

# Clients & Friends Memo

## The Tenth Circuit Rules SEC Administrative Judges Are Unconstitutional, Setting Up Potential Supreme Court Review

January 11, 2017

The constitutionality of the SEC's in-house administrative proceedings is in doubt following the 10th Circuit Court of Appeals' ruling in *Bandimere v. SEC*.<sup>1</sup> In *Bandimere*, a three-judge panel held, by a 2-1 decision, that SEC administrative law judges ("ALJs") are inferior officers under the Appointments Clause of the Constitution and that they must be appointed in accordance with that clause, rather than hired as employees. The decision directly conflicts with the August 2016 holding of the Court of Appeals for the D.C. Circuit in *Raymond J. Lucia Cos. v. SEC*.<sup>2</sup> This circuit split sets the stage for a potential Supreme Court review of the SEC's administrative proceedings.

*Bandimere* caps an eventful year for SEC administrative proceedings. Following several high-profile challenges to the agency's in-house court, the SEC promulgated new rules for its ALJ hearings that expanded discovery and provided for longer timelines in complex cases, among other changes.<sup>3</sup> Despite the new rules, many commentators remained skeptical about the fundamental fairness of SEC ALJ hearings, particularly in complex cases.<sup>4</sup> Now, in the wake of *Bandimere*, the controversy around the SEC's administrative proceedings is sure to last into the new regime of Chairman-to be Jay Clayton.

### Background

Since passage of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, the SEC has been authorized to seek monetary penalties in administrative proceedings.<sup>5</sup> This power originally was limited to entities directly regulated by the SEC, such as investment advisers and broker-dealers. If the SEC wanted to seek monetary penalties against other parties, it was required

---

<sup>1</sup> *Bandimere v. U.S. Sec. Exch. Comm'n*, No. 15-9586 (10th Cir. Dec. 27, 2016).

<sup>2</sup> 832 F.3d 277 (2016).

<sup>3</sup> See Amendments to the Commission's Rules of Practice, 17 CFR Part 201, available at <https://www.sec.gov/rules/final/2016/34-78319.pdf>.

<sup>4</sup> See, e.g., Jodi Avergun, Douglas Fischer, Joseph Moreno, Emily Rockwood, and Lex Urban, The SEC Retains its House Advantage During Administrative Proceedings, Aug. 5, 2016, available at <http://www.cadwalader.com/resources/clients-friends-memos/the-sec-retains-its-house-advantage-during-administrative-proceedings>.

<sup>5</sup> Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990).

to file a civil lawsuit in federal court. Following the financial crisis, the Dodd-Frank Act of 2010 expanded the SEC's powers, permitting the agency to seek civil penalties from other parties (e.g., public and private companies) in its own in-house court through the use of administrative proceedings.<sup>6</sup> Since that time, the SEC has increasingly used its administrative forum, a shift which caused one SEC official in 2014 to describe administrative proceedings as “the new normal.”<sup>7</sup> The SEC's rate of victory has been notably greater in its in-house administrative court than in federal court.<sup>8</sup>

Administrative proceedings offer the SEC several advantages over civil suits in federal court, including limited discovery obligations for the petitioner and limited discovery rights for respondents, a shortened time frame that can make preparing a defense challenging, more permissive evidence rules that may allow for admission of hearsay, and the inability of respondents to demand a jury trial. These advantages have led many individuals facing SEC administrative suits to challenge the constitutionality of administrative proceedings, mostly without success. In 2015 and 2016, four federal circuit courts of appeal—the Second, Seventh, Eleventh and D.C. Circuits—rejected challenges to the SEC's administrative proceedings process on jurisdictional grounds.<sup>9</sup> Because these four courts held in favor of the SEC on jurisdictional grounds, none ruled on the constitutionality of SEC administrative proceedings.

The SEC's winning streak continued through August 2016, with the D.C. Circuit's decision in *Lucia*. In that case, an SEC ALJ found that the respondents violated a rule against misleading advertising that was promulgated under the Investment Advisers Act of 1940. The respondents appealed to the Commission, which rejected the respondents' argument that the administrative hearing was unconstitutional because the ALJ had been hired in violation of the Appointments Clause.

The Appointments Clause provides that the President:

shall nominate, and by and with the Advice and Consent of the Senate, shall appoint ...  
Officers of the United States, whose Appointments are not herein otherwise provided for,  
and which shall be established by Law: but the Congress may by Law vest the

---

<sup>6</sup> See 15 U.S.C. § 77h-1 (2012).

<sup>7</sup> See Jean Eaglesham, SEC Is Steering More Trials to Judges It Appoints, *The Wall Street Journal*, May 6, 2015, available at <http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it-appoints-1413849590>.

<sup>8</sup> See Jean Eaglesham, SEC Wins With In-House Judges, *The Wall Street Journal*, May 6, 2015, available at <http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803> (observing that from October 2010 to March 2015, the SEC won 90% of contested cases in administrative proceedings, but just 69% of such cases in federal court).

<sup>9</sup> *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015), cert. denied, 136 S. Ct. 1500 (Mar. 28, 2016); *Jarkesy v. SEC*, 803 F.3d 9 (D.C. Cir. 2015); *Tilton v. SEC*, 824 F.3d 276 (2d Cir. 2016); *Hill v. SEC*, 825 F.3d 1236 (11th Cir. 2016).

Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.<sup>10</sup>

An individual is considered an “officer” if he or she exercises “significant authority pursuant to the laws of the United States.”<sup>11</sup> Only people who are deemed to be employees or other “lesser functionaries” need not be selected in compliance with the strict requirements of Article II.<sup>12</sup>

In considering whether SEC ALJs exercise significant authority and are therefore Officers who must be appointed, the D.C. Circuit focused on whether ALJs have the power to issue final decisions.<sup>13</sup> The Court observed that, pursuant to the laws governing administrative proceedings, the Commission retains “a discretionary right to review the action of any” ALJ.<sup>14</sup> Moreover, respondents may appeal ALJ decisions to the Commission, which will review the ALJ decisions *de novo*. Noting that the ALJs were part of a “carefully devised scheme established after years of legislative consideration and agency interpretation,” the Court held that the ALJs are not officers for purposes of the Appointments Clause.<sup>15</sup>

### **Bandimere v. SEC**

*Bandimere* breaks the SEC’s winning streak in cases concerning the constitutionality of administrative proceedings. In October 2013, an ALJ decided that David Bandimere had violated several securities laws by misleading investors about two Ponzi schemes.<sup>16</sup> On appeal, the SEC rejected Bandimere’s argument that the ALJ was an inferior officer who had not been appointed under the Appointments Clause.<sup>17</sup> Bandimere then petitioned for review by the 10th Circuit Court of Appeals.

The Court began its analysis by listing examples of positions deemed by courts as inferior officers, including Tax Court special trial judges, election supervisors, and district court clerks, and noting that the term “inferior officer” has an “unusually broad” sweep.<sup>18</sup> It then turned to the case of *Freytag v. Commissioner of Internal Revenue*,<sup>19</sup> which it found controlling. In *Freytag*, the Supreme

---

<sup>10</sup> U.S. Const. Art. II, § 2, cl. 2.

<sup>11</sup> *Buckley v. Valeo*, 424 U.S. 1, 126 (1976).

<sup>12</sup> *Freytag v. Comm’r, Internal Revenue*, 501 U.S. 868, 880 L. Ed. 2d 764 (1991) (quoting *Buckley v. Valeo*, 424 U.S. at 126).

<sup>13</sup> *Lucia*, 832 F.3d at 285.

<sup>14</sup> See 15 U.S.C. § 78d-1(b).

<sup>15</sup> *Lucia*, 832 F.3d at 289.

<sup>16</sup> *In the Matter of David F. Bandimere*, Initial Decision Release No. 507, 2013 WL 5553898 (Oct. 8, 2013).

<sup>17</sup> *In the Matter of David F. Bandimere*, SEC Release No. 9972, 2015 WL 6575665 (Oct. 29, 2015).

<sup>18</sup> *Bandimere* at 10.

<sup>19</sup> 501 U.S. 868 (1991).

Court unanimously held that tax court special trial judges were inferior officers. Three main characteristics led the Supreme Court to hold that the special trial judges were inferior officers: (1) the position was “established by law”; (2) “the duties, salary, and means of appointment . . . are specified by statute”; and (3) the special trial judges “exercise significant discretion” in “carrying out . . . important functions.”<sup>20</sup> The Supreme Court in *Freytag* rejected the government’s argument that the special trial judges were not inferior officers because they did not issue final decisions, countering that such an argument “ignore[d] the significance of the duties and discretion that special trial judges possess.”<sup>21</sup>

The Tenth Circuit analyzed the duties of SEC ALJs in light of *Freytag*. The Court found that SEC ALJs clearly met the first two characteristics of the special trial judges in *Freytag* because the ALJ position is established by the Administrative Procedures Act, and ALJs’ duties, salaries, and means of appointment are also provided by statute. The Court went on to analyze the significance of the SEC ALJs’ duties. It pointed out that, under SEC regulations, SEC ALJs are “responsible for the fair and orderly conduct of [SEC administrative] proceedings” and “have the authority to do all things necessary and appropriate to discharge [their] duties.”<sup>22</sup> These duties include, among other things, administering oaths, examining witnesses, entering default judgments, ordering depositions and document productions, ruling on the admissibility of evidence, punishing contemptuous conduct, and issuing initial decisions that declare respondents liable and impose sanctions. Because the ALJs “closely resemble” the special trial judges from *Freytag* and perform important functions, the Court ruled that they are “inferior officers who must be appointed in conformity with the Appointments Clause.”<sup>23</sup>

The Tenth Circuit took issue with the D.C. Circuit’s decision in *Lucia*, arguing that the D.C. Circuit placed “undue weight on final decision-making authority” when declaring that SEC ALJs are not inferior officers.<sup>24</sup> The Tenth Circuit read *Freytag* as rebutting the argument that final decision-making authority is a necessary condition for declaring a position an inferior officer. The Court stated, “[f]inal decision-making power is relevant in determining whether a public servant exercises significant authority. But that does not mean every inferior officer must possess final decision-making power.”<sup>25</sup>

---

<sup>20</sup> *Id.* at 881-82.

<sup>21</sup> *Id.* at 881.

<sup>22</sup> 17 C.F.R. §§ 200.14, 200.11.

<sup>23</sup> *Bandimere* at 22.

<sup>24</sup> *Id.* at 24.

<sup>25</sup> *Id.* at 28.

Circuit Judge Monroe McKay's dissent explains his disagreement with the majority's reading of *Freytag* and, perhaps more notably, highlights the massive consequences that could follow if the Supreme Court were to adopt the Tenth Circuit's holding that SEC ALJs are inferior officers. Judge McKay argues that "[u]nder the majority's reading of *Freytag*, all federal ALJs are at risk of being declared inferior officers." As an example, Judge McKay pointed out that the 1,537 Social Security Administration ALJs could be deemed inferior officers because their duties closely resemble those of SEC ALJs.

### Impact of *Bandimere*

*Bandimere* is a significant victory for opponents of SEC administrative proceedings. Undoubtedly, many respondents in such proceedings, as well as those who have been adjudged liable by ALJs, will attempt to capitalize on the ruling. The SEC, therefore, has significant motivation to petition the Supreme Court for certiorari, rather than let the ruling stand. The matter appears ripe for review by the Supreme Court in light of the split between the D.C. and Tenth Circuits, and the potentially broad ramifications of *Bandimere*. If the Supreme Court adopts the Tenth Circuit's holding, do not expect SEC administrative proceedings to wither away. Rather, the SEC (and possibly other agencies) would need to change the process by which it appoints ALJs or, alternatively, reduce the powers of ALJs so that they are not inferior officers.

Nonetheless, *Bandimere* represents a threat to the "new normal," in which the SEC favors bringing cases in its administrative forum. Until the issue presented in *Bandimere* and *Lucia* is clarified by the Supreme Court, the murky constitutional status of SEC ALJ hearings could cause the SEC to bring more of its enforcement actions—particularly high profile cases—in federal court.

President-elect Trump's nominee for Chairman of the SEC, Jay Clayton, has not yet publically expressed his views about the SEC's reliance on administrative proceedings or the constitutionality of those proceedings. However, in light of the *Bandimere* decision and public interest in the topic, Mr. Clayton will likely need to consider the role and powers of the SEC's in-house court soon after taking office.

\* \* \* \*

If you have questions, please contact any of the following Cadwalader attorneys:

Jodi L. Avergun	+1 202 862 2456	jodi.avergun@cwt.com
Douglas H. Fischer	+1 202 862 2276	douglas.fischer@cwt.com
Kendra Wharton	+1 202 862 2333	kendra.wharton@cwt.com