Legal Backgrounder

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202.588.0302 wlf.org

Unconstitutionally Appointed Administrative Law Judges Continue to Haunt SEC

by Lawrence S. Ebner

Are Securities and Exchange Commission (SEC) administrative enforcement proceedings constitutional? According to a recent, well-reasoned opinion issued by the US Court of Appeals for the Tenth Circuit, *Bandimere v. SEC*, 844 F.3d 1168 (10th Cir. 2016), the answer is no. *Bandimere* focuses on SEC Administrative Law Judges (ALJs), who preside over in-house, trial-type proceedings in which SEC's enforcement staff, with the benefit of the Commission's own slanted procedural rules, almost always succeeds in imposing liability and harsh civil penalties upon alleged violators of federal securities laws.

In a 2-1 panel decision, the appeals court held that "SEC ALJs are inferior officers under the Appointments Clause." *Id*. at 1179. The Appointments Clause, US Const. art. II, § 2, cl.2, requires that "inferior Officers" be appointed to their positions by the President, a court of law, or a department head. Because SEC ALJs have not been appointed in that manner, the panel majority held that they hold their positions, and adjudicate cases, "unconstitutionally." *Bandimere*, 844 F.3d at 1188. The Tenth Circuit's decision directly conflicts with the DC Circuit's now-vacated opinion in *Raymond J. Lucia Companies, Inc. v. SEC*, 832 F.3d 277 (DC Cir. 2016), *pet. for reh'g en banc granted* (Feb. 16, 2017), which held that SEC ALJs are mere employees not subject to the Appointments Clause.

The US Supreme Court ultimately may have to decide the Appointments Clause issue, which potentially affects numerous pending (and possibly prior) SEC administrative proceedings.[1] The Supreme Court has never directly addressed the Appointments Clause status of ALJs, whom federal departments and agencies appoint under the Administrative Procedure Act, 5 U.S.C. §§ 556, 3105. The issue may have repercussions beyond SEC, where there currently are 5 ALJs. According to Office of Personnel Management statistics, there are around 175 ALJs employed by various federal departments and agencies other than the Department of Health and Human Services; adding in Social Security and Medicare ALJs, the total increases to 1,770.

Case Background

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in July 2010, an SEC "enforcement action may be brought as a civil action in federal court or as an administrative action before

[1] *See, e.g.*, *Timbervest LLC v. SEC*, No. 15-1416 (DC Cir. filed Nov. 13, 2015) (challenging SEC final enforcement decision on several grounds, including constitutional status of SEC ALJs); *Tilton v. SEC*, 824 F.3d 276 (2d Cir. 2016), *pet. for cert. filed* (US Jan 18, 2017) (No. 16-906) (rejecting collateral Appointments Clause challenge to pending SEC administrative enforcement proceeding); *see also Bandimere*, 844 F.3d at 1171 n.2 (collecting cases).

Lawrence S. Ebner, a Fellow of the American Academy of Appellate Lawyers, is founder of Capital Appellate Advocacy PLLC, a Washington, DC-based appellate litigation boutique. Mr. Ebner's firm focuses on Supreme Court and US court of appeals cases involving federal issues important to businesses and industry.

an ALJ." *Bandimere*, 884 F.3d at 1171. Not surprisingly, SEC repeatedly has exercised its broad choice-of-forum authority to give itself a home-court advantage. *See* Jean Eaglesham, *SEC Wins with In-House Judges*, Wall St. J., May 6, 2015 (discussing SEC's high success rate before its own ALJs). In fact, during FY 2014 SEC brought more than 80% of its enforcement actions as administrative cases rather than as federal court actions. *Ibid.*

Following a trial-like administrative hearing, SEC's 2012 enforcement action against Colorado businessman David Bandimere resulted in an SEC ALJ "initial decision," *see* 17 C.F.R. § 360, finding him liable for securities fraud and registration violations, barring him from participation in the securities industry, and imposing monetary fines and disgorgement. When Bandimere appealed to the full Commission, SEC issued an opinion essentially affirming the ALJ's decision, *see id.* § 201.411. It rejected as "meritless" Mr. Bandimere's Appointments Clause argument "because, in its view, the ALJ was not an inferior officer" and thus not subject to the Appointments Clause. *Bandimere*, 844 F.3d at 1171. Bandimere petitioned the Tenth Circuit to review the SEC decision. The court of appeals granted the petition, held that SEC ALJs are inferior officers, and set aside SEC's unconstitutional administrative enforcement action against Bandimere.

Majority Opinion

In its seminal case on the Appointments Clause, the Supreme Court wrote, "[A]ny appointee exercising significant authority pursuant to the laws of the United States is an 'Officer of the United States,' and must, therefore, be appointed in the manner prescribed by § 2, cl. 2, of [Article II]." *Freytag v. Commissioner of Internal Revenue*, 501 U.S. 868, 881 (1991) (cite omitted). The *Bandimere* majority opinion, authored by Circuit Judge Scott M. Matheson and joined by Circuit Judge Mary Beck Briscoe, found *Freytag* compelling.

Judge Matheson explains that "[t]he Appointments Clause embodies both separation of powers and checks and balances." 844 F.3d at 1172. It separates powers "[b]y defining unique roles for each branch in appointing officers." *Ibid.* And it "checks and balances the appointment authority of each branch by providing (1) the President may appoint principal officers [*e.g.*, Supreme Court Justices; department heads; ambassadors] only with Senate approval and (2) Congress may confer appointment power over inferior officers to the President, courts, or department heads but may not itself make appointments." *Ibid.* In so doing, the Appointments Clause "promotes public accountability by identifying the public officials who appoint officers." *Ibid*.[2] More specifically, "[t]he Appointments Clause prevents Congress from dispensing power too freely; it limits the universe of eligible recipients of the power to appoint." *Freytag*, 501 U.S. at 880.

SEC has "conceded ... that its ALJs are not appointed by the President, a court of law, or the head of a department." *Bandimere*, 884 F.3d at 1176. As a result, the "sole question" in *Bandimere* was "whether SEC ALJs are inferior officers under the Appointments Clause." *Ibid.* More specifically, the court of appeals was called upon to address "the distinction between inferior officers and employees." *Id.* at 1173; *see also id.* at 1173-74 (listing examples of inferior officers drawn from Supreme Court cases).

The Tenth Circuit majority held that *Freytag* "controls the result." *Id*. at 1174. In *Freytag*, the Supreme Court held that "special trial judges" (STJs) appointed by the US Tax Court were inferior officers subject to the Appointments Clause. Holding that "SEC ALJs are inferior officers who must be appointed in conformity with the Appointments Clause," *Bandimere* indicates that "SEC ALJs closely resemble the STJs described in *Freytag.*" *Id.* at 1181. "Both occupy offices established by law; both have duties, salaries, and means

[2] *See also Lucia*, 832 F.3d at 284 ("The Clause's limitations are not mere formalities, but have been understood to be 'among the significant safeguards of the constitutional scheme.'") (quoting *Edmond v. United States*, 520 U.S. 651, 659 (1997)).

of appointment specified by statute; and both exercise significant discretion while performing 'important functions' that are 'more than ministerial tasks.'" *Ibid.* The panel majority explained that its "holding serves the purposes of the Appointments Clause," in contrast to the SEC's "current ALJ hiring process ... a diffuse process that does not lend itself to the accountability that the Appointments Clause was written to secure." *Id.* at 1181.[3]

SEC Position Rejected

The *Bandimere* majority opinion squarely rejects SEC's principal, often-repeated argument, which is that SEC "ALJs are not inferior officers because they cannot render final decisions and the agency retains authority to review ALJs' decisions de novo." *Id*. at 1182. In making that argument, SEC relies primarily on *Landry v. FDIC*, 204 F.3d 1125, 1134 (DC Cir. 2000), in which the DC Circuit held that Federal Deposit Insurance Corporation ALJs are employees rather than inferior officers. That court read *Freytag* as placing "exceptional stress" on the Tax Court STJs' "final decisionmaking power." *See also Lucia*, 832 F.3d at 284 ("Our analysis begins and ends [with *Landry*]."). Along the same lines, Senior Circuit Judge Monroe G. McKay's dissent in *Bandimere* contends that "the special trial judges at issue in *Freytag* had the sovereign power to bind the Government and third parties. SEC ALJs do not. And under the Appointments Clause, that difference makes all the difference. … [I]t is the difference between chiseling in stone and drafting in pencil." *Bandimere*, 884 F.3d at 1194-95 (McKay, J. dissenting).

The *Bandimere* majority "disagree[d] with the SEC's reading of *Freytag* and its argument that final decision-making power is dispositive to the question" of whether SEC ALJs are inferior officers subject to the Appointments Clause. *Id.* at 1179. The majority explained that the Court in *Freytag* emphasized the key fact that Tax Court STJs "'exercise[d] significant discretion' in 'carrying out ... important functions.'" *Id.* at 1175-76 (quoting *Freytag*, 501 U.S. at 882). While "[f]inal decision-making power is relevant in determining whether a public servant exercises significant authority ... that does not mean that *every* inferior officer *must* possess final decision-making power." *Id.* at 1183. In other words, "the Court has not equated significant authority with final decision-making power." *Id.* at 1184.

***Bandimere* Reaches the Correct Result**

Regardless of the similarities or differences between Tax Court STJs and SEC ALJs, *Bandimere*'s conclusion that SEC ALJs are "inferior Officers" of the United States, and therefore must be appointed to their positions in conformity with the Appointments Clause (*i.e.*, through direct appointment by the Commission) is correct. SEC ALJs are federal officers—not mere Commission employees—because they wield "significant authority," *Freytag*, 501 U.S. at 881, both as a matter of law and fact, when adjudicating liability and imposing monetary penalties and other sanctions.

SEC's website asserts that SEC ALJs "serve as independent adjudicators." https://www.sec.gov/alj. While SEC ALJs' "independence" is debatable, *see* Eaglesham, *supra* (discussing the ALJs' pro-SEC bias), their constitutional status as federal officers is not. The *Bandimere* majority opinion includes a table listing SEC ALJs' broad and numerous adjudicatory duties.[4] The important functions that SEC ALJs fulfill include "authority to shape the administrative record by taking testimony, regulating document production and depositions, ruling on the admissibility of evidence, receiving evidence, ruling on dispositive and procedural

[3] SEC ALJs are hired by SEC's Chief ALJ, in conjunction with SEC's Office of Human Resources, from a list of candidates provided by the Office of Personnel Management, which administers a government-wide ALJ merit-selection process. *See Bandimere*, 844 F.3d at 1177.

[4] *See Bandimere*, 844 F.3d at 1178 (citing 17 C.F.R. §§ 200.14 (Office of Administrative Law Judges); Part 201, Subpart D (Rules of Practice)).

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motions, issuing subpoenas, and presiding over trial-like hearings," as well as making "credibility findings to which the SEC affords 'considerable weight' during agency review," and "authority to issue initial decisions that declare respondents liable and impose sanctions." *Id.* at 1180. "SEC ALJs exercise significant authority in part because their initial decisions can and do become final without plenary agency review." *Id.* at 1180 n.25 (citing 15 U.S.C. § 78-d(1)(c)).

In fact, according to the majority opinion, 90% of SEC ALJ decisions become final without plenary Commission review. *Ibid.* This is not surprising in view of a *Wall Street Journal* analysis indicating that "[t]he SEC won against 90% of defendants before its own judges in contested cases from October 2010 through March [2015]." Eaglesham, *supra.* And when ALJ decisions are appealed to the full Commission, *see* 17 C.F.R. § 201.410, the commissioners—again not surprisingly—almost always rule in SEC's favor.

As a matter of law and fact, therefore, SEC ALJs fulfill important functions and exercise broad discretion that qualifies them as officers of the United States subject to the Appointments Clause. The dissent's "fears [that] under the majority's reading of *Freytag*, all federal ALJs are at risk of being declared inferior officers" are not well founded. *Bandimere*, 884 F.3d at 1194 (McKay, J., dissenting). *Bandimere* does add to Appointments Clause jurisprudence by discussing in detail why, under *Freytag*, an ALJ's authority to render "final decisions" is not a prerequisite to inferior-officer status. But contrary to Judge McKay's characterization of the majority's holding as "sweeping," *ibid*, *Bandimere* addresses the status of SEC ALJs only.

As Judge Briscoe's concurring opinion explains, *Freytag* "commands that courts undertake a "position-by-position analysis of the authority Congress by law and a particular executive agency by rule and practice ha[ve] delegated to its personnel" to determine whether a class of federal employees is subject to the Appointments Clause. *Id.* at 1189 (Briscoe, J. concurring). For this reason, whether the dissent is correct that more than 1,500 Social Security Administration ALJs "have largely the same duties as SEC ALJs," *id.* at 1200 (McKay, J., dissenting), is a case for another day.

Likewise the impact, if any, that the unconstitutional status of SEC ALJs has on cases already decided is still an open question. Contrary to the implication in the *Bandimere* dissent, which expresses concern that the majority's holding "has effectively rendered invalid thousands of administrative actions," *id.* at 1199, the potentially thorny issues of retroactivity and ratification have no bearing on the question of whether SEC ALJs are subject to the Appointments Clause. *See id.* at 1188 (noting that "[q]uestions about ... other agencies' ALJs ... and retroactivity ... are not issues on appeal").

The enigma underlying *Bandimere* is SEC's apparent refusal to resolve the Appointments Clause controversy simply by issuing constitutionally proper letters of appointment to its ALJs. The reason may be that SEC fears risking invalidation of a multitude of pending and prior administrative enforcement proceedings. It seems that SEC will continue to defend its incredible ALJs-are-mere-employees position until the Supreme Court, by applying *Freytag* and other Appointments Clause precedents, addresses the issue and holds that SEC ALJs must be constitutionally appointed.

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