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3 Key Defense Arguments For Post-Lucia SEC Proceedings

By **Andrew Morris and Ben Aiken** (July 6, 2018, 4:23 PM EDT)

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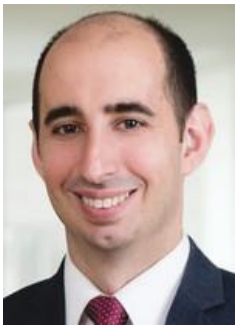

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In Lucia v. U.S. Securities and Exchange Commission, the U.S. Supreme Court held that SEC administrative law judges have been serving in violation of the Constitution's appointments clause — so that all of their actions have been legally invalid.[1] Lucia has rattled federal enforcement agencies, and it has triggered a torrent of commentary about its long-term implications for agency in-house courts. Lucia also set up several concrete defense arguments for respondents in SEC administrative actions. This article identifies three of the most significant arguments.

The Lucia Decision

The Lucia court held that SEC ALJs are "officers of the United States" and, therefore, must be appointed in a way that satisfies the appointments clause. Because they are second-tier, "inferior" officers, the ALJs can be appointed by the "head" of their "department" — by the SEC as a body.[2] But the SEC as a body did not appoint them; they were hired through the civil-service process, in violation of the appointments clause. To remedy this violation, the court ruled, the SEC must provide the respondent a new administrative proceeding before a different, and properly appointed, ALJ.

Post-Lucia Defenses in SEC Proceedings

This same remedy will be available to every respondent in an SEC administrative case who has preserved the appointments clause issue (and probably some who did not yet raise it, a topic not addressed here). The number of cases could be significant. About a dozen are pending in the federal courts of appeals and significantly more are at the SEC. (Based on the SEC website, it is not possible to say exactly which proceedings should be included in this count.) These cases will require significant SEC resources: Each one must be relitigated by the SEC Enforcement Division, retried by an ALJ, and in all likelihood re-evaluated and redecided by the full commission. Lucia's case, for example, involved a nine-day hearing (after extensive prehearing matters), a 46-page decision by the ALJ, an appeal to the full commission and, more than two years later, a resulting 41-page decision. That was followed by litigation in the D.C. Circuit, with the panel's opinion issued almost four years after the SEC case began.

But the SEC's post-Lucia problems extend beyond the practical challenge of litigating these cases for a second time; the SEC also faces legal arguments it did not have to address squarely, if at all, the first time around. Two of these arguments contend that SEC ALJs still are serving in violation of the appointments clause: that the SEC still has not appointed them properly, and that the ALJs have protection from removal that constitutes an independent constitutional violation. A third argument is that the statute of limitations has expired in some of these cases, so that the SEC cannot refile them now.

1. The SEC still has not properly appointed its ALJs.

To begin, it appears that the SEC still has not appointed the ALJs in a way that satisfies the appointments clause. Last November, the SEC issued an order that purported to put the "appointment" issue to rest.[3] That should be simple enough: Issue an order stating that the SEC appoints the ALJs. But that order would have had only a prospective effect, and the commission wanted a fix that would be retroactive back to the dates when the ALJs were hired. So rather than simply stating that it now was appointing the ALJs, the SEC issued an order that "ratifi[ed] the agency's prior appointment of" them.

A court presented with this "ratify" order is likely to conclude it did not satisfy the appointments clause. The order's use of the words "prior appointment" does not change the fact that there was no prior appointment under the appointments clause for the SEC to ratify. And because the order rests on the earlier hiring of the ALJs by the SEC staff, it incorporates the same constitutional defect that led to the Lucia litigation in the first place. Because the earlier hiring did not satisfy the appointments clause, neither does "ratifying" that same hiring. Can the SEC really satisfy the appointments clause by "ratifying" the same act the Supreme Court has held constitutionally defective? The appointments clause and long-standing principles of ratification indicate it cannot.

Lucia explained this defect in his brief before the Supreme Court, but the court did not reach the issue. Other respondents have made the argument in SEC administrative proceedings where — it is no surprise — ALJs have brushed it aside.[4] When Article III courts reach this issue, however, they are likely to agree that the ALJs still are not properly appointed.

2. SEC ALJs violate the appointments clause for the separate reason that they are improperly protected from removal by the president.

The SEC can fix the appointment problem, but it may be unable to fix the second constitutional violation, which is the ALJs' tenure protection: the impermissible protection they enjoy against removal by the executive. The appointments clause safeguards the executive's power to remove officers, while also permitting Congress to grant certain officers "for-cause" removal protections that prevent at-will removal by the president. But Congress cannot limit the executive by granting an officer two levels of "for cause" protection, making the officer removable only for good cause as determined by another officer also removable only for good cause. This was the lesson of the Supreme Court's 2010 decision in Free Enterprise Fund v. Public Company Accounting Oversight Board.[5]

SEC ALJs appear to have the forbidden two levels of protection. They can be removed only if the Merit Systems Protection Board finds good cause to remove them — a protection written into the Administrative Procedure Act[6] — and the members of that board can be removed only for good

cause.[7] (SEC commissioners also have for-cause protection against removal.) These two levels of protection appear to violate the principles set out in Free Enterprise Fund, though that court specifically put off for another day the question whether its holding applies to ALJs.[8]

The Lucia court did not reach the removal issue, though the government's brief had urged it to do so. The court declined that invitation, noting that it would "await 'thorough lower court opinions to guide our analysis of the merits.'"[9] The courts of appeals that have ruled on the appointments clause issue, the D.C. and Tenth Circuits, did not reach the removal question.[10]

Because ALJs' tenure protection is written into the Administrative Procedure Act, resolving this issue could require action by Congress. And the solution is not yet obvious, because the removal question has more potential constitutional significance than the "appointment" element of the appointments clause: The possible removal of ALJs brings to a head the tension between the political accountability required by the appointments clause and the judicial independence written into the APA. Concern about this tension led Justice Stephen Breyer to discuss it in his separate opinion in Lucia, expressing the view that eliminating any for-cause protection for ALJs "would risk transforming [them] from independent adjudicators into dependent decisionmakers, serving at the pleasure of the Commission."[11]

It may be years before the removal issue is resolved and, until then, it is not clear that any SEC administrative proceedings can go forward. In the meantime, respondents in those proceedings have a formidable argument that SEC ALJs still serve in violation of the appointments clause.

3. SEC cases that rest on conduct more than five years old cannot be retried because the limitations period has expired.

In the wake of Lucia, every respondent in pending administrative proceedings will receive a new hearing, including respondents now in courts of appeals. In some of these pending actions, however, the SEC cannot bring a new proceeding because the statute of limitations has expired.

Here is why. The governing statute requires the SEC to "commence[]" an enforcement action no later than five years after the conduct at issue in the case.[12] The SEC commences an action by issuing an order instituting proceedings, or OIP.[13] Under the approach typically followed by the SEC, each OIP states that the required administrative proceeding will be conducted by an ALJ.[14] This approach ties those OIPs to the authority of the ALJs — and under Lucia the ALJs are unconstitutionally appointed. This dependence on the unconstitutional ALJs rendered the OIPs invalid, and because the OIPs were invalid, the SEC never "commenced" any proceedings in those cases. The statute of limitations was never tolled.

As the Supreme Court stated in Freytag v. Commissioner, the appointments clause precedent that was controlling in Lucia, any defect in the appointment of an adjudicator "goes to the validity of the [] proceeding."[15] More broadly, the Supreme Court has held that government action taken pursuant to unconstitutional authority has no legal effect. And two recent Supreme Court decisions, Kokesh v. SEC and Gabelli v. SEC, specifically emphasized the importance of this five-year limitations statute in SEC enforcement actions.[16] Against this background, respondents whose conduct is more than five years old will have a strong statute-of-limitations argument.

When those respondents assert this defense, they might point out that this outcome cannot be a surprise to the SEC. It created this risk when it made the strategic choice to refrain from appointing its ALJs during the years it was contesting the appointments clause lawsuits. Now that the Supreme Court

has ruled against the SEC on the appointments clause, the bar against refiling these cases is a direct result of that same strategic choice.

Conclusion

To predict that respondents can prevail on the above arguments in the SEC administrative forum would be, to say the least, optimistic. So some respondents may go directly to federal district court, arguing that the unusual circumstances of these cases satisfy the requirements to challenge pending administrative proceedings: The cases implicate an important "structural" constitutional provision, and they would impose the unusual demand that respondents exhaust the entire course of agency procedures not just once, but for a second time. Some federal courts may decide they have jurisdiction to hear such a challenge.

Whatever the forum, the SEC faces difficult practical and legal challenges in the wake of Lucia. We will see a wave of litigation over the next year or two, with the above issues continuing to work their way through the system for some years after that. In the meantime, until the removal issue is resolved, it may prevent the SEC from conducting any administrative proceedings that comply with the appointments clause.

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Disclosure: Orrick Herrrington & Sutcliffe filed an amicus brief in Lucia v. SEC and represents parties in pending SEC proceedings.

[1] Lucia v. SEC, 585 U.S. __, No. 17-130, 2018 WL 3057893 (June 21, 2018).

[2] Id. at *5-8.

[3] In re Pending Administrative Proceedings, Securities Act Release No. 10, 440, 2017 WL 5969234, at *1 (Nov. 30, 2017).

[4] See, e.g., Order on Ratification, In the Matter of RD Legal Capital LLC, SEC A.P. Release No. 3-17342 (Feb. 23, 2018) (addressing Respondents' Response to Commission's Nov. 30, 2007 Order).

[5] Free Enterprise Fund v. Public Co. Accounting Oversight Bd., 561 U.S. 477, 496-97 (2010).

[6] 5 U.S.C. § 7521(a).

[7] 5 U.S.C. § 1202(d).

[8] 561 U.S. at 507 n.10.

[9] 2018 WL 3057893, at *5 n.1.

[10] See Raymond J. Lucia Companies Inc. v. SEC, 832 F.3d 277, 281 (D.C. Cir. 2016), reh'g en banc granted, judgment vacated, SNR Wireless License Co LLC v. FCC, 868 F.3d 1021 (D.C. Cir. 2017), rev'd and remanded, Lucia, 2018 WL 3057893, at *5 n.1; Bandimere v. SEC, 844 F.3d 1168, 1188 (10th Cir. 2016), cert. denied SEC. v. Bandimere, No. 17-475, 2018 WL 3148308 (U.S. June 28, 2018) ("We recognize that our holding potentially implicates other questions. But no other issues have been presented to us here, and we therefore cannot address them. Nothing in this opinion should be read to answer any but the precise question before this court: whether SEC ALJs are employees or inferior officers. Questions about officer removal, officer status of other agencies' ALJs, civil service protection, rulemaking, and retroactivity ... are not issues on appeal and have not been briefed by the parties.").

[11] Lucia, 2018 WL 3057893 at *14 (Breyer, J., concurring in judgment and dissenting in part).

[12] 28 U.S.C. § 2462.

[13] See Rules of Practice, Release No. 35833, 1995 WL 368865, at *27 (June 9, 1995) (commenting on SEC Rule of Practice 141(a)) ("The Commission commences proceedings to enforce the Federal securities laws by issuing an 'order instituting proceedings.") (internal quotations removed).

[14] For the OIP in Lucia, see Order Instituting Administrative and Cease-and-Desist Proceeding, In the Matter of RD Legal Capital LLC, SEC A.P. Release No. 33-10111 (July 14, 2016).`

[15] Freytag v. Comm'r, 501 U.S. 868, 879 (1991).

[16] See Kokesh v. SEC, 137 S. Ct. 1635, 1643-45 (2017) (Section 2462 applies to SEC claims for disgorgement); Gabelli v. SEC, 568 U.S. 442, 454 (2013) (Section 2462 is not tolled under the "discovery rule").