

June 22, 2018

Lucia v. SEC: U.S. Supreme Court Holds That SEC Administrative Law Judges Are “Officers” of the United States

Court Rules That SEC’s ALJs Were Improperly Appointed and Orders Reconsideration of Matters Before Them

SUMMARY

On June 21, 2018, the U.S. Supreme Court held that administrative law judges (“ALJs”) of the U.S. Securities and Exchange Commission (“SEC” or “Commission”) are “inferior officers of the United States subject to the Appointments Clause of the Constitution,” and so must be appointed to their positions by the President, Courts of Law, or Heads of Departments.¹ Prior to November 2017, none of those actors had appointed the SEC’s ALJs overseeing the SEC’s claims against defendants, including the defendant in this case.² Accordingly, the Supreme Court held that matters reviewed by ALJs prior to November 2017 must be re-reviewed, and must be done by a different ALJ.

The import of the Court’s decision is that the Commission itself must appoint its ALJs (as it has done since November 2017), rather than delegate the selection of ALJs to the Commission’s staff (as was the previous practice). The decision could also force a review of numerous pre-November 2017 decisions by SEC ALJs, and also call into question whether similar administrators at other federal agencies have been unconstitutionally appointed. Finally, by ruling that SEC ALJs are officers of the United States, and not simply civil service employees, the Court has likely made it easier for heads of departments to remove ALJs from their positions.

BACKGROUND

One way many federal agencies, including the SEC, seek to enforce federal law is by bringing administrative enforcement actions against alleged wrongdoers.³ The SEC typically delegates the task of

SULLIVAN & CROMWELL LLP

presiding over enforcement proceedings to ALJs.⁴ The agency enforcement proceeding resembles a trial before a federal district court, but with modified and more flexible rules of procedure and evidence.⁵ ALJs have the “authority to do all things necessary and appropriate to discharge his or her duties and ensure a fair and orderly adversarial proceeding.”⁶ After a hearing ends, the ALJ issues an initial decision, including findings of fact and law and any relief.⁷ The Commission can then review the ALJ’s decision, but if it chooses not to review the decision, the ALJ’s decision becomes the final action of the Commission.⁸

In this case, Raymond Lucia, a former investment advisor, challenged sanctions leveled against him by the SEC.⁹ The SEC charged Lucia with violations of the Investment Advisors Act in connection with promoting his “Buckets of Money” retirement savings strategy.¹⁰ The SEC asserted that Lucia used “misleading” slideshow presentations to deceive prospective clients.¹¹ In an initial decision issued in July 2013, the SEC ALJ assigned to the case concluded that Lucia violated the Investment Advisors Act, imposed \$300,000 in sanctions, and barred Lucia from the investment industry for life.¹²

On appeal to the full Commission, Lucia argued that the ALJ who made the initial decision to sanction him lacked the authority to adjudicate his case, because the ALJ was an “inferior officer” of the United States subject to the Appointments Clause of the U.S. Constitution, and neither the President, a court of law, nor a head of a department appointed him.¹³

The SEC issued an order in September 2015 that rejected Lucia’s argument, finding instead that the SEC ALJs are mere “employees” not covered by the Appointments Clause.¹⁴ A three-judge panel of the D.C. Circuit affirmed.¹⁵ The D.C. Circuit then granted Lucia’s petition for rehearing *en banc*, but divided evenly, resulting in a denial of Lucia’s claim.¹⁶ On January 12, 2018 the U.S. Supreme Court agreed to hear Lucia’s case to resolve a disagreement between the D.C. Circuit and the Tenth Circuit over whether SEC ALJs were employees or inferior officers.

THE SUPREME COURT’S DECISION¹⁷

In an opinion by Justice Kagan, the U.S. Supreme Court held that the SEC’s ALJs are “Officers of the United States.”¹⁸ The Court held that its decision in *Freytag v. Commissioner*, 501 U.S. 868 (1991), was controlling.¹⁹

Freytag concerned Special Trial Judges (“STJs”) of the U.S. Tax Court.²⁰ STJs had the authority to hear and resolve minor matters.²¹ In major matters, STJs had the power to prepare proposed findings for the review and decision of a regular Tax Court judge.²² *Freytag* involved a major \$1.5 billion alleged tax deficiency.²³ The STJ made proposed findings, and a regular Tax Court judge adopted the proposed findings as the opinion of the Tax Court.²⁴

SULLIVAN & CROMWELL LLP

The *Freytag* Court concluded that the STJs are “officers” of the United States subject to the requirements of the Appointments Clause. The Court stressed that STJs hold a continuing office; that the STJs’ duties, salaries, and means of appointment are specified in the Tax Code; and that STJs can “take testimony, conduct trials, rule on admissibility of evidence, and [] enforce discovery orders.”²⁵ Furthermore, in carrying out their functions, STJs exercise “significant discretion.”²⁶ The Court noted that the STJs’ lack of power to enter a final decision was relevant but not controlling.²⁷

In *Lucia*, the Court relied on *Freytag*, which “says everything necessary to decide this case.”²⁸ Like the STJs, SEC ALJs hold continuing office established by law because they receive a career appointment with their duties, salary, and means of appointment laid out by statute.²⁹ ALJs have the same authority to conduct a hearing—“nearly all the tools of a federal trial judge”—including the power to rule on the admissibility of evidence, receive evidence, examine witnesses, rule on motions, generally conduct the course of the adjudication, and enforce discovery orders.³⁰ Like STJs, ALJs have “significant discretion” when carrying out “important functions.”³¹

Furthermore, the Court emphasized that, unlike the judicial review and approval process of STJ decisions in *Freytag*, SEC ALJs have “last-word capacity”: the Commission may decline to review an ALJ’s decision, in which case the ALJ decision automatically becomes final and is deemed the action of the Commission.³² So even if the power to make final judgments was conclusive, the majority reasoned, the ALJs would still be officers of the United States.

Having concluded that SEC ALJs are officers of the United States subject to the Appointments Clause, the Court decided that the “remedy for an adjudication tainted with an appointments violation is a new hearing before a properly appointed official,” and that that official cannot be the ALJ who administered the original proceeding.³³

Justice Breyer concurred in the judgment in part, and dissented in part. He argued that the Court should have decided the case on statutory grounds.³⁴ The Administrative Procedure Act (“APA”) requires agencies to appoint ALJs as needed. In Justice Breyer’s view, because the Commission itself did not appoint the ALJ in this case (a duty the Commission delegated to SEC staff), the agency ran afoul of the APA.³⁵ Because the case could be resolved on statutory grounds, Justice Breyer argued that the Court did not need to decide the constitutional question.³⁶

More important in Justice Breyer’s view, is the implication of deciding the constitutional question: designating ALJs as “Officers of the United States” may make it easier to fire them without good cause. In a previous case, *Free Enterprise Fund v. Public Company Accounting Oversight Bd*,³⁷ the Court held that statutory provisions protecting members of the Public Company Accounting Oversight Board from removal were unconstitutional because they involved “multilevel protection from removal” by the President.³⁸ According to Justice Breyer, “[i]n addressing the constitutionality of the Board members’

SULLIVAN & CROMWELL LLP

removal protections, the Court emphasized that the Board members were ‘executive officers’—more specifically, ‘inferior officers’ for purposes of the Appointments Clause.”³⁹

Like the Board members in *Free Enterprise Fund*, SEC ALJs currently are protected from removal by a multilevel process under the APA, which only permits ALJs to be terminated for good cause after a hearing by the Merit Systems Protection Board. Justice Breyer’s concern is that “if” the holding of *Free Enterprise Fund* applies to SEC ALJs, this “perhaps” implies that “their removal protections are unconstitutional” because they are subject to protections similar to those addressed in *Free Enterprise Fund*.⁴⁰ Justice Breyer expressed concern that such a conclusion “would risk transforming administrative law judges from independent adjudicators into *dependent* decisionmakers, serving at the pleasure of the Commission.”⁴¹ This might result in opening the door for “the Commission to remove an administrative law judge with whose judgments it disagrees—say, because the judge did not find a securities-law violation where the Commission thought there was one, or vice versa.”⁴²

IMPLICATIONS

The Court did not provide definitive guidance on who counts as an “Officer of the United States” within the meaning of the Appointments Clause, but it is likely that ALJs adjudicating adversarial proceedings across federal agencies fall within the definition. The attorney for Lucia estimated for the Court at oral argument that there are approximately 150 ALJs at 25 federal government agencies who decide adversarial proceedings.⁴³

As for the effect on pending cases, the Commission took steps in November 2017 to address this case, issuing an order ratifying the agency’s previous appointments of ALJs.⁴⁴ Whether this step was sufficient to satisfy the Court’s ruling remains to be seen (the Government argued in oral argument that this step was sufficient; the Court did not directly address it). The November order also instructed ALJs to reconsider the record and actions taken in cases pending before them, as well as cases for which an initial decision was issued, but are still pending before the Commission. In light of the Court’s remedy requiring a different ALJ to reconsider Lucia’s case, the agency’s instruction to ALJ to reconsider their own cases may be insufficient. It’s also unclear whether cases already decided may need to be reopened. This may depend on whether the litigants raised the constitutional issue during the course of any proceedings—thereby preserving the argument.

It also remains to be seen whether there will be future challenges to the provisions protecting ALJs from termination. Given the Government’s interest in the question, there is a good chance a case on this issue may find its way to the Court in the future.

* * *

Copyright © Sullivan & Cromwell LLP 2018

ENDNOTES

- 1 *Lucia* v. SEC, ___ U.S. ___, No. 17-130, slip op. at 1 (June 21, 2018).
- 2 *Id.*
- 3 *Id.*
- 4 *Id.*
- 5 *Id.* at 2 (June 21, 2018); see also, e.g., 17 C.F.R. § 201.320.
- 6 *Id.* at 2 (internal quotation marks and citation omitted).
- 7 *Id.*
- 8 *Id.*
- 9 *Id.* at 2-3.
- 10 *Id.* at 2.
- 11 *Id.*
- 12 *Id.* at 3.
- 13 *Id.* at 3. The Appointments Clause distinguishes between “principal officers,” who can only be appointed by the President and must be approved by the Senate, and “inferior officers,” which Congress can specify may be appointed by the President, a court, or a department head. See *Edmond v. United States*, 520 U.S. 651, 659-60 (1997). The latter—inferior officers—are at issue here.
- 14 *Id.*
- 15 *Id.* at 4.
- 16 *Id.* (citing 868 F.3d 1021 (2017)).
- 17 As a result of the change in presidential administration, the government switched sides before oral argument at the Supreme Court. The Court then appointed counsel to represent the SEC’s previous position under the Obama Administration.
- 18 *Lucia*, slip op. at 1.
- 19 *Id.* at 6.
- 20 *Id.*
- 21 *Id.* at 6-7.
- 22 *Id.* at 7.
- 23 *Id.*
- 24 *Id.*
- 25 *Freytag*, 501 U.S. at 881-82.
- 26 *Id.* at 882.
- 27 *Id.* at 881.
- 28 *Lucia*, slip op. at 8.
- 29 *Id.*
- 30 *Id.* at 8-9.
- 31 *Id.* at 8.

ENDNOTES (CONTINUED)

- 32 *Id.* at 10.
- 33 *Id.* at 12.
- 34 *Id.* at 1 (Breyer, J., concurring in part and dissenting in part).
- 35 *Id.* at 2 (Breyer, J., concurring in part and dissenting in part).
- 36 *Id.* at 3 (Breyer, J., concurring in part and dissenting in part).
- 37 561 U. S. 477 (2010).
- 38 *Lucia*, slip op. at 4 (Breyer, J., concurring in part and dissenting in part).
- 39 *Id.* at 4 (Breyer, J., concurring in part and dissenting in part).
- 40 *Id.* at 6 (Breyer, J., concurring in part and dissenting in part).
- 41 *Id.* at 6 (Breyer, J., concurring in part and dissenting in part).
- 42 *Id.* at 8 (Breyer, J., concurring in part and dissenting in part).
- 43 See Oral Argument at 06:31, 09:01, *Lucia v. SEC*, __ U.S. __, No. 17-130 (June 21, 2018), available at https://apps.oyez.org/player/#/roberts8/oral_argument_audio/24602.
- 44 *Lucia*, slip op. at 13 n.6 (citing SEC Order (Nov. 30, 2017), available at <https://www.sec.gov/litigation/opinions/2017/33-10440.pdf> (last visited June 22, 2018)).

SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.

CONTACTS

New York

Nicolas Bourtin	+1-212-558-3920	bourtinn@sullcrom.com
Justin J. DeCamp	+1-212-558-1688	decampj@sullcrom.com
Stephen Ehrenberg	+1-212-558-3269	ehrenbergs@sullcrom.com
Robert J. Giuffra Jr.	+1-212-558-3121	giuffrar@sullcrom.com
Sharon L. Nelles	+1-212-558-4976	nelless@sullcrom.com
Richard C. Pepperman II	+1-212-558-3493	peppermanr@sullcrom.com
Matthew A. Schwartz	+1-212-558-4197	schwartzmatthew@sullcrom.com
Jeffrey T. Scott	+1-212-558-3082	scottj@sullcrom.com
Benjamin R. Walker	+1-212-558-7393	walkerb@sullcrom.com
Alexander J. Willscher	+1-212-558-4104	willschera@sullcrom.com
Stephanie G. Wheeler	+1-212-558-7384	wheelers@sullcrom.com
