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D.C. Circuit Affirms Constitutionality Of SEC's In-House Tribunals

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The U.S. Court of Appeals for the D.C. Circuit recently became the first appellate court to conclude that the U.S. Securities and Exchange Commission's (SEC) in-house administrative tribunals are constitutional and do not violate the Appointments Clause. The constitutionality of the SEC's in-house administrative courts has been questioned repeatedly since the Dodd-Frank Act dramatically expanded the kinds of cases the SEC could litigate on its home turf and the kinds of remedies it could obtain there, including against entities the SEC does not traditionally regulate. Since Dodd-Frank, the SEC has made no bones about its increased attraction to litigating cases in-house that it previously brought in federal district court. The SEC benefits from a shorter timeframe from initiating the action to its conclusion, as well as defendants' diminished ability to conduct discovery. Critics have also noted that the SEC's winning percentage in-house is substantially greater than when it litigates in federal court. All of this, particularly defendants' sense that the playing field does not seem level, has led to numerous litigants raising various constitutional challenges to the SEC's administrative forum. These challenges have typically argued that the SEC's administrative tribunal process runs afoul of the Equal Protection, Due Process, or Appointments Clauses. However, before the D.C. Circuit's decision in *Lucia v. SEC* this month, litigants had raised constitutional challenges by trying to circumvent the SEC's in-house administrative tribunal and bring their challenges directly in federal district court, usually seeking to enjoin a pending administrative proceeding. These appeals have typically argued that the U.S. Supreme Court's decision several terms ago in *Free Enterprise* allowed them to bring constitutional challenges directly in federal court. In each previous instance, an appellate court ultimately determined that 15 U.S.C. §78y allowed for "meaningful review" of any constitutional challenges by first requiring a litigant to raise those issues before the administrative court and then, if unsuccessful, appeal that decision to a federal appellate court (see the Eleventh Circuit's decision in *Hill v. SEC*, the Second Circuit's decision in *Tilton v. SEC*; the D.C. Circuit in *Jarkesy v. SEC*, and the Seventh Circuit's decision in *Bebo v. SEC*). These litigants likely sought to avoid raising their constitutional challenges before the administrative agency first because:

- it seems odd and perhaps improper for an SEC administrative law judge (ALJ) to decide the constitutionality of his or her own appointment
- litigating the issue in a venue that is unconstitutionally constituted causes precisely the injury the constitutional challenge attempts to

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- the deferential standard of review that appellate courts employ when reviewing an administrative agency decision (at least the factual determinations) makes this appellate route more challenging.

However, courts have concluded that only "exceptional" cases are allowed to short-circuit the administrative enforcement process, and these courts have concluded uniformly that challenging the SEC's in-house forum is not such an "exceptional" case. But in *Lucia*, respondents Raymond Lucia and the Raymond J. Lucia Companies, Inc., went through the entire administrative adjudicative process. The SEC initiated an administrative enforcement action against Lucia, asserting violations of the anti-fraud provisions of the Investment Advisers Act arising from presentations made regarding a retirement wealth-management strategy called "Buckets of Money." An ALJ conducted a hearing and issued an initial decision, concluding that Lucia and his company made at least one material misrepresentation and, based on that, imposed a lifetime industry bar against Lucia. Thereafter, Lucia asked the full Commission to review the ALJ's initial decision. After an "independent review of the record," which included analyzing whether the presiding ALJ was appointed in accordance with the Article II, Section 2, Clause 2 of the Constitution (the Appointments Clause)., the full Commission concluded that its ALJs were not covered by the clause and imposed the same sanctions as the ALJ. Thereafter, Lucia appealed to the D.C. Circuit. Lucia argued to the D.C. Circuit that the SEC's decision must be vacated because the ALJ who rendered the initial decision was a constitutional Officer who had not been appointed pursuant to the Appointments Clause. The Clause essentially requires that: (1) the President appoint all "Officers of the United States" with the advice and consent of the Senate; and (2) Congress can by statute delegate authority to appoint "inferior officers" to the President, the federal courts, or the heads of departments (here, the full Commission). While seemingly arcane, the Supreme Court has called the Appointments Clause a "significant structural safeguard[] of the constitutional scheme." Because the SEC's ALJs are not appointed by the Commission itself (they are simply hired through the traditional federal hiring process), if ALJs are "inferior officers," not employees, their appointment would violate the Appointments Clause. The D.C. Circuit concluded that ALJs were employees, not inferior officers, because it believed that an ALJ does not wield "significant authority" under federal law. In particular, the court explained that, based on D.C. Circuit precedent (*Landry* and *Tucker*), the line between an "inferior officer" and an "employee" could be discerned by examining: (1) the significance of the matters resolved by the official; (2) the discretion the official exercised in her decisions; and (3) the finality of those decisions. In prior cases, when an official only issued recommendations and not final decisions or lacked substantial discretion, the official was not acting as the government itself and therefore was not an "inferior officer." Using that framework, the court concluded that SEC ALJs were not "inferior officers" because they did not issue final decisions on behalf of the Commission. An ALJ's initial decision only became final after the Commission itself issued a "finality order." Even though the Commission could, and does at times, issue such orders without substantively reviewing the ALJ's initial decision, as Lucia pointed out, the court viewed the finality order as a crucial step in the adjudicative process and not simply a ministerial formality. The court noted that the Commission always retains the discretion to review an ALJ's decision even when it has not been appealed. It also noted that the Commission reviews the ALJ's initial

determination *de novo* and can modify or set aside the ALJ's decision in whole or in part. Based on this finality analysis alone, without examining the other factors mentioned in *Landry*, the court concluded that SEC ALJs were employees rather than "inferior officers." As a result, they did not need to be appointed consistent with the Appointments Clause. The D.C. Circuit's decision in *Lucia* does not end the litigation of this issue. On the contrary, several of the aforementioned cases may ultimately address the Appointments Clause issue after litigating it in-house as required by 15 U.S.C. §78y. Nonetheless, *Lucia* may well be persuasive when other circuits address this issue. In fact, the SEC has already relied on *Lucia* when deciding a similar challenge in an in-house administrative proceeding. We will look at how the SEC has changed its rules of practice to address some of the procedural issues giving rise to these challenges in our next blog post.