

Supreme Court Holds That the SEC’s Administrative Law Judges Are Officers Subject to the Constitution’s Appointments Clause

On June 21, 2018, the Supreme Court of the United States held in *Lucia v. SEC* that the Securities and Exchange Commission’s (“SEC” or “Commission”) administrative law judges (“ALJs”) are “Officers of the United States” subject to the Appointments Clause of Article II of the Constitution.¹ The Appointments Clause states that only the President, “Courts of Law,” or “Heads of Departments” can appoint “Officers.”² Because the SEC’s ALJs were appointed by SEC staff members, not by any of the actors mentioned in Article II, the Court held that SEC ALJ proceedings run afoul of the Constitution.

I. Background

Section 4A of the Securities Exchange Act of 1934 (the “Exchange Act”) authorizes the SEC to delegate its functions to “a division of the Commission, an individual Commissioner, [or] an administrative law judge,” among other individuals and groups.³ Pursuant to this section, the SEC has delegated to ALJs the authority to conduct administrative hearings and to make initial decisions in certain SEC proceedings.⁴ At the outset of an SEC enforcement action, the SEC has discretion to submit its case to an ALJ for a decision, or instead, to file its case in federal district court.

In some important respects, an ALJ’s authority mirrors that of federal district court judges, including the authority to administer oaths, rule on offers of proof and motions filed by parties, examine witnesses, enter orders of default, and punish contemptuous conduct. Unlike federal district court actions, however, there is no right to a jury trial in SEC administrative proceedings, and administrative proceedings allow for only abbreviated pretrial practice (with significant limitations imposed on fact discovery and motion practice), resulting in a much less developed factual record than that typically produced through the federal court discovery process.⁵ The ALJ decisions that result from SEC administrative proceedings are subject to review by the Commission, but federal district court decisions are not. The SEC believes administrative proceedings to be beneficial in that they offer the SEC a mechanism to adjudicate enforcement actions comparable to the process afforded in federal district court, without the delay and expenditure of SEC resources that protracted federal court litigation can entail.

In September 2012, the SEC brought an enforcement action against Raymond J. Lucia and Raymond J. Lucia Companies, Inc. for violations of the antifraud provisions of the Investment Advisers Act of 1940 and related SEC rules. The SEC filed the case as an administrative action instead of filing in federal court.⁶ The

¹ See *Lucia v. SEC*, No. 17-130, 2018 WL 3057893, at *5, 585 U.S. ____ (2018).

² *Id.* (citing U.S. Const. art. II, § 2, cl. 2). The Court noted that Article II distinguishes between “principal” and “inferior” officers. “Only the President, with the advice and consent of the Senate, can appoint a principal officer; but Congress (instead of relying on that method) may authorize the President alone, a court, or a department head to appoint an inferior officer.” *Id.* at *5 n.3. This distinction was at issue in *Ortiz v. United States*, a case decided the day after *Lucia*, in which the Court held that the Appointments Clause does not prohibit an individual from simultaneously serving as a principal officer and an inferior officer. See No. 16-1423, 2018 WL 3073840, at *16, 585 U.S. ____ (2018).

³ 15 U.S.C. § 78d-1.

⁴ 17 C.F.R. § 200.30-9.

⁵ See *Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement: Hearing on H.R. 2128 and H.R. 5037 Before the Subcomm. on Capital Mkts., Secs., and Inv. of the H. Fin. Servs. Comm.*, 115th Cong. 9-10 (2018) (statement of Bradley J. Bondi).

⁶ See *In re Raymond J. Lucia Companies, Inc.*, Exchange Act Release No. 67781 (Sept. 5, 2012).

presiding ALJ issued an initial decision finding the respondents liable for making misrepresentations in their presentations to prospective investors concerning the investment strategy that respondents were promoting. Exercising its statutory authority to review ALJ decisions, the Commission remanded the case for further findings of fact, which ultimately resulted in a revised initial decision by the ALJ. Both the SEC Staff and the respondents sought Commission review of the revised initial decision.

On review, the Commission affirmed the ALJ's revised initial decision as it pertained to the SEC's fraud charges. In addition, the Commission rejected the respondents' argument that the administrative proceeding was unconstitutional because the presiding ALJ was not appointed in accordance with the Appointments Clause under Article II, Section 2, Clause 2 of the Constitution. Relying on an earlier decision from the United States Court of Appeals for the D.C. Circuit, "the Commission concluded its ALJs are employees, not Officers, and their appointment is [therefore] not covered by the" Constitution's Appointments Clause.⁷

II. The Circuit Court's Opinion

On appeal to the D.C. Circuit, Raymond J. Lucia and Raymond J. Lucia Companies argued, as they had before the Commission, that the Commission's decision on the constitutional question should be vacated because "the ALJ rendering the initial decision was a constitutional Officer who was not appointed pursuant to the Appointments Clause" of the Constitution.⁸ The SEC acknowledged that the ALJ presiding in the underlying action was not appointed according to the process set out in the Appointments Clause.⁹ All the parties conceded that the Appointments Clause has been interpreted to apply to judicial officers and officers of administrative agencies such as the SEC.

The D.C. Circuit's decision turned on the authority of ALJs to resolve SEC enforcement disputes. Citing the Supreme Court's decision in *Buckley v. Valeo*, the D.C. Circuit observed that "generally an appointee is an Officer, and not an employee who falls beyond the reach of the [Appointments] Clause, if the appointee exercises 'significant authority pursuant to the laws of the United States.'"¹⁰ According to the D.C. Circuit, whether government officials exercise "significant authority" is determined by three factors: "(1) the significance of the matters resolved by the officials, (2) the discretion they exercise in reaching their decisions, and (3) the finality of those decisions."¹¹ The principal issue before the D.C. Circuit concerned the third factor—"whether Commission ALJs issue final decisions of the Commission."¹²

After analyzing the statutory scheme governing the Commission's process for reviewing ALJ decisions, the D.C. Circuit determined that ALJs do not have authority to issue final Commission decisions, and so are not "Officers" within the meaning of the term contemplated by the Appointments Clause. The court explained:

There can be no serious question that [the Exchange Act] reserves to the Commission a discretionary right to review the action of any ALJ as it sees fit. * * * [T]he 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

⁷ *Raymond J. Lucia Cos., Inc. v. SEC*, 832 F.3d 277, 283 (D.C. Cir. 2016).

⁸ *Id.*

⁹ *Id.* at 283 (citing U.S. Const. art. II, § 2, cl. 2).

¹⁰ *Raymond J. Lucia Cos., Inc.*, 832 F.3d at 284 (quoting *Buckley v. Valeo*, 424 U.S. 1, 126 (1976)).

¹¹ *Id.* at 284 (quoting *Tucker v. Comm'r, Internal Revenue*, 676 F.3d 1129, 1133 (D.C. Cir. 2012)).

¹² *Id.* at 285.

government itself, for the public benefit. . . . The Commission’s right of discretionary review under [the Exchange Act] and adoption of its regulatory scheme for delegation . . . ensure that the politically accountable Commissioners have determined that an ALJ’s initial decision is to be the final action of the Commission.¹³

Because of this statutory check on their decision-making authority, the D.C. Circuit deemed ALJs to be employees of the Commission and, therefore, “beyond the reach” of the Constitution’s Appointments Clause. As a result, the D.C. Circuit held that the ALJ proceedings were constitutional.

Lucia and Raymond J. Lucia Companies filed a petition asking the Supreme Court of the United States to review the D.C. Circuit’s decision.¹⁴ In November 2017, while their petition was pending, the SEC issued an Order (the “Ratification Order”) ratifying the prior appointment of its ALJs in an attempt “[t]o put to rest any claim that administrative proceedings pending before, or presided over by, Commission administrative law judges violate the Appointments Clause.”¹⁵ In response, Lucia and Raymond J. Lucia Companies argued to the Court that the Ratification Order did not provide them any redress and did not render their petition moot.¹⁶ They continued to pursue Supreme Court review of the D.C. Circuit’s opinion.

III. The Supreme Court’s Opinion

In January 2018, the Supreme Court granted certiorari to review the D.C. Circuit’s opinion. On June 21, 2018, the Court reversed the D.C. Circuit and held that ALJs are “Officers of the United States” subject to the Appointments Clause of Article II. Because the ALJ who presided over Lucia’s administrative proceeding had not been appointed as prescribed by Article II, the Court held that Lucia’s proceeding was constitutionally invalid.

The Court’s opinion describes two main criteria for distinguishing between officers and employees who are not subject to the Appointments Clause. According to the Court, to be an officer “an individual must occupy a ‘continuing’ position established by law” and must exercise “significant authority pursuant to the laws of the United States.”¹⁷ All parties had agreed that the ALJs occupied continuing positions established by law,¹⁸ but there was disagreement about whether the ALJs exercised significant authority.¹⁹

The Court resolved the “significant authority” question by analogizing the SEC’s ALJs to the “special trial judges” (“STJs”) of the U.S. Tax Court, which were at issue in an earlier Supreme Court case, *Freytag v.*

¹³ *Id.* at 285-86 (internal quotations and citations omitted).

¹⁴ In support of their petition, Lucia and Raymond J. Lucia companies cited a circuit split created when the Tenth Circuit “conclude[d] SEC ALJs are inferior officers under the Appointments Clause.” *See Bandimere v. SEC*, 844 F.3d 1168, 1179 (10th Cir. 2016).

¹⁵ *See Securities and Exchange Commission, In re Pending Administrative Proceedings*, Securities Act Release No. 10440 (Nov. 30, 2017), available at <https://www.sec.gov/litigation/opinions/2017/33-10440.pdf>.

¹⁶ Petitioners’ Reply Brief in Support of Petition for Writ of Certiorari at 5-9 *Lucia*, 2018 WL 3057893 (No. 17-130).

¹⁷ *See Lucia*, 2018 WL 3057893, at *5 (citing *United States v. Germaine*, 99 U.S. 508, 511-12 (1879) and *Buckley*, 424 U.S. at 126).

¹⁸ *See Lucia*, 2018 WL 3057893, at *6 (citing 5 C.F.R. § 930.204(a); 5 U.S.C. §§ 556-557, 5372, 3105).

¹⁹ The disagreement was between Lucia and the *amicus curiae* appointed by the Court to defend the D.C. Circuit’s judgment. The Court appointed the *amicus* because, in responding to Lucia’s petition to the Supreme Court, the SEC switched sides and conceded that the ALJs were officers. *See* Brief for Respondent at 9-10, *Lucia*, 2018 WL 3057893 (No. 17-130) (“Upon further consideration, and in light of the implications for the exercise of executive power under Article II, the government is now of the view that such ALJs are officers.”).

Commissioner.²⁰ In *Freytag*, the Court held that the STJs were officers because they presided over adversarial proceedings by taking testimony, conducting trials, ruling on the admissibility of evidence, and having the power to enforce compliance with discovery orders. And, in performing these functions, the STJs exercised significant discretion.²¹ Analyzing *Freytag*, the Court in *Lucia* stated that this exercise of significant discretion meant that the STJs at issue in *Freytag* “were officers, even when their decisions were not final.”²² The Court determined that the SEC’s ALJs were “near-carbon copies” of the STJs because the ALJs also exercise significant discretion in conducting tasks similar to the STJs in *Freytag*. The Court further observed that an ALJ initial decision, unlike STJ findings or opinions, can become final without being reviewed by the Commission.²³ In this regard, the Court determined that ALJs are even more autonomous than the STJs in *Freytag*, whose findings and opinions in major cases always must be reviewed by a Tax Court judge.²⁴

In view of *Freytag*, the Court determined that the SEC’s ALJs are “Officers of the United States,” subject to the Appointments Clause. In *Lucia*’s case, the presiding ALJ had not been appointed properly, and, because *Lucia* timely challenged the constitutional validity of the ALJ, the Court held that *Lucia* was entitled to relief.²⁵

After deciding the substantive Appointments Clause question, the Court held that “the ‘appropriate’ remedy for an adjudication tainted with an appointments violation is a new ‘hearing before a properly appointed’ official.”²⁶ The Court explained that a different ALJ needed to preside over the new hearing even if the ALJ who presided in *Lucia*’s original proceeding were to receive a proper appointment.²⁷

In view of the Court’s opinion, on June 21, 2018, the SEC issued an Order immediately staying all administrative proceedings pending before its ALJs.²⁸ The stay will last until July 23, 2018, or further order of the SEC.

IV. Conclusion

The Court’s opinion clarifies that the SEC’s ALJs are officers subject to the Appointments Clause. But a key unresolved question from the Court’s opinion is whether the SEC’s November 2017 ratification of its ALJs would pass constitutional muster. In an important footnote, the Court stated that it saw “no reason to address that issue” because the Commission “ha[d] not suggested that it intend[ed] to assign *Lucia*’s case on remand to an ALJ whose claim to authority rests on the ratification order,” and the Commission could decide to rehear *Lucia*’s case itself or assign it to an ALJ with a constitutional appointment independent of the Ratification Order.²⁹ By not

²⁰ 501 U.S. 868 (1991).

²¹ See *Freytag*, 501 U.S. at 881-82.

²² See *Lucia*, 2018 WL 3057893, at *6.

²³ See *id.* at *5-7.

²⁴ See *id.* at *7.

²⁵ See *id.* at *8.

²⁶ See *id.* (quoting *Ryder v. United States*, 515 U.S. 177, 183, 188 (1995)).

²⁷ See *id.*

²⁸ See Securities and Exchange Commission, *In re Pending Administrative Proceedings*, Securities Act Release No. 10510 (June 21, 2018), available at <https://www.sec.gov/litigation/opinions/2018/33-10510.pdf>.

²⁹ See *Lucia*, 2018 WL 3057893, at *8 n.6; see also Securities and Exchange Commission, *In re Pending Administrative Proceedings*, Securities Act Release No. 10440 (Nov. 30, 2017), available at <https://www.sec.gov/litigation/opinions/2017/33-10440.pdf>.

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addressing the validity or effect of the SEC's Ratification Order, the Court may have laid the foundation for additional challenges to the ALJ proceedings and orders of the SEC and other administrative agencies.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email Bradley J. Bondi at 202.862.8910 or bbondi@cahill.com; Helene R. Banks at 212.701.3439 or hbanks@cahill.com; Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Geoffrey E. Liebmann at 212.701.3313 or gliebmann@cahill.com; David Slovic at 212.701.3978 or dslovick@cahill.com; Sara Ortiz at 212.701.3368 or sortiz@cahill.com; or Michael D. Wheatley at 202.862.8932 or mwheatley@cahill.com.

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