

# Supreme Court Holds Appointment of SEC's In-House Judges Unconstitutional

June 25, 2018

On Thursday, June 21, 2018, the United States Supreme Court resolved a constitutional question that had split the federal courts of appeal and that had been a hotly-debated topic: whether the Administrative Law Judges (“ALJs”) of the U.S. Securities and Exchange Commission (the “SEC” or the “Commission”) were validly appointed. The Supreme Court held in *Raymond James Lucia Cos. Inc. et al. v. U.S. Securities and Exchange Commission* that the appointment of the SEC’s ALJs by members of the

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Commission’s staff, rather than the Commission itself, violated the Appointments Clause of the United States Constitution.<sup>1</sup> The decision reversed the U.S. Court of Appeals for the District of Columbia Circuit (the “D.C. Circuit”), which had held that the ALJs were “mere employees” and thus did not constitute “Officers of the United States” within the meaning of the Appointments Clause.<sup>2</sup>

**The Court’s analysis.** The dispute arose from an administrative proceeding in which former investment adviser Ray Lucia was found liable for misleading prospective investors as to his firm’s retirement wealth-management strategy in violation of the Investment Advisers Act of 1940. The ALJ had imposed a civil penalty of \$300,000 and a permanent industry bar. Lucia argued that the ALJ had lacked authority to render that decision because he had been appointed in violation of the Constitution’s Appointments Clause, which empowers Congress to “vest the Appointment of [ ] inferior Officers . . . in the President alone, in the Courts of Law, or in the Heads of Departments.”<sup>3</sup> Although the Commission itself qualifies as a “Head[ ] of Department[ ],” the SEC’s five ALJs were appointed not by the Commission itself, but by members of the SEC’s staff.<sup>4</sup> On appeal, the D.C. Circuit sided with the SEC, reasoning that the Commission’s ALJs held insufficient authority to fall within the constitutional category of “inferior Officer.”<sup>5</sup> After a hearing *en banc*, the full D.C. Circuit deadlocked, resulting in an order denying Lucia’s claim. Following this decision and the Court’s granting of certiorari, the Justice

<sup>1</sup> *Lucia et al. v. Sec. Exch. Comm’n*, No. 17-130, 585 U.S. \_\_ (2018).

<sup>2</sup> *Raymond J. Lucia Cos., Inc. v. Sec. Exch. Comm’n*, 832 F.3d 277 (D.C. Cir. 2016).

<sup>3</sup> U.S. Const. art. II, § 2, cl. 2

<sup>4</sup> See *Lucia et al. v. Sec. Exch. Comm’n*, No. 17-130, 585 U.S. \_\_ at \*3 (2018).

<sup>5</sup> *Raymond J. Lucia Cos., Inc. v. Sec. Exch. Comm’n*, 832 F.3d 277 (D.C. Cir. 2016).

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Department reversed its prior position and endorsed the appellant's view that the ALJs were inferior Officers.

Reversing the appellate court's decision, the Supreme Court held that the appointment violated the Constitution. The opinion, authored by Justice Elena Kagan, explained that the Court's prior precedent on the special trial judges of the United States Tax Court compelled the conclusion that SEC ALJs similarly constitute "inferior Officers."<sup>6</sup> Kagan cited the ALJs' "extensive powers" over discovery, subpoenas, motions, admission of evidence, administration of oaths, witness examination, and sanctions.<sup>7</sup> She concluded that "an SEC ALJ exercises 'all the authority needed to ensure fair and orderly adversarial hearings—indeed, nearly all the tools of federal trial judges.'"<sup>8</sup> The SEC ALJs' career appointments and their "significant discretion" further supported the Court's analysis.

The Court also examined the finality of the ALJs' decisions, noting that the ALJs "issue initial decisions containing factual findings, legal conclusions, and appropriate remedies," and that these opinions "become[] final and [are] deemed the action[s] of the Commission" if the SEC opts not to review the decision.<sup>9</sup> By comparison to the special tax judges that the Court had previously determined to be Officers, the Court opined that the ALJ's decisions have "potentially more independent effect": "[A special tax judge's] opinion counts for nothing unless the regular judge adopts it as his own. By contrast, the SEC can decide against reviewing an ALJ decision at all. . . . That last-word capacity makes this an *a fortiori* case: If the Tax Court's STJs are officers . . . then the Commission's ALJs must be too."<sup>10</sup>

Because the ALJs were not properly appointed at the time of Lucia's proceeding, the Court remanded the case for a new proceeding. The Court also ordered that Lucia's original ALJ not oversee the new proceeding, "even if he has by now received (or receives sometime in the future) a constitutional appointment."<sup>11</sup> The Court noted that this instruction was motivated both by fairness concerns and by a desire to incentivize Appointments Clause challenges in general "by providing a successful litigant with a hearing before a new judge."<sup>12</sup>

The decision also illuminated meaningful doctrinal differences among the Justices. Although six Justices joined in the ultimate judgment, their reasoning differed, with less

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<sup>6</sup> See *Freytag v. Comm'r*, 501 U.S. 868 (1991).

<sup>7</sup> *Lucia et al. v. Sec. Exch. Comm'n*, No. 17-130, 585 U.S. \_\_ at \*2 (2018).

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at \*8.

<sup>10</sup> *Id.* at \*9-10.

<sup>11</sup> *Id.* at \*12.

<sup>12</sup> *Id.* at \*12 n.5.

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than half of the Court joining in Justice Kagan's opinion. Justice Sotomayor, joined by Justice Ginsburg, dissented on the grounds that the ALJs' initial decisions were not "final, binding decisions on behalf of the Government" in light of the Commission's plenary authority over their rulings.<sup>13</sup>

The concurring Justices also split over the appropriate analytical framework. Justice Breyer concurred in part with the judgment, but argued that the case should have been decided based on the Administrative Procedure Act, so as to avoid the constitutional question. Justice Breyer observed that the Court's decision may have immediate ramifications for the statutory restrictions on removing the SEC's ALJs, which he felt should have been considered together with the Appointments Clause question. He expressed concern that any decision invalidating the removal protections would "risk transforming administrative law judges from independent adjudicators into dependent decisionmakers, serving at the pleasure of the Commission."<sup>14</sup> Justice Thomas, joined by Justice Gorsuch, also concurred in the judgment, but provided an alternative rationale based on an originalist reading of the Appointments Clause.

The Court's analytical divisions muddy any predictions of Lucia's relevance for the broader administrative state. Because the basis for the decision varies by Justice, the analysis may play out differently when applied to other agencies' administrative judges who exhibit different characteristics and exercise differing levels of authority.

**Practical implications of the ruling.** Immediately following the ruling, the Commission issued an order staying pending administrative proceedings for the next 30 days.<sup>15</sup> It remains to be seen whether the ruling will have any long-term impact on the Commission's prior actions or its future proceedings, as several other issues await further litigation.

#### **Ratification of the existing ALJs**

The Commission issued an order in November 2017 that retroactively "ratified" the appointments of the Commission's five ALJs in an effort to "resolve[] any concerns that administrative proceedings presided over by its ALJs violate the Appointments Clause."<sup>16</sup> The order instructed the ALJs to review and consider ratifying their own actions in their open administrative proceedings. The majority opinion appears to cast doubt on that ratification. In a footnote, the majority opinion stated that although Lucia

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<sup>13</sup> *Id.* at \*2-3 (Sotomayor, J., dissenting).

<sup>14</sup> *Id.* at \*6 (Breyer, J., concurring in part) (emphasis omitted). Justice Breyer also opined that he believed the case could be remanded to the same ALJ, Judge Elliott, for a new hearing, since the reversal on a "technical constitutional question" implied no criticism of the ALJ or his ability to conduct a new hearing. *Id.* at \*13.

<sup>15</sup> *Order, In re: Pending Administrative Proceedings*, Release No. 10510 (June 21, 2018).

<sup>16</sup> Press Release, Sec. Exch. Comm'n, SEC Ratifies Appointment of Administrative Law Judges (Nov. 30, 2017), available at <https://www.sec.gov/news/press-release/2017-215>.

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challenged the validity of the ratification, the Court saw no reason to address that issue because the Commission “has not suggested that it intends to assign Lucia’s case to an ALJ whose claim to authority rests on the ratification order.”<sup>17</sup> The Court further stated that the SEC could decide to conduct the rehearing itself, or assign the rehearing to an ALJ “*who has received a constitutional appointment independent of the ratification*,”<sup>18</sup> which suggests that the majority does not believe the ratification was sufficient. If the SEC’s ratification order ultimately stands, then at minimum, the SEC’s administrative proceedings post-dating November 2017 should be unaffected by the Appointments Clause issue. If not, the SEC will need to re-appoint its ALJs (although it is unclear what such a process would look like).

The SEC’s recent order, staying all administrative proceedings, suggests that the Commission is concerned that the ratification did not go far enough in curing the problem. The order provides the Commission with additional time to consider whether reappointing the ALJs will disturb prior decisions and settled actions. It also assures future litigation over this question.

#### **Impact of a constitutional violation on prior cases**

The Supreme Court also emphasized that Lucia’s “timely challenge” entitled him to relief,<sup>19</sup> implying that respondents who have not brought timely challenges, including individuals who have settled with the SEC, may be left empty-handed by the ruling. The Court, however, has also occasionally exercised its discretion—including in a decision that the Court relied on in *Lucia*—to consider claims that were not timely raised but that nonetheless implicate “the strong interest of the federal judiciary in maintaining the constitutional plan of separation of powers.”<sup>20</sup> Therefore, it is possible that respondents who did not timely raise the issue could seek relief in the courts now that the Supreme Court has decided the issue as a matter of constitutional—rather than statutory—rights. Otherwise, however, the door could be closed to respondents who settled or otherwise did not timely challenge the authority of the relevant ALJs.

Finally, the constitutionality of the removal protections for ALJs remains open to challenge. The Court expressly declined to address that issue, noting that it “ordinarily await[s] thorough lower court opinions to guide [its] analysis of the merits.”<sup>21</sup> This leaves respondents with an additional tool to attack adverse ALJ rulings, and effectively invites such litigation.

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<sup>17</sup> *Lucia et al. v. Sec. Exch. Comm’n*, No. 17-130, 585 U.S. \_\_ at \*13, fn. 6 (2018).

<sup>18</sup> *Id.*

<sup>19</sup> *Lucia et al. v. Sec. Exch. Comm’n*, No. 17-130, 585 U.S. \_\_ at \*12 (2018).

<sup>20</sup> See, e.g., *Freytag v. Comm’r*, 501 U.S. 868, 879 (1991).

<sup>21</sup> *Id.* at 4 n.1 (internal citations and quotation marks omitted).

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Given the constitutional landmines remaining in the wake of *Lucia*, the SEC may continue to decrease its use of administrative proceedings—as it has done over the past couple of years already—and opt instead to litigate significant contested matters in federal court, so as to avoid additional high-stakes appeals of its ALJ decisions. Of course, there are causes of action that are only available in administrative proceedings, such as failure to supervise and violations of Rule 102(e) of the SEC Rules of Practice, and these sorts of proceedings will still need to be litigated as administrative proceedings. The federal courts may look even more inviting to the SEC because the *Lucia* decision follows a handful of losses by the SEC in administrative proceedings, which have raised questions about whether administrative proceedings are as advantageous to the SEC as previously believed. The SEC’s actions in the next few months may shed light on its strategies for navigating its venue options and protecting the constitutional legitimacy of its administrative proceedings.

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