

## The Supreme Court Rules that SEC ALJs Were Unconstitutionally Appointed

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The U.S. Supreme Court has held that administrative law judges (ALJs) of the Securities and Exchange Commission are "Officers of the United States" under the Appointments Clause of the U.S. Constitution, and are not mere employees. Consequently, the Court stated in its June 21, 2018 opinion in *Lucia v. Securities and Exchange Commission* that the SEC ALJs must be appointed by the Commission itself, as the "Head of the Department" under the Appointments Clause.

Because the Commission had delegated selection of its ALJs to other staff members, SEC enforcement actions were decided by ALJs without the kind of appointment the Constitution requires. Therefore, the Court found that SEC actions tainted with appointments violations are entitled to the standard remedy of a new hearing before a "properly appointed official." The Court in *Lucia* then went one step further and held that the ALJ who re-hears Mr. Lucia's case cannot be the same ALJ who previously decided his case, even if that ALJ was subsequently properly appointed.

The Court's decision in *Lucia* has some obvious—and some more subtle—consequences. For starters, any individual or entity subject to an administrative action by an SEC ALJ should contact legal counsel to examine the effect of *Lucia* on the validity of that action, and what remedies may be available.

More broadly, the SEC may need to determine whether and how to address previous decisions made without properly appointed ALJs. On November 30, 2017, while *Lucia* was pending, the SEC issued an order ratifying the prior appointments of its ALJs, and ordered its ALJs with pending cases to revisit them with specific directives in an effort to insulate those pending cases from any infirmities that may arise if the Court decided *Lucia* the way it ultimately did. Moreover, *Lucia* has the potential to affect all government agency administrative procedures and proceedings, and arguably creates uncertainty about the classification and authority of civil service decision-makers across the government.

### **The Controversy of SEC Administrative Proceedings and SEC ALJs**

The Commission is authorized to pursue one of two forums to prosecute violations of the nation's federal securities laws under its jurisdiction: 1) file a lawsuit in federal district court seeking to enjoin the offending conduct and obtain penalties and disgorgement; or 2) file an administrative proceeding before an SEC ALJ. Different rules apply and some different remedies are available between a federal district court judge and an SEC ALJ. The details of these distinctions are outside the scope of this alert. It will suffice here to say that many defense lawyers feel the Commission's administrative proceedings "stack the deck" against their clients for a variety of reasons, including that it is unfair for the SEC to act as both "prosecutor and judge," and the perceived limited scope of and time for discovery and hearing preparation. The constitutionality of the SEC ALJs was another source of objection for many respondents in SEC administrative proceedings, including Mr. Lucia.

### **Issues Remaining After *Lucia***

Mr. Lucia argued that the SEC's November 30, 2017 order ratifying its ALJs was invalid. The Court declined to address this issue because the SEC did not indicate it would assign Lucia's case on remand "to an ALJ whose claim to authority rests on the ratification order." Thus, disappointed respondents subject to adverse decisions from ratified SEC ALJs may

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seek this avenue to appeal the decision.

*Lucia* does not provide much guidance in the application of its decision beyond the facts of the case before it. In determining whether SEC ALJs are officers and not merely employees, the Court relied on a two-part test taken from its prior decisions in *United States v Germaine* (1879) and *Buckley v Valeo* (1976): 1) the ALJ must occupy a "continuing" position established by law; and 2) the ALJ must "exercise significant authority pursuant to the laws of the United States." The first prong was not subject to much debate; the debate centered around whether the ALJs had "significant [enough] authority." The Court saw no need to "refine or enhance" this standard because the Court relied squarely on what it said was its analogous decision in *Freytag v. Commissioner* (1991), where the Court found that similarly-situated "special trial judges" in the U.S. Tax Court were officers and not mere employees. In his concurrence, Justice Clarence Thomas recognized that courts "will not be able to decide every Appointments Clause case by comparing it to *Freytag*," and the Court's precedents in this area do not provide much guidance. To provide this guidance, Justice Thomas proposed an analysis that did not require application of the "significant authority" factor.

Rather, according to Justice Thomas, the only factor the law requires be considered is whether the ALJ occupies a continuing position of statutory duty. In her dissent, Justice Sonia Sotomayor suggested that whether an ALJ has "significant discretion" be decided by a single factor: does the ALJ have final decision-making authority? Because SEC ALJs do not (the Commission does) they do not wield "significant authority" sufficient to be called "officers" under Justice Sotomayor's view of the law.

It will be interesting to see how courts and administrative agencies apply *Lucia*.

Miller Canfield's securities lawyers represent and assist companies, officers, and directors in all securities matters, including litigation and class actions, internal investigations, as well as in regulatory investigations, examinations, and enforcement actions by the Securities and Exchange Commission and other federal and state agencies. If you would like more information about the SEC's enforcement authority, the Supreme Court's *Lucia* decision, or any other securities matter, please contact us.