

Securities Litigation Alert

January 18, 2018

Key Points

- On January 12, 2018, the Supreme Court granted certiorari in *Lucia v. SEC*, to resolve a circuit split over whether the SEC's administrative law judges serve in violation of the Appointments Clause of the Constitution.
- Under the Appointments Clause, "inferior officers" must be appointed by officials accountable to the president. Historically, SEC ALJs were not appointed, but rather selected by SEC staff through a merits-based hiring process, consistent with the government's long-held position that SEC ALJs were "mere employees"—not inferior officers—and thus not subject to the Appointments Clause.
- After years of litigation around the country, the government unexpectedly reversed course, agreeing with the Petitioner in *Lucia* that SEC ALJs are, in fact, "inferior officers." The SEC responded in step by ratifying the appointment of its ALJs as such, which some hypothesized would moot the controversy. The Supreme Court nonetheless granted certiorari, opening the door to a decision that could have vast ramifications for numerous federal agencies that rely on the use of ALJs, including with respect to the validity of thousands of past decisions by ALJs.



Administrative Proceedings in Peril? Supreme Court Grants Certiorari in *Lucia v. SEC*

Background

The U.S. Securities and Exchange Commission (SEC) can bring an enforcement action either in federal court or in its administrative proceedings forum over which an SEC administrative law judge (ALJ) presides.

SEC administrative proceedings are substantially different from federal court: there is limited pretrial discovery and motion practice, special evidentiary rules created by the SEC, no right to a jury (the ALJ decides both legal and factual issues), and a longer appellate process that affords *Chevron* deference to legal determinations made by the SEC.

Unsurprisingly, many have criticized these administrative proceedings as giving an unfair home court advantage to the SEC that can be said to serve as prosecutor, judge and jury.¹ These criticisms have led to a wave of litigation under various grounds, with a constitutional challenge ultimately opening the door to Supreme Court review.

The constitutional challenge arises under the Appointments Clause, which requires “inferior officers” to be appointed by officials accountable to the President.² Inferior officers are those who exercise significant authority based on the discretion and powers that they are granted.³

The SEC’s ALJs are not appointed, but rather chosen through a merit-selection hiring process. If the ALJs function as mere government employees, this selection process is constitutional. But, if ALJs have the power and responsibilities of “inferior officers,” they must be appointed by the President or by the SEC itself in order to be consistent with the Constitution.

Circuit Split

An ALJ decision in December 2013 subjected Lucia, an investment advisor, to \$300,000 in fines and a lifetime ban from investment work. Lucia appealed, arguing that ALJs are inferior officers who serve in violation of the Appointments Clause because they are not appointed by the President or the SEC. In June 2017, the D.C. Circuit disagreed with Lucia, holding that because ALJs do not “issue final decisions,” they are not inferior officers, but instead mere employees that do not implicate the Appointments Clause.⁴

Meanwhile, the 10th Circuit reached the opposite conclusion in *Bandimere v. SEC*, holding that ALJs’ considerable power and discretion in shaping the administrative record is sufficient to confer “inferior officer” status.⁵ Because the ALJ was not constitutionally appointed, the 10th Circuit overturned the ALJ’s decision,⁶ and the SEC shortly thereafter paused all administrative proceedings in the 10th Circuit.⁷

While Lucia’s petition for Supreme Court review was pending,⁸ two major twists occurred. First, the Solicitor General’s office filed a brief with the Supreme Court on November 29, 2017, reversing its prior position and stating that the government now views SEC ALJs as inferior officers who should be subject to the Appointments Clause. Second, the SEC announced just one day later that it had formally ratified the appointment of its ALJs, which many hypothesized might moot the issue before the Supreme Court.

Supreme Court Review and Impact

On January 12, 2018, the Supreme Court granted certiorari in *Lucia v. SEC*⁹ to resolve the issue. Its ultimate decision might have minimal impact on the SEC. The SEC has only five ALJs. By ratifying these ALJs’ appointments, and implementing a simple appointment process going forward, the practical change to the SEC’s administrative proceedings might be quite insignificant. But, the potential ramifications for other federal agencies that use ALJs could be substantial.

The Social Security Administration, for example, has more than 1,500 ALJs. Establishing a process to ensure the constitutionality of their appointments could be a considerable undertaking. For numerous

other federal agencies that select ALJs and use them in enforcement proceedings in a manner similar to the SEC (such as the Federal Energy Regulatory Commission and the Environmental Protection Agency), substantial challenges to these ALJs' appointments and decision-making authority are sure to come.

The Supreme Court could hear oral arguments in *Lucia* in the coming months. Stay tuned.

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¹ See, e.g., Hon. Jed S. Rakoff, U.S. Dist. Judge, S.D.N.Y., Keynote Address at PLI Securities Regulation Institute: Is the S.E.C. Becoming a Law unto Itself? (Nov. 5, 2014), [<https://perma.cc/5N8A-TNYN>] (noting “[i]t is hardly surprising . . . that the SEC won 100% of its internal administrative hearings in the fiscal year ending September 30, 2014, whereas it won only 61% of its trials in federal court during the same period”); Russell G. Ryan, *The SEC as Prosecutor and Judge*, Wall St. J. (Aug. 4, 2014, 7:36 PM), <https://www.wsj.com/articles/russell-g-ryan-the-sec-as-prosecutor-and-judge-1407195362>; Jean Eaglesham, *SEC Wins with In-House Judges*, Wall St. J. (May 6, 2015, 10:30 PM), <https://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803>.

² U.S. Const. art. II, § 2, cl. 2.

³ *Freytag v. Comm’r*, 501 U.S. 868 (1991).

⁴ *Lucia v. SEC*, 868 F.3d 1021 (D.C. Cir. 2017) (en banc), *aff’g* 832 F.3d 277 (D.C. Cir. 2016).

⁵ *Bandimere v. SEC*, 844 F.3d 1168 (10th Cir. 2016), *reh’g denied*, 855 F.3d 1128 (10th Cir. 2017).

⁶ *Id.*

⁷ Order, In Re: Pending Administrative Proceedings, Securities Act Release No. 10365, Exchange Act Release No. 80741, Investment Advisers Act Release No. 4708, Investment Company Act Release No. 32643 (May 22, 2017).

⁸ *Lucia v. SEC*, 868 F.3d 1021 (D.C. Cir. 2017), *petition for cert. filed*, 2017 WL 3189046 (U.S. July 21, 2017) (No. 17-130).

⁹ *Lucia v. SEC*, 868 F.3d 1021 (D.C. Cir. 2017), *cert. granted*, 2018 WL 386565 (U.S. Jan. 12, 2018) (No. 17-130).