CLIENT ALERT

Supreme Court Finds SEC In-House Judges Must Be Appointed, Past Hiring Deemed Unconstitutional

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On June 21, 2018, the United States Supreme Court found that in-house Securities and Exchange Commission ("SEC") judges are "inferior officers" under the Constitution's Appointments Clause, and are therefore constitutionally required to be appointed by either the President or the head of an agency. The decision, *Lucia v. S.E.C.*, No. 17-130, 2018 WL 3057893, (U.S. June 21, 2018), leaves several questions unresolved, particularly as to the status of any cases currently pending before SEC internal judges. It is also unclear whether the decision will have an impact on administrative judges at other federal agencies.

The decision overturns a lower court ruling and addresses a circuit split between the D.C. Circuit and the 10th Circuit. In *Raymond J. Lucia Companies, Inc. v. Sec. & Exch. Comm'n*, 832 F.3d 277 (D.C. Cir. 2016), Raymond Lucia and Raymond J. Lucia Companies, Inc. ("Petitioners") petitioned for review of a decision by the SEC that imposed sanctions on them for violations of the Investment Advisors Act of 1940 and the rule against misleading advertising thereunder. The SEC had rejected Petitioners' argument that the initial decision, which had been made by an in-house SEC judge, also known as an administrative law judge ("ALJ"), was unconstitutional because the hearing had been "an unconstitutional procedure because the administrative law judge who heard the enforcement action was unconstitutionally appointed." *Id.* The D.C. Circuit found that the ALJs working for the SEC were not constitutional officers and were therefore not subject to the requirements of the Appointments Clause of the U.S. Constitution. On appeal to the U.S. Court of Appeals for the D.C. Circuit, the 10-judge panel was divided, 5-5, on the issue, teeing up the case for the Supreme Court. The D.C. Circuit's decision also conflicted with the holding of the 10th Circuit in *Bandimere v. Sec. & Exch. Comm'n*, 844 F.3d 1168

(10th Cir. 2016), which held that the SEC's ALJs were "inferior officers" whose appointments must comport with the Appointments Clause. Despite coming to contrary conclusions, both the D.C. Circuit's and the 10th Circuit's decisions utilized the well-established analytical framework used by the Supreme Court in *Freytag v. C.I.R.*, 501 U.S. 868, 111 S. Ct. 2631, 115 L. Ed. 2d 764 (1991). In that case, the Supreme Court held that special trial judges ("STJs") in the Tax Courts were "inferior officers" subject to the Appointments Clause based on three characteristics of their position: (1) the position was "established by Law"; (2) the "duties, salary, and means of appointment . . . are specified by statute"; and (3) the STJs "exercise significant discretion" in "carrying out . . . important functions." *Id.* at 881-82.

Petitioners argued that the ALJs satisfied the *Freytag* criteria and were therefore unconstitutionally hired. In 2017, the SEC changed its position and argued that the ALJs were indeed officers, forcing the Supreme Court to appoint an amicus to argue on behalf of the lower court's position. In its briefing, the amicus warned of significant adverse practical consequences of adopting a standard within which ALJs would be considered officers. In particular, the amicus raised concerns related to expanding the definition of an "officer," and warned that such a ruling could call into question such widespread and longstanding practices as establishing congressional and investigative commissions without using the Appointments Clause.

The Supreme Court, also utilizing *Freytag*'s framework, agreed with Petitioners. In Justice Kagan's majority opinion, joined by Chief Justice Roberts and Justices Kennedy, Alito, Thomas, and Gorsuch, the Court held that the ALJs satisfy all of the criteria in *Freytag* and that the *Freytag* decision was sufficient to determine the case. First, the Court determined that ALJs hold a "continuing office established by law," as the ALJs "receive[ ] a career appointment." No. 17-130, 2018 WL 3057893, at *6. Second, the Court noted that the appointment is "created by statute, down to its 'duties, salary, and means of appointment.'" *Id.* Finally, the Court said that ALJs "exercise . . . 'significant discretion' when carrying out . . . 'important functions.'" *Id.* Specifically, the Court noted that ALJs have "all the authority needed to ensure fair and orderly adversarial hearings –indeed, nearly all the tools of federal trial judges." *Id.* at *7. After determining that the judge that oversaw Lucia's case was "without the kind of appointment the Clause requires," the Supreme Court remanded the case, as the "remedy for an adjudication tainted with an appointments violation is a new 'hearing before a properly appointed' official." *Id.* at *8.

Concurring in part and dissenting in part, Justice Breyer argued that the outcome should have been determined under the Administrative Procedure Act, which "governs the appointment of administrative law judges" and provides that "[e]ach agency shall appoint as many administrative law judges as are necessary for" hearings governed by the Administrative Procedure Act. Accordingly, Justice Breyer reasoned that the ALJ overseeing Lucia's case should have been appointed by the SEC, rather than hired by SEC staff. Justice Breyer also dissented as to the relief.

Justice Sotomayor drafted a dissent, joined by Justice Ginsburg, that primarily argued that the "ALJs are not officers because they lack final decision-making authority," as the SEC can "review any initial decision upon petition or on its own initiative" and that review is "*de novo*." *Id.* at *21.

As yet, it is unclear how this ruling affects pending SEC administrative decisions being heard by SEC ALJs. The SEC stated that it is "reviewing the decision." Also, on November 30, 2017, while the matter was still under review, the SEC issued an order to ratify the prior appointments of its ALJs. In addition to ratifying the ALJs appointment, the order directs the ALJs, in all pending cases for which no initial decision had been given, to (1) reconsider the record, (2) issue an order granting parties until January 5, 2018 to submit new evidence relevant to the reexamination of the record, (3) determine whether to ratify or revise any prior actions, and (4) issue an order by February 16, 2018 stating the completeness and outcome of the reconsideration. Similar procedures were ordered for cases pending before the Commission that had already received an initial decision by the ALJ.

Petitioners argued that this ratification did not resolve the constitutional issue. However, the order did not apply to Lucia's case, as it was no longer pending before an ALJ or the Commission at the time the order was issued. The Supreme Court skirted the question, stating in a footnote: "Lucia argues that the [ratification] order is invalid. . . . We see no reason to address that issue. The Commission has not suggested that it intends to assign Lucia's case on remand to an ALJ whose claim to authority rests on the ratification order. The SEC may decide to conduct Lucia's rehearing itself. Or it may assign the hearing to an ALJ who has received a constitutional appointment independent of the ratification." *Id.* at *8. It is unclear whether the Court's failure to affirm the constitutionality of the ratification order is an intentional signal that there is a question regarding the sufficiency of the ratification order to cure the constitutional defect, or if the Court simply felt that the issue was irrelevant to the facts of Lucia's case.

Regardless, by not resolving the ratification issue, there is a looming question as to the validity of the cases pending before the ALJs at the time of, and since, the ratification order. This uncertainty creates a significant likelihood of future litigation challenging the constitutionality of the ratification order and the hearings conducted before the ALJs subject to that order.

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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