congressional leaders. In the wake of the recent uptick in SEC administrative proceedings, efforts to find a legislative solution have gained increasing momentum. Last October, Rep. Scott Garrett of New Jersey, chairman of the House Financial Services Subcommittee on Capital Markets and Government- Sponsored Enterprises, gave force to his outspoken criticism of SEC administrative proceedings by introducing the Due Process Restoration Act of 2015. The proposed legislation would empower a respondent to terminate an administrative proceeding, forcing the commission to bring its case instead as a civil action.

In the same vein, Rep. Jeb Hensarling of Texas, chairman of the House Financial Services Committee, introduced the Financial CHOICE Act in June of this year, which would essentially repeal much of Dodd-Frank. As part of that effort, Hensarling proposed a provision that would allow for SEC administrative cases to be removed to federal court.

Under mounting pressure to address the serious fairness concerns associated with these proceedings, the SEC signaled to its critics last week that their concerns have not gone unnoticed. Despite its recent victories in court, on July 13, the SEC adopted certain amendments to its rules of practice, which were hailed by Chair Mary Jo White as "promot[ing] the fair and timely resolution of the proceedings." Among other things, the amendments extend the length of the prehearing period for certain cases, provide certain parties with the opportunity to take depositions, and offer additional clarity with respect to the applicable procedures, as follows:

• Extend the potential length of the prehearing period from the current four months to a maximum of 10 months for cases designated as 120-day proceedings, a maximum of six months for 75-day proceedings, and a maximum of four months for 30-day cases.

• Allow parties in cases designated as 120-day proceedings the right to notice three depositions per side in single-respondent cases and five depositions per side in multi-respondent cases, and would permit each side to request an additional two depositions under an expedited procedure.

• Clarify the types of dispositive motions that may be filed at various stages of proceedings and the applicable procedures and legal standards for the motions.

• Additional clarifying and conforming changes to other rules including the admissibility of evidence, expert disclosures and reports, requirements for the contents of an answer and procedure for appeals.

While the rule changes are unquestionably a positive development, they do not come close to eliminating the SEC's clear home-court advantage. The rule changes do nothing, for example, to address the lack of fairness inherent in legal proceedings that are both prosecuted and adjudicated by individuals who are paid by and housed in the same agency.

Although the circuits are in agreement so far that administrative proceedings should not be subject to collateral attacks in federal court, none has ruled on the merits of the respondents' underlying claims. Once these cases work their way through the administrative forum, the courts of appeals will have to decide whether administrative proceedings and the judges who preside over them run afoul of the Constitution. Until that time, however, the SEC should take additional steps to make good on White's stated goal of "promot[ing] the fair [] resolution of" administrative proceedings.

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