TENTH CIRCUIT DECISION FINDS AGAINST THE SEC AND CREATES A CIRCUIT SPLIT ON THE CONSTITUTIONALITY OF THE COMMISSION'S ALJS

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Government Enforcement Alert

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In the final days of 2016, the U.S. Court of Appeals for the Tenth Circuit denounced the constitutional authority of the five administrative law judges ("ALJs") who preside over contested administrative proceedings brought by the Division of Enforcement of the Securities and Exchange Commission ("SEC" or the "Commission"), giving rise to a split between two federal circuit courts with respect to the authority of the ALJs to render administrative adjudications.[1] Directly opposing the D.C. Circuit's recent decision in *Raymond J. Lucia Cos. v. SEC*,[2] the Tenth Circuit ruled that SEC ALJs are "inferior officers" of the United States, as opposed to employees, and therefore subject to the Appointments Clause of the Constitution. Accordingly, the Tenth Circuit vacated the SEC's ruling against petitioner David Bandimere on the grounds that the ALJ who presided over the underlying enforcement hearing—and rendered an initial decision that the Commission later confirmed—was not appointed in accordance with the Appointments Clause and thus held his position unconstitutionally.

CONSTITUTIONAL APPOINTMENT OF INFERIOR OFFICERS AND THE D.C. CIRCUIT'S DECISION

The Appointments Clause requires inferior officers to receive their appointments from the President, a court of law, or the head of a department. Employees or "lesser functionaries," on the other hand, are not bound by this requirement.[3] The Supreme Court has found that an appointee qualifies as an "officer" when he exercises "significant authority pursuant to the laws of the United States."[4]

The divergence between the *Lucia* and *Bandimere* decisions stems from each court's characterization of the "significant authority" attendant to inferior officers.

In concluding that SEC ALJs lack the requisite authority, the *Lucia* court focused wholly on the ALJs' inability to render final decisions. The D.C. Circuit reasoned that, unlike special trial judges ("STJs") serving on the Internal Revenue Service's Tax Court, who were designated as inferior officers by the Supreme Court in *Freytag v. Commissioner of Internal Revenue*, SEC ALJs make *initial* decisions that become final only when the Commission has entered an order exercising or declining review. Because they cannot act independently from the Commission, the court explained, SEC ALJs are employees whose appointment falls outside of the Appointments Clause.

THE TENTH CIRCUIT'S REASONING

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The *Bandimere* court expressly disagreed with the *Lucia* court's analysis of *Freytag* and its conclusion that the power to render final decisions is determinative. Instead, the Tenth Circuit interpreted *Freytag* as directing lower courts to consider whether the appointee "'exercise[s] significant discretion' in 'carrying out . . . important functions.'"[5] The court listed the many responsibilities of SEC ALJs—such as taking testimony, issuing subpoenas, presiding over trial-like hearings, and making initial determinations as to liability and damages—and concluded that these duties correspond with those of the STJs considered in *Freytag*.

In the Tenth Circuit's view, theSupreme Court's characterization of inferior officers in *Freytag* and other cases has turned on the significance of the officers' duties and not the finality of their decisions. Thus, the Tenth Circuit regarded the *Lucia* decision as exaggerating the importance of final decision-making authority. As Judge Briscoe put it in her concurrence, "[t]hough final decision-making authority might be *sufficient* to make an employee an Officer, that does not mean such authority is *necessary* for an employee to be an Officer."[6]

Moreover, the majority explained, the ALJs' decisions become "the action of the Commission" where the SEC declines review or the respondent does not seek timely review, which is the outcome for approximately 90% of initial decisions by SEC ALJs.[7] The court further noted that, where the SEC does grant review, it still gives "considerable weight" to the ALJs' credibility determinations.[8] The rationale for the Appointments Clause—to promote transparency and accountability in the appointment of federal officers—also motivated the *Lucia* court's decision.[9]

The Tenth Circuit concluded the majority opinion by dismissing the concerns of the dissent, which expressed trepidation about the breadth of the decision and its potential effect on the status of other federal ALJs. The *Bandimere* majority emphasized that its holding is a narrow one, limited to SEC ALJs.

RAMIFICATIONS

At a minimum, the SEC's loss in *Bandimere* calls into question the structure and operation of the Commission's administrative hearing system, in which the SEC's Division of Enforcement historically has experienced substantial success. According to a report by *The Wall Street Journal*, the SEC won 90% of cases before its ALJs from October 2010 through March 2015, as compared to 69% of cases in federal court during the same period.[10] The conflict between the Tenth and D.C. Circuits may disrupt the practice of the SEC staff in its approach to contested enforcement actions.

With the Trump Administration poised to take office, the Commission's response to *Bandimere* is difficult to predict. The Commission could amend the appointment process through rulemaking that, for example, confers the power to appoint ALJs to a department head, thereby removing the constitutional problem. Or, the Commission could seek review by the Supreme Court. Given the circuit split and its seemingly narrow scope—*i.e.*, the divergence of two circuit courts considering the same question of law and reaching opposite conclusions on the application of a prior Supreme Court decision—the Court may very well agree to hear the case. Notably, a petition for *en banc* review of the *Lucia* case is pending before the D.C. Circuit, and *en banc* review in the Tenth Circuit is also possible, both of which may offer some clarity.

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In the meantime, the *Bandimere* decision provides respondents with another basis to object to administrative enforcement by the Commission. And it now seems certain that challenges to administrative proceedings under the Appointments Clause will persist while the conflict in law remains.

Notes:

[1] Bandimere v. SEC, No. 15-9586, 2016 WL 7439007 (10th Cir. Dec. 27, 2016).

[2] 832 F.3d 277 (D.C. Cir. 2016).

[3] Freytag v. Comm'n of Internal Revenue, 501 U.S. 868, 880 (1991).

[4] Buckley v. Valeo, 424 U.S. 1, 126 (1976).

[5] *Bandimere*, 2016 WL 7439007, at *8 (quoting *Freytag*, 501 U.S. at 882).

[6] *Id.* at *19 (Briscoe, J., concurring).

[7] *Id.* at *9, *14.

[8] *Id.* at *8.

[9] *Id.* at *10.

[10] Jean Eagelsham, *SEC Wins With In-House Judges*, Wall St. J., May 6, 2015, http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

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