

DEVELOPMENTS IN SEC ADMINISTRATIVE PROCEEDINGS: AN EVALUATION OF RECENT APPOINTMENT CLAUSE CHALLENGES, THE RAPIDLY EVOLVING JUDICIAL LANDSCAPE, AND THE SEC’S RESPONSE TO CRITICS

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The Dodd-Frank Wall Street Reform and Consumer Protection Act bestowed upon the Securities and Exchange Commission the right to pursue an enforcement action against any person either in federal court or through an administrative proceeding. Since 2012, the SEC has chosen to pursue an unprecedented percentage of its enforcement actions administratively, and it has prevailed in those administrative proceedings at a much higher rate than in federal court. Since mid-2015, administrative respondents have begun turning to the federal courts for relief, alleging that administrative law judges, the SEC employees who preside over administrative proceedings, are appointed in violation of Article II’s Appointments Clause and therefore have no lawful authority to hear cases.

The challengers found early success in a number of district courts, both in establishing subject matter jurisdiction and in securing preliminary injunctions on the merits. Between August 2015 and December 2016, however, the momentum quickly shifted in favor of the SEC. Five federal appellate courts—the Second, Fourth, Seventh, Eleventh, and D.C. Circuit Courts of Appeals—have all found that the federal courts lack subject matter jurisdiction to hear challenges addressing an ALJ’s constitutional authority to preside over an enforcement action until the respondent has exhausted all administrative remedies provided by the relevant statute. In other words, the appellate courts have held that an administrative respondent may not collaterally attack the constitutionality of an administrative proceeding in federal court before the administrative proceeding is complete—rather, the administrative respondent must wait

* J.D., 2016, University of Pennsylvania Law School. I would like to thank the Honorable Cheryl Ann Krause of the United States Court of Appeals for the Third Circuit and Mary Mulligan of Friedman Kaplan Seiler & Adelman LLP for their invaluable guidance in shaping the topic and execution of this Article.

for an adverse ALJ decision, appeal that decision directly to the full Commission, and only then, once the administrative proceeding has concluded, may the respondent seek judicial review through a proper federal court of appeals.

While the jurisdictional question is now all but settled, the merits question is very much alive. In August 2016, the United States Court of Appeals for the D.C. Circuit, the first federal appellate court to rule on a fully ripe Appointments Clause challenge, held that SEC ALJs are mere employees of the SEC, not “inferior officers” within the meaning of Article II, and thus do not trigger Article II’s protections. The D.C. Circuit’s decision represented a significant victory for the SEC. In December 2016, however, the United States Court of Appeals for the Tenth Circuit came to the opposite conclusion, holding that SEC ALJs are unconstitutionally appointed inferior officers and creating a significant circuit split worthy of Supreme Court review. While the judicial landscape continues to rapidly evolve, administrative respondents seeking to challenge ALJs’ constitutional authority to hear cases should be emboldened by the Tenth Circuit’s decision. Challengers should continue to assert that the SEC’s ALJ appointment scheme violates the Constitution, although they should now wait until the administrative proceeding is complete and should bring the subsequent judicial challenge in the federal court of appeals in the circuit in which they reside, rather than in the D.C. Circuit. This Article encourages courts hearing such challenges to follow the Tenth Circuit, not the D.C. Circuit, and to hold that the SEC’s ALJ appointment scheme violates the protections provided by the Appointments Clause of Article II of the United States Constitution.

In addition to the Appointments Clause challenges, the SEC has faced a deluge of criticism from judges, academics, and practitioners over its administrative system as a whole, which many feel gives the Commission an unfair advantage when it decides to pursue an enforcement action administratively. While the SEC has steadfastly refused to reappoint its ALJs in accordance with the Appointments Clause, it has capitulated to the growing criticism by adopting a number of amendments to the Rules of Practice that govern its administrative proceedings and by promulgating guidance regarding forum selection. This Article argues that these concessions are a step in the right direction but that they do not go far enough in leveling the playing field between the SEC and administrative respondents. It also urges the SEC to undertake a number of concrete steps to restore public trust and to protect the constitutional rights of individuals and entities accused of wrongdoing.

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INTRODUCTION

With its passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress authorized the Securities and Exchange Commission to seek civil penalties from any person accused of violating the securities laws either in an administrative proceeding or in federal district court.¹ Prior to Dodd-Frank, if the SEC wanted to seek monetary penalties from non-regulated entities or individuals, it had to bring its case in federal court. Now, the SEC can bring such cases administratively in its in-house courts in front of its in-house judges. The newfound grant of power is significant, and the SEC has been taking full advantage of it.

The Commission brought approximately eighty percent of its enforcement actions as administrative proceedings, rather than in federal district court, in the fiscal year ended September 30, 2015, which was roughly the same percent that it brought in the prior fiscal year but twenty percent more than its average between 2005 and 2013.² The increased use

1. Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(a), 15 U.S.C. § 78u-2 (2012).

2. *Select SEC and Market Data: Fiscal 2015*, U.S. SECURITIES AND EXCHANGE COMMISSION 3 tbl. 2 (2015), <https://www.sec.gov/reportspubs/select-sec-and-market-data/secstats2015.pdf> [<https://perma.cc/HKR5-8DU5>] [hereinafter *Select SEC and Market Data 2015*]; *Select SEC and Market Data: Fiscal 2014*, U.S. SECURITIES AND EXCHANGE COMMISSION 3 tbl. 2 (2014), <https://www.sec.gov/reportspubs/select-sec-and-market-data/secstats2014.pdf> [<https://perma.cc/4BP6-9LQE>] [hereinafter *Select SEC and Market Data 2014*]. See also Ryan Jones, Comment, *The Fight over Home Court: An Analysis of*

of administrative proceedings should not be surprising, given that the SEC won more than ninety percent of its contested administrative proceedings from October 2010 through March 2015, while winning only sixty-nine percent of the cases it brought in federal court over the same period.³

The Commission's noteworthy administrative winning percentage should not be surprising either, given the significant procedural advantages that come with bringing cases administratively. Administrative proceedings operate on an expedited schedule, undermining respondents' ability to prepare for hearings and defend themselves.⁴ Respondents in administrative proceedings are entitled to far less discovery than what is available in federal court, leaving respondents with little more than the record that the Commission itself developed during its investigation.⁵ Administrative proceedings are tried without a jury to an ALJ appointed, employed, and paid by the Commission,⁶ and appeals of adverse administrative decisions must be brought to the same five-member Commission that authorized the enforcement action in the first place.⁷

The Article proceeds in four parts. First, it discusses SEC administrative proceedings generally, describes how administrative proceedings differ from cases brought in federal district court, and notes the SEC's recent trend in favor of bringing a larger percentage of its enforcement actions administratively. Second, the Article presents a number of criticisms and constitutional challenges levied at SEC administrative proceedings, arguing specifically that federal courts should rule that the SEC's ALJ appointment scheme is unconstitutional. Third, the Article discusses and evaluates the Commission's two main responses to that criticism—adopting proposed amendments to its Rules of Practice and promulgating guidance regarding forum selection. Finally, the Article concludes by suggesting a number of concrete steps that the SEC should take to ameliorate the constitutional violations and assuage concerns that administrative proceedings offer the SEC an unfair “home field advantage.”

the SEC's Increased Use of Administrative Proceedings, 68 SMU L. REV. 507, 524 (2015) (collecting SEC enforcement action data from 2005 to 2014).

3. Jean Eaglesham, *SEC Wins with In-House Judges*, WALL ST. J., May 6, 2015, <http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803> [<https://perma.cc/AV2X-VCEQ>] [hereinafter Eaglesham, *SEC Wins*].

4. 17 C.F.R. § 201.360(a).

5. 17 C.F.R. § 201.230-234.

6. 5 U.S.C. § 5372; 5 C.F.R. § 930.204.

7. 17 C.F.R. § 201.410.

I. SEC ADMINISTRATIVE PROCEEDINGS

Congress created the Securities and Exchange Commission by statute in 1934⁸ and charged it with serving the public by “enforcing the federal securities laws and regulating securities broker-dealers, investment advisers, and national securities exchanges.”⁹ The Commission fulfills its mission in a number of different ways, including through disciplinary actions brought by its Enforcement Division.¹⁰

Historically, the Commission could bring enforcement actions administratively only in limited circumstances, such as when the Commission was targeting regulated entities or seeking only cease-and-desist orders or disgorgement.¹¹ With its passage of the Dodd-Frank Act in 2010, however, Congress authorized the Commission to seek a full range of remedies, including civil monetary penalties, from any party accused of wrongdoing, not simply from the industry insiders who it was previously allowed to target administratively.¹²

In administrative proceedings, an ALJ appointed and employed by the SEC presides over the matter and issues the initial decision.¹³ SEC ALJs enjoy career appointments, their salaries are specified by statute, and they are not subject to the probationary periods that apply to certain other government employees.¹⁴ In administrative proceedings, ALJs serve as the finder of fact and law and have powers and responsibilities nearly equivalent to those of a federal judge presiding over a bench trial, including administering oaths, issuing subpoenas, taking and ruling on the admissibility of evidence, and generally overseeing proceedings.¹⁵ ALJs ultimately decide whether the respondent violated the law,¹⁶ and their

8. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78pp (2012)).

9. DANIEL J. FETTERMAN & MARK P. GOODMAN, *DEFENDING CORPORATIONS AND INDIVIDUALS IN GOVERNMENT INVESTIGATIONS* § 7:1 (2015).

10. *See* Administrative Procedures Act, 5 U.S.C. § 554 (1978) (authorizing administrative agencies, such as the SEC, to conduct adjudicative proceedings administratively). *See also* U.S. SECURITIES AND EXCHANGE COMMISSION, DIVISION OF ENFORCEMENT, <http://www.sec.gov/divisions/enforce/about.htm> [https://perma.cc/F8R4-5CLY] (last visited Aug. 22, 2016) (“The Commission’s enforcement staff conducts investigations into possible violations of the federal securities laws, and prosecutes the Commission’s civil suits in the federal courts as well as its administrative proceedings.”).

11. *See* *Duka v. SEC*, 103 F. Supp. 3d 382, 386 (S.D.N.Y. 2015) (“Prior to the enactment of Dodd-Frank, the SEC was authorized to impose civil penalties in Administrative Proceedings only against ‘regulated person[s]’ or companies.”).

12. 15 U.S.C. § 78u-2.

13. 5 C.F.R. § 930.204; 17 C.F.R. § 201.360.

14. 5 U.S.C. § 5372; 5 C.F.R. § 930.204(a).

15. 17 C.F.R. § 201.111.

16. 17 C.F.R. § 201.360.

decision is appealable to the full Commission.¹⁷ If the ALJ's decision is not appealed or the Commission declines to review it, the Commission enters an order that the ALJ's decision has become final and the action "shall, for all purposes, . . . be deemed the action of the Commission."¹⁸

A. *Administrative and Federal District Court Proceedings Differentiated*

While the remedies available to the SEC administratively and in federal district court are now comparable, administrative proceedings are fundamentally different from traditional federal district court proceedings. According to many, the differences redound almost entirely to the Commission's benefit and "stack the deck"¹⁹ in a way that amounts to a "home court advantage"²⁰ for the Commission.

First, administrative proceedings move at a much faster pace than cases brought in federal district court. Until recently, the presiding ALJ had only 300 days from the date of service of the Order Instituting Proceedings ("OIP"), the Commission's charging instrument, to render a decision, and the hearing was required to be held within four months from the date of service of the OIP.²¹ Within those four months, the respondent needed to answer the OIP, review the Commission's often-voluminous investigative file, prepare for the hearing, and attend the hearing. In what remained of the 300 days, the respondent had to review the transcript and submit any post-hearing briefing. Under the Commission's July 13, 2016 amendments to its Rules of Practice, respondents now have as many as ten months to prepare, instead of four.²² While counsel for the respondent still has a limited time to prepare, the Commission may take as long as it wants to investigate a case before filing the OIP, subject only to the applicable statute of limitations. Given that the Commission has a very significant

17. 17 C.F.R. § 201.411.

18. 15 U.S.C. § 78d-1(c).

19. *SEC In-house Justice System Stacks the Deck*, INVESTMENTNEWS (July 26, 2015, 12:01 AM), <http://www.investmentnews.com/article/20150726/REG/307269998/sec-in-house-justice-system-stacks-the-deck> [https://perma.cc/3WNM-TKC2].

20. Joel M. Cohen, Mary Kay Dunning, & Darcy Harris, *SEC Plans to Play Insider-Trading Cases on Home Court*, NATIONAL LAW JOURNAL, Sept. 16, 2014, <http://www.nationallawjournal.com/id=1202670286446/SEC-Plans-to-Play-Insider-Trading-Cases-on-Home-Court-?slreturn=20151022101115> [https://perma.cc/E24A-43GM].

21. 17 C.F.R. § 201.360(a).

22. U.S. Securities and Exchange Commission, *Amendments to Commission's Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Final Rule 360, <https://www.sec.gov/rules/final/2016/34-78319.pdf> [https://perma.cc/VGL4-KK8Z]; 17 C.F.R. § 201.360(a). For an extended discussion of the SEC's amendments to its Rules of Practice, see *infra* Part III.A.

amount of time to gather and review documents and to conduct extensive witness interviews before filing charges, some argue that the expedited administrative schedule undermines respondents' abilities to defend themselves and calls into question the fairness of the entire administrative scheme.²³

Second, respondents in administrative proceedings are entitled to far less discovery than is available in federal district court. While the Commission is required to turn over much of its investigative file before serving the OIP and the respondent can ask the ALJ to issue subpoenas to third parties and to the Commission for documents and for testimony of witnesses who are unlikely to be available at the hearing,²⁴ until the recent amendments, the Commission's Rules of Practice contained no provisions for typical depositions or interrogatories.²⁵ This means that respondents had to either call witnesses to the stand with no knowledge of what they might say, if they were not interviewed by the SEC and therefore not included in its investigative file, or for those that did testify before the Commission, with no ability to develop impeachment or respondent-friendly material in advance. Under the amended Rules of Practice, each side is permitted to take up to three depositions in a single-party administrative proceeding, up to five depositions in a multi-party administrative proceeding, and up to two additional depositions upon the showing of a compelling need.²⁶ The Commission's Rules also permit the introduction of hearsay and other evidence that would be inadmissible in federal court under the Federal Rules of Evidence.²⁷ These limited discovery provisions leave respondents with little more than the record the Commission itself developed during the course of its investigation.

Third, administrative proceedings are tried without a jury to an ALJ appointed, employed, and paid by the Commission, creating a potential for bias.²⁸ Indeed, one former ALJ commented that she was criticized for finding in favor of respondents too often and that ALJs were expected to work under the assumption that "the burden was on the people who were accused to show that they didn't do what the agency said they did."²⁹ While the rationale of utilizing ALJs to hear complex securities cases

23. Jones, *supra* note 2, at 524.

24. 17 C.F.R. § 201.230-232.

25. 17 C.F.R. § 201.233-234.

26. *Rules of Practice*, Exchange Act Release No. 34-78319 (July 13, 2016), Final Rule 233; 17 C.F.R. § 201.233.

27. See 17 C.F.R. § 201.320 ("The Commission or the hearing officer may receive relevant evidence and shall exclude all evidence that is irrelevant, immaterial or unduly repetitious.").

28. 5 U.S.C. § 5372; 5 C.F.R. § 930.204.

29. Eaglesham, *SEC Wins*, *supra* note 3.

requiring specialized expertise has intuitive appeal, complex securities cases are not fundamentally different from general complex commercial cases, which federal district court judges and juries hear regularly. Further, the need for a specialized decision-maker diminished considerably when the Commission expanded from bringing administrative proceedings only against regulated entities to bringing administrative proceedings against non-regulated entities.³⁰

If a respondent is unsatisfied with an adverse ALJ determination, the respondent must appeal to the full Commission in the first instance.³¹ While the Commission's review is de novo based on the record in the case, briefing, and argument,³² the Commission is the entity that authorized the Enforcement Division to bring the action against the respondent in the first place,³³ meaning that the Commission "is akin to the prosecutor and then, in an appeal, the judge in the same case."³⁴ If the Commission affirms the ALJ's decision, the respondent may then appeal to the United States Court of Appeals for the District of Columbia Circuit or to the federal court of appeals in the circuit in which the respondent resides.³⁵ At that point, the court of appeals retains exclusive jurisdiction "to affirm or modify and enforce or set aside the order in whole or in part."³⁶ However, by the time a case reaches a federal court of appeals, the court of appeals' role is quite limited because Commission administrative decisions are entitled to deference.³⁷

30. Some commentators have pointed out that SEC ALJs are not even particularly specialized in securities law. See David Zaring, *Enforcement Discretion at the SEC*, 94 TEX. L. REV. 1155, 1178 (2016) (chronicling the background of SEC ALJs, who often join the SEC from other administrative agencies such as the Social Security Administration, and concluding that "[a]s relative newcomers to securities work, these adjudicators did not come with a depth of knowledge about the nature of securities litigation or administrative proceedings at the SEC; nor would they have been known, and held in particular esteem, by the securities bar upon appointment").

31. 17 C.F.R. § 201.410.

32. 17 C.F.R. §§ 201.411(a), 201.452.

33. U.S. SECURITIES AND EXCHANGE COMMISSION, DIVISION OF ENFORCEMENT, ENFORCEMENT MANUAL § 2.5 (2015), <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf> [https://perma.cc/J23F-D4LJ].

34. Eaglesham, *SEC Wins*, *supra* note 3 (quoting Bradley Bondi, a former counsel to two former SEC commissioners).

35. 15 U.S.C. § 78y(a)(1).

36. 15 U.S.C. § 78y(a)(3).

37. See *Chevron, USA v. NRDC*, 467 U.S. 837, 844-45 (1984) (holding that "a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency"). But see *Flannery v. SEC*, 810 F.3d 1, 15 (1st Cir. 2015) (finding that a decision made by the full Commission was not supported by substantial evidence). SEC ALJs' formal rulings on otherwise undecided issues of statutory interpretation of the securities laws made in the context of administrative

B. *Recent Trends in SEC Enforcement*

While the Dodd-Frank Act was signed into law in 2010, only recently has the Commission been taking advantage of its benefits by bringing a greater number of cases administratively. The Commission initiated only 462 administrative proceedings in fiscal year 2012, but it initiated 610 such proceedings in fiscal year 2014 and 645 in fiscal year 2015.³⁸ Conversely, it initiated 272 civil actions in fiscal year 2012, but only 145 civil actions in fiscal year 2014 and 162 in fiscal year 2015.³⁹ The number of enforcement actions brought administratively in fiscal years 2014 and 2015, as opposed to in federal court, amounted to approximately eighty percent of the SEC's enforcement actions, while only sixty-three percent of its enforcement actions were brought administratively in fiscal year 2012.⁴⁰ Between 2005 and 2013, the SEC brought only fifty-nine percent of its enforcement actions administratively on average, over twenty percent less than in fiscal years 2014 and 2015.⁴¹ Indeed, one senior SEC official commented that it is "fair to say" that the increased use of administrative proceedings is "the new normal."⁴²

When the Commission does bring enforcement actions administratively rather than in federal court, it wins at a noteworthy rate. According to one study, the SEC won more than ninety percent of contested administrated proceedings from October 2010 through March 2015, while winning only sixty-nine percent of its federal court cases over the same period.⁴³ In 2014, the Commission won all six administrative hearings that came to verdict, but lost seven of the eighteen cases that it

adjudications are entitled to *Chevron* deference in the same manner as are rules enacted by the Commission. See Steven Croley, THE SCOPE OF *CHEVRON* 2-3 (July 2001) (unpublished manuscript),

<http://www.americanbar.org/content/dam/aba/migrated/adminlaw/apa/chevrscopejuly.doc> [<https://perma.cc/C4X4-YRPM>] ("The Supreme Court has made it clear that *Chevron* deference is not to be confined to interpretations occasioned by agency rulemaking, however, but extends to agency interpretations made in connection with a formal adjudication, including enforcement actions.").

38. *Select SEC and Market Data 2015* 3 tbl. 2; *Select SEC and Market Data 2014* 3 tbl. 2; *Select SEC and Market Data: Fiscal 2012*, U.S. SECURITIES AND EXCHANGE COMMISSION 3 tbl. 2 (2012), <https://www.sec.gov/about/secstats2012.pdf> [<https://perma.cc/MMR8-ASEV>].

39. *Id.*

40. *Id.*

41. Jones, *supra* note 2, at 518.

42. Jean Eaglesham, *SEC Is Steering More Trials to Judges It Appoints*, WALL ST. J., Oct. 21, 2014, <http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it-appoints-1413849590> [<https://perma.cc/5RZQ-58DF>] (quoting Kara Brockmeyer, chief of the Enforcement Division's Foreign Corrupt Practices Act Unit).

43. Eaglesham, *SEC Wins*, *supra* note 3.

litigated in federal court.⁴⁴ Many expect that given its recent high-profile losses in federal court⁴⁵ and the Commission's "near-perfect" record before its ALJs, the Commission will continue to bring more cases administratively.⁴⁶ Indeed, the Commission appeared to be bracing for such an increase when it hired two new ALJs in late 2014, bringing the total number of SEC ALJs to five,⁴⁷ and when it increased the Office of Administrative Law Judges' budget by forty-four percent for the 2014-2015 fiscal year.⁴⁸ The disparity in success rates has led commentators to observe that "ALJs' close ties with the agency, combined with the [administrative law court] outcome record, suggests that there may exist some bias within the SEC's [administrative law courts]."⁴⁹

II. CHALLENGES TO THE ADMINISTRATIVE SCHEME

A. *General Criticism*

The Commission has come under heavy criticism for its "new normal" of bringing administrative enforcement actions against non-regulated entities. United States District Judge Jed S. Rakoff, for example, has warned of the "dangers that seem . . . to lurk in the S.E.C.'s apparent new policy of bringing a greater percentage of its significant enforcement actions as administrative proceedings."⁵⁰ Since formal administrative decisions made by ALJs are entitled to deference and most significant SEC cases, especially those involving complicated or novel questions of law, are brought under the general antifraud provisions of the federal securities

44. Jones, *supra* note 2, at 519.

45. In two highly-publicized insider-trading cases, the SEC brought actions with novel and difficult legal theories in federal court. Both were dismissed by the district court, but the issues were ultimately resolved favorably to the SEC on appeal. When the SEC retried the cases to juries on remand, the SEC lost both cases. See Jed. S. Rakoff, PLI Securities Regulation Institute Keynote Address, *Is the S.E.C. Becoming a Law Unto Itself?*, Nov. 5, 2014, <https://securitiesdiary.files.wordpress.com/2014/11/rakoff-pli-speech.pdf> [<https://perma.cc/U8U8-LCE7>] (citing SEC v. Obus and SEC v. Cuban).

46. See, e.g., David A. Wilson, *Coming to an Administrative Law Judge Near You: Insider-Trading Cases*, 30 No. 12 WESTLAW J. CORP. OFFICERS & DIRECTORS LIAB. 2 (2014).

47. Press Release, U.S. Securities and Exchange Commission, SEC Announces New Hires in the Office of Administrative Law Judges, Release No. 2014-129 (June 30, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542202073> [<https://perma.cc/WC8E-KMXK>].

48. Eaglesham, *SEC Wins*, *supra* note 3.

49. Tyler L. Spunaugle, Comment, *The SEC's Increased Use of Administrative Proceedings: Increased Efficiency or Unconstitutional Expansion of Agency Power?*, 34 REV. BANKING & FIN. L. 406, 413 (2015).

50. Rakoff, *supra* note 45, at 1.

laws,⁵¹ Judge Rakoff expressed his concern that the increase in administrative enforcement actions may effectively lead to the securities laws being made “not by neutral federal courts, but by S.E.C. administrative judges.”⁵² According to Judge Rakoff, a trend toward preferring administrative proceedings to federal courts will “hinder[] the balanced development of the securities laws” and will be “unlikely . . . to lead to as balanced, careful, and impartial interpretations as would result from having those cases brought in federal court.”⁵³

Commentators have criticized the Commission on public policy grounds as well. One commentator has theorized that a main reason the SEC is bringing an increased number of cases administratively is to gain increased bargaining power.⁵⁴ Indeed, Andrew Ceresney, the Director of the SEC’s Enforcement Division, has acknowledged that simply by threatening to bring an enforcement action administratively rather than in federal court, the Commission enjoys increased bargaining power in settlement talks.⁵⁵ Since the majority of cases settle before trial, increased bargaining power in settlement negotiations provides the Commission with a significant advantage. Commentators have also argued that the SEC “places far too much significance on simply winning cases and collecting monetary penalties . . . rather than deterring future illegal action and protecting the public,” which may lead non-regulated entities to see settlements as a “cost of doing business.”⁵⁶

Congress has held hearings to examine the constitutionality of ALJ appointments and related constitutional issues of due process, with the Chairman of the Subcommittee on Capital Markets remarking on the “very troubling pattern of the SEC’s attempting to stack the rules and process in a way that the outcome of the case is, well, predetermined.”⁵⁷

51. Judge Rakoff also pointed out that the development of the law under the “catch-all provisions” of Section 17(a) of the 1933 Securities Act and Section 10(b) of the 1934 Securities Exchange Act has “mostly been judge-made.” *Id.* at 8.

52. *Id.* at 10.

53. *Id.* at 7, 11.

54. Spunaugle, *supra* note 49, at 411.

55. Brian Mahoney, *SEC Could Bring More Insider Trading Cases In-House*, LAW360, (June 11, 2014, 6:53 PM), <http://www.law360.com/articles/547183/sec-could-bring-more-insider-trading-cases-in-house> [<https://perma.cc/UQ3U-QLW5>] (“I will tell you that there have been a number of cases in recent months where we have threatened administrative proceedings, it was something we told the other side we were going to do and they settled.”).

56. Jones, *supra* note 2, at 532.

57. *Oversight of the SEC’s Division of Enforcement: Hearing Before the H. Subcomm. on Capital Markets and Government Sponsored Enterprises*, 114th Cong. 2-3 (2015) (statement of Rep. Scott Garrett) (“While bringing more cases through the administrative proceedings can lead to lower costs for the agency and increases in efficiency, it is

Senior Commission officials have steadfastly defended the integrity of the Commission's increased use of administrative proceedings. SEC Chair Mary Jo White has called the Commission's use of administrative proceedings "very fair."⁵⁸ Ceresney has stated that the Commission's use of administrative forums is "eminently proper, appropriate, and fair to respondents."⁵⁹ Specifically, Ceresney noted that the Commission's relaxed evidentiary rules can even "benefit the respondents" because "witnesses' recollections are fresher" and the rules may give respondents "more flexibility in offering evidence."⁶⁰ The Commission has also argued that by relying on ALJs, it is taking advantage of subject matter experts to fairly and efficiently resolve "complicated . . . securities and financial law . . . cases that the district courts are often ill-prepared to handle," freeing up "overburdened district courts, potentially providing benefits for the entire legal system."⁶¹

B. *Constitutional Challenges*

The most significant criticisms facing the SEC come not from federal judges in their personal capacities or legal commentators but from respondents bringing constitutional challenges to the Commission's right to pursue enforcement actions outside of federal court. The constitutional challenges have been brought in several forms,⁶² but the most noteworthy

important to realize that those benefits come with a cost. The cost is less due-process protections for defendants."). Representative Garrett also introduced legislation intending to "restore due process rights for all Americans" by granting administrative respondents a mandatory right of removal to federal district court. Due Process Restoration Act of 2015, H.R. 3798, 114th Congress (2015-2016); Press Release, Representative Scott Garrett, House of Representatives, Garrett Introduces Bill to Restore Due Process Rights for All Americans (Oct. 22, 2015), <http://garrett.house.gov/media-center/press-releases/garrett-introduces-bill-to-restore-due-process-rights-for-all-americans> [https://perma.cc/U2LF-RBSN]. The legislation, which would essentially eliminate administrative proceedings as a mechanism for resolving securities fraud matters, has yet to receive a full House vote. The Financial CHOICE Act of 2016, the bill introduced by Republicans to overhaul Dodd-Frank, contains a similar provision. Financial CHOICE Act of 2016, H.R. 5983, 114th Congress (2015-2016).

58. Yuka Hayashi, *SEC's White Defends In-House Courts, but Sees Need to Modernize*, WALL ST. J. MONEYBEAT (Nov. 17, 2015, 2:52 PM), <http://blogs.wsj.com/moneybeat/2015/11/17/secs-white-defends-in-house-courts-but-sees-need-to-modernize> [https://perma.cc/2T29-NS54].

59. Andrew Ceresney, Remarks to the American Bar Association's Business Law Section Fall Meeting (Nov. 21, 2014), <https://www.sec.gov/News/Speech/Detail/Speech/1370543515297> [https://perma.cc/ZY5B-CA7C].

60. *Id.*

61. Spunaugle, *supra* note 49, at 411.

62. Additional challenges have been brought under Article I, the Seventh Amendment, and the Due Process and Equal Protection Clauses. These challenges have been uniformly

challenge arises under Article II's Appointments Clause.

1. Subject Matter Jurisdiction

In response to these constitutional challenges, the Commission has argued that federal courts do not have subject matter jurisdiction to hear the challenges until the challenging party has exhausted all possible administrative remedies.⁶³ The argument rests on 15 U.S.C. § 78y, which provides that judicial review of administrative proceedings can come only from a federal court of appeals, and only after the administrative proceeding has concluded and the Commission has issued a final order.⁶⁴ While federal district courts have original jurisdiction over claims arising under the Constitution,⁶⁵ Congress may restrict that original jurisdiction with a statutory scheme that “displays a ‘fairly discernible’ intent to limit jurisdiction, and [if] the claims at issue ‘are of the type Congress intended to be reviewed within the statutory structure.’”⁶⁶ The Commission has argued that Congressional intent to limit jurisdiction is clear from the text of 15 U.S.C. § 78y and the claims at issue are of the type that Congress intended to be reviewed within the statutory scheme.⁶⁷

Plaintiffs seeking to collaterally attack their administrative proceedings in federal district court prior to the conclusion of the administrative process experienced early success in establishing federal subject matter jurisdiction.⁶⁸ In order for a constitutional claim against the SEC to receive an intermediate ruling, the plaintiff must show that (1) “a finding of preclusion could foreclose all meaningful judicial review,” (2) the suit is “wholly collateral to [the] statute’s review provisions,” and (3) the “claims are outside [of] the agency’s expertise.”⁶⁹ First, courts held that

rejected. *See, e.g.*, *Hill v. SEC*, 114 F. Supp. 3d 1297, 1316 (N.D. Ga. 2015) (rejecting a Seventh Amendment argument), *vacated on other grounds*, 825 F.3d 1236 (11th Cir. 2016).

63. *See, e.g., id.* at 1305.

64. *Id.*

65. *See* 28 U.S.C. § 1331 (“The district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States.”).

66. *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 489 (2010) (quoting *Thunder Basin Coal Co. v. Reich*, 510 U.S. 200, 207-12 (1994)).

67. *Hill*, 114 F. Supp. 3d at 1305-06.

68. *Ironridge Global IV, Ltd. v. SEC*, 146 F. Supp. 3d 1294, 1302-04 (N.D. Ga. 2015); *Duka v. SEC*, 103 F. Supp. 3d 382, 392 (S.D.N.Y. 2015); *Hill*, 114 F. Supp. 3d at 1305-06; *Timbervest, LLC v. SEC*, No. 1:15-CV-2106-LMM, 2015 U.S. Dist. LEXIS 132082, at *20 (N.D. Ga. Aug. 4, 2015); *Gray Financial Group v. SEC*, No. 1:15-CV-0492-LMM, 2015 U.S. Dist. LEXIS 131792, at *33 (N.D. Ga. Aug. 4, 2015), *vacated*, 825 F.3d 1236 (11th Cir. 2016).

69. *Free Enter. Fund*, 516 U.S. at 489 (quoting *Thunder Basin*, 510 U.S. at 212-13 (internal quotation marks omitted)).

the statutory scheme for judicial review is not meaningful because if the plaintiff were required to raise his constitutional claims following the entire administrative proceeding, he would be forced to endure what he contends is an unconstitutional process.⁷⁰ Further, if a plaintiff were forced to endure the entire administrative process before raising his claim, the plaintiff's claim would be moot because a court of appeals cannot foreclose an unconstitutional proceeding that has already occurred.⁷¹ Second, courts held that constitutional claims are wholly collateral to the administrative proceeding because the plaintiffs are not challenging the Commission's decision, but rather the Commission's ability to constitutionally make that decision.⁷² Third, courts held that constitutional challenges are outside of the Commission's expertise because constitutional claims are governed by Supreme Court jurisprudence, not "technical considerations of agency policy."⁷³

While plaintiffs experienced early success in establishing subject matter jurisdiction, the SEC has achieved a number of significant appellate victories over the past seventeen months, virtually settling the law regarding jurisdiction in the SEC's favor. Between August 2015 and December 2016, five federal appellate courts—the Second, Fourth, Seventh, Eleventh, and D.C. Circuit Courts of Appeals—held that the statutory scheme contained in 15 U.S.C. § 78y provides the exclusive mechanism for a party seeking review of an adverse administrative decision.⁷⁴ Analyzing the *Free Enterprise* factors, the courts first determined that the administrative scheme does not foreclose all meaningful judicial review because, even if constitutional claims cannot be raised administratively, the statutory scheme provides for federal appellate court review of those claims after the plaintiff has exhausted the administrative process.⁷⁵ Second, the courts held that the constitutional

70. See, e.g., *Hill*, 114 F. Supp. 3d at 1307-09; see also Jones, *supra* note 2, at 523 (commenting that winning a federal securities case on a constitutional issue after all administrative remedies have been exhausted may be "little more than a Pyrrhic victory" since by that point "[a]ll the clients and business will have already left, and the respondent will have nothing left to fight for").

71. *Hill*, 114 F. Supp. 3d at 1307-09.

72. See, e.g., *id.* at 1309.

73. See, e.g., *id.* at 1309-10.

74. *Hill v. SEC*, 825 F.3d 1236, 1241 (11th Cir. 2016); *Tilton v. SEC*, 824 F.3d 276, 282 (2d Cir. 2016); *Jarkesy v. SEC*, 803 F.3d 9, 29-30 (D.C. Cir. 2015); *Bebo v. SEC*, 799 F.3d 765, 775 (7th Cir. 2015), *cert. denied*, 136 S. Ct. 1500 (2016); *Bennett v. SEC*, No. 15-2584, slip op. at 30 (4th Cir. Dec. 16, 2016).

75. See, e.g., *Hill*, 825 F.3d at 1243. See also *Bebo*, 799 F.3d at 775 ("This Court's jurisdiction is not an escape hatch for litigants to delay or derail an administrative action when statutory channels of review are entirely adequate.") (quoting *Chau v. SEC*, 72 F. Supp. 3d 417, 425 (S.D.N.Y. 2014)).

claims are not “wholly collateral” to any Commission orders or rules from which review might be sought because the plaintiffs have raised the constitutional issue as an affirmative defense and the Commission will eventually rule on those claims in its final orders.⁷⁶ Third, the courts held that the Commission and its ALJs are “fully capable” of hearing constitutional challenges, at least in the first instance.⁷⁷

While it is likely that the recent precedent created by the Second, Fourth, Seventh, Eleventh, and D.C. Circuits will continue to gain traction across the country, reviewing courts in other circuits should consider finding subject matter jurisdiction and proceeding to the merits of the constitutional challenge. There is a strong argument that all of the *Free Enterprise* factors are satisfied and the courts denying jurisdiction came to an incorrect conclusion. First, judicial review under the administrative scheme should not be considered meaningful because, even though a federal court of appeals could vacate an adverse Commission order on constitutional grounds, it could not remedy the harm that the plaintiff attempted to allege in district court. Judicial review that comes at a point when the harm alleged cannot possibly be remedied should not be considered meaningful. Second, the constitutional claims should be considered wholly collateral to the Commission decisions from which review is sought because the claims do not depend upon the facts of any particular case. Even if a plaintiff raised the issue as an affirmative defense, as the plaintiff must to preserve his ability to later object, the constitutional challenge is entirely unrelated to the underlying alleged securities law violation. For that reason, the constitutional challenge should also be considered outside of the ALJs’ expertise. Questions of administrative and constitutional law are squarely within the province of federal judges, not SEC employees. Therefore, reviewing courts should consider holding that they do have jurisdiction to hear plaintiffs’ constitutional claims and proceeding to the merits of those claims.

2. Appointments Clause Violation

The most significant constitutional challenge facing the Commission asserts that the Commission’s scheme for appointing ALJs violates the Appointments Clause of Article II of the United States Constitution and therefore the ALJs designated as hearing officers have no lawful authority to preside over cases.⁷⁸ Article II provides that “Congress may by Law vest

76. See, e.g., *Tilton*, 824 F.3d at 287-88.

77. See, e.g., *Jarkesy*, 803 F.3d at 28.

78. See, e.g., *Tilton v. SEC*, No. 15-CV-2472 (RA), 2015 WL 4006165, at *2 (S.D.N.Y. June 30, 2015), *aff’d*, 824 F.3d 276 (2d Cir. 2016); *Hill v. SEC*, 114 F. Supp. 3d

the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.”⁷⁹ Commission ALJs are not appointed by the President, the courts, or the SEC Commissioners, but are instead hired by the SEC’s Office of Administrative Law Judges, with input from the Chief Administrative Law Judge, human resource functions, and the Office of Personnel Management.⁸⁰ Accordingly, respondents have contended that the ALJ appointment scheme is unconstitutional.

While arguing about the precise technicalities of how ALJs are appointed may seem pedantic, the Supreme Court has recognized that the Appointments Clause is “more than a matter of ‘etiquette or protocol’; it is among the significant structural safeguards of the constitutional scheme.”⁸¹ Its fundamental purpose is to preserve “the Constitution’s structural integrity by preventing the diffusion of the appointment power” by guarding against Congressional encroachment upon the Executive Branch.⁸²

On the merits, the Commission has argued that, even if federal district courts do have subject matter jurisdiction, the Appointments Clause claims should fail because its ALJs are not “inferior officers” under the Constitution, but are instead mere employees, the hiring and firing of whom is not governed by Article II.⁸³ (Indeed, the full Commission came to that conclusion itself in an appealed administrative proceeding.⁸⁴) An appointee is an inferior officer, and not a mere employee, if the appointee exercises “significant authority pursuant to the laws of the United States.”⁸⁵ To determine whether an appointee exercises “significant authority,” courts look to “(1) the significance of the matters resolved by the officials, (2) the discretion they exercise in reaching their decisions, and (3) the finality of those decisions.”⁸⁶ The Commission relied on *Landry v. FDIC* to argue that since ALJs cannot issue final orders, they cannot be considered inferior

1297, 1305 (N.D. Ga. 2015), *vacated*, 825 F.3d 1236 (11th Cir. 2016).

79. U.S. CONST. art. II, § 2, cl. 2.

80. *See generally* 5 C.F.R. § 930.204 (discussing the ALJ appointment process).

81. *Edmond v. United States*, 520 U.S. 651, 659 (1997) (quoting *Buckley v. Valeo*, 424 U.S. 1, 125 (1976) (per curiam)).

82. *Freytag v. Comm’r.*, 501 U.S. 868, 878 (1991). *See also* *Ryder v. United States*, 515 U.S. 177, 182 (1995) (“The Clause is a bulwark against one branch aggrandizing its power at the expense of another branch . . .”).

83. *See, e.g., Hill*, 114 F. Supp. 3d at 1317.

84. In the Matter of Raymond J. Lucia Companies, Inc., Exchange Act Release No. 75837, Investment Advisers Act Release No. 4190, Investment Company Act Release No. 31806, Admin. Proc. File No. 3-15006, 2015 WL 5172953, at *23 (Sept. 3, 2015), *aff’d*, No. 15-1345, 2016 U.S. App. LEXIS 14559 (D.C. Cir. Aug. 9, 2016).

85. *Buckley*, 424 U.S. at 126.

86. *Tucker v. Comm’r.*, 676 F.3d 1129, 1133 (D.C. Cir. 2012).

officers.⁸⁷ In *Landry*, the D.C. Circuit considered whether FDIC ALJs were inferior officers and held that they were not because they could not issue final orders, even though their office is established by law, their duties, salaries, and means of appointment are specified by statute, and they conduct trials, take testimony, rule on evidence admissibility, enforce discovery compliance, and exercise significant discretion.⁸⁸

Before appellate cases *Bebo*, *Bennett*, *Jarkesy*, *Tilton*, and *Hill* were decided in the past seventeen months, the district courts finding subject matter jurisdiction and reaching the merits had uniformly ruled in favor of the plaintiffs and preliminarily enjoined the SEC from pursuing the plaintiffs' cases administratively, relying on *Freytag v. Commissioner* and finding that the ALJ appointments likely violated Article II's Appointment Clause.⁸⁹ In *Freytag*, the Supreme Court held that Tax Court "special trial judges" are inferior officers because the office is established by law, the duties, salary, and means of appointment are specified by statute, and the judges perform significant tasks such as taking testimony, conducting trials, ruling on the admissibility of evidence, enforcing compliance with discovery orders, issuing final decisions in certain limited circumstances, and exercising significant discretion throughout.⁹⁰ Relying on *Freytag*, the district courts held that, like the special trial judges in that case, SEC ALJs exercise "significant authority" and discretion sufficient to make them inferior officers.⁹¹ The district court in *Hill*, for example, concluded that "the Supreme Court in *Freytag* found that the [special trial judges'] powers—which are nearly identical to the SEC ALJs['] here—were independently sufficient to find that [special trial judges] were inferior officers."⁹² It reasoned that *Landry* was incorrect in reading *Freytag* as holding that authority to render a final decision is a necessary factor for an appointee to be considered an inferior officer.⁹³

In August 2016, a federal appellate court reviewed a fully ripe Appointments Clause challenge for the first time. In *Lucia v. SEC*, an SEC ALJ imposed sanctions on Lucia for violating the Investment Advisors Act

87. *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000); *Hill*, 114 F. Supp. 3d at 1317-18.

88. *Landry*, 204 F.3d at 1133-34.

89. *Ironridge Global IV, Ltd. v. SEC*, 146 F. Supp. 3d 1294, 1316-17 (N.D. Ga. 2015); *Duka v. SEC*, 124 F. Supp. 3d 287, 290 (S.D.N.Y. 2015); *Hill*, 114 F. Supp. 3d at 1320-21; *Gray Financial Group v. SEC*, No. 1:15-CV-0492-LMM, 2015 U.S. Dist. LEXIS 131792, at *46-*51 (N.D. Ga. Aug. 4, 2015), *vacated*, 825 F.3d 1236 (11th Cir. 2016).

90. *Freytag v. Comm'r*, 501 U.S. 868, 881-82 (1991).

91. *Hill*, 114 F. Supp. 3d at 1317; *Ironridge Global IV*, 146 F. Supp. 3d at 1313; *Duka*, 124 F. Supp. 3d at 289.

92. *Hill*, 114 F. Supp. 3d at 1318.

93. *Id.*

of 1940 and the rule against misleading advertising.⁹⁴ In accordance with the statutory review scheme provided for in § 78y, Lucia waited for the full Commission to rule against him and appealed the decision to the D.C. Circuit, arguing that the ALJ who heard the enforcement action was unconstitutionally appointed.⁹⁵

The D.C. Circuit came to the opposite conclusion from the district courts that reached the merits and ruled in favor of the SEC.⁹⁶ Although the Commission acknowledged that the ALJ who heard Lucia's case was not appointed in accordance with the Appointments Clause, the D.C. Circuit held that Article II did not apply because the ALJ was a mere employee of the SEC, not an inferior officer.⁹⁷ Relying on *Landry*, the D.C. Circuit determined that the presence or absence of final decision-making power is "critical" to determining whether an appointee is an inferior officer, and its analysis "beg[an], and end[ed]," there.⁹⁸ Because an ALJ decision cannot "be deemed the action of the Commission" until the Commission issues a final order, the court held that SEC ALJs are mere employees, not inferior officers, and thus do not trigger the protections of Article II.⁹⁹

In December 2016, however, a second federal appellate court reviewed a fully ripe Appointments Clause challenge and came to the opposite conclusion. In *Bandimere v. SEC*, the United States Court of Appeals for the Tenth Circuit held that SEC ALJs are appointed in violation of the Appointments Clause, marking the first time that a federal appellate court has accepted an argument challenging the constitutionality of the SEC's ALJ appointment scheme and creating a significant circuit split.¹⁰⁰

The court in *Bandimere* utilized much of the same reasoning that the district courts used in preliminarily enjoining the SEC from pursuing cases administratively. Relying on *Freytag*, the court held that SEC ALJs are inferior officers under the Appointments Clause because the office of the SEC ALJ is established by law, statutes set forth SEC ALJs' duties, salaries, and means of appointment, and SEC ALJs exercise "significant discretion" in performing the same types of "important functions" as the

94. *Lucia v. SEC*, No. 15-1345, 2016 U.S. App. LEXIS 14559, at *2 (D.C. Cir. Aug. 9, 2016).

95. *Id.*

96. *Id.* at *44.

97. *Id.* at *9, *19-*25.

98. *Id.* at *12-*14.

99. 15 U.S.C. § 78d-1(c); *id.* at *19-*25.

100. *Bandimere v. SEC*, No. 15-9586, slip op. at 22 (10th Cir. Dec. 27, 2016).

special trial judges did in *Freytag*.¹⁰¹ The court rejected the SEC's argument and the D.C. Circuit's holding in *Lucia* that ALJs' lack of final decision-making power is dispositive.¹⁰² According to the court, "[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. *Freytag*'s holding undermines that contention. In short, the [Supreme] Court did not make final decision-making power the essence of inferior officer status."¹⁰³ Because ALJs are inferior officers subject to the Appointments Clause and the SEC ALJ at issue held his office unconstitutionally when he presided over Bandimere's hearing, the Tenth Circuit set aside the SEC's opinion imposing liability on Bandimere.¹⁰⁴

The Tenth Circuit's argument better comports with Supreme Court precedent, and courts confronted with an Appointments Clause challenge should hold that SEC ALJs are inferior officers. ALJs wield significant authority and exercise significant discretion pursuant to the laws of the United States, even if they cannot issue final orders. The office of the ALJ is established by law, and ALJs' duties, salaries, and means of appointment are specified by statute. ALJs are permanent employees who have the power to take testimony, conduct trials, rule on the admissibility of evidence, and enforce compliance with discovery orders.¹⁰⁵ They also have authority to issue initial decisions that declare respondents liable and impose sanctions,¹⁰⁶ and to enter default judgments and steer the outcome of proceedings by requiring attendance at settlement conferences.¹⁰⁷ As the Tenth Circuit noted in *Bandimere*, nothing in *Freytag* indicates that the ability to issue a final order is a necessary condition for an official to be considered an inferior officer.¹⁰⁸ Indeed, as the *Landry* concurrence noted, the *Landry* majority's holding was based on an alternative holding from *Freytag*, since the Supreme Court had already determined that special trial

101. *Id.*, slip op. at 17-19. As the Tenth Circuit pointed out, its holding serves the purposes of the Appointments Clause. "The current ALJ hiring process whereby the OPM screens applicants, proposes three finalists to the SEC, and then leaves it to somebody at the agency to pick one, is a diffuse process that does not lend itself to the accountability that the Appointments Clause was written to secure. In other words, it is unclear where the appointment buck stops." *Id.*, slip op. at 23.

102. *Id.*, slip op. at 28.

103. *Id.* (emphasis in original).

104. *Id.*, slip op. at 37.

105. 5 C.F.R. § 930.204; 17 C.F.R. §§ 200.14, 201.180.

106. 17 C.F.R. §§ 200.14(a)(8), 200.30-9(a), 201.360.

107. 17 C.F.R. §§ 201.155, 201.111(e).

108. *Bandimere*, slip op. at 27.

judges were inferior officers before it analyzed the final order authority issue.¹⁰⁹ The special trial judges' limited authority to issue a final order was only an additional reason, not *the* reason, that the Supreme Court held that Tax Court special trial judges are inferior officers.¹¹⁰ Therefore, the presence or absence of final decision-making authority should not be dispositive.

Even if SEC ALJs cannot issue final orders, the significant authority and discretion bestowed upon them should be sufficient for them to be considered inferior officers. Much like the "district court clerk," "thousands of clerks in the Departments of Treasury [and the] Interior," the "assistant surgeon," "cadet-engineer," "election monitors," "federal marshals," "military judges," "judges in Article I courts," and "the general counsel of the Department of Transportation," all of which the Supreme Court has held are inferior officers,¹¹¹ SEC ALJs should be considered inferior officers and trigger Article II protections.

Once a court determines that ALJs are inferior officers, the Appointments Clause violation is apparent. SEC ALJs are not appointed by the President, the courts of law, or the SEC Commissioners, as is required by Article II, but are instead hired by the SEC's Office of Administrative Law Judges, with input from the Chief Administrative Law Judge, human resource functions, and the Office of Personnel Management.¹¹² Indeed, the SEC itself admitted in *Lucia* that its ALJs are not appointed in accordance with the Appointments Clause.¹¹³ Accordingly, reviewing courts should find the ALJ appointment scheme to be unconstitutional.

C. *Consequences of a Finding of Unconstitutionality*

A Supreme Court determination that the SEC's ALJ appointment process is unconstitutional would affect not only the SEC, but also all 31 other federal administrative agencies, which together appoint more than 1,300 ALJs.¹¹⁴ The Commodities and Futures Trading Commission, for

109. Landry v. FDIC, 204 F.3d 1125, 1142 (D.C. Cir. 2000) (Randolph, J., concurring).

110. *Id.*

111. Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 561 U.S. 477, 540 (2010) (Breyer, J., dissenting).

112. 5 C.F.R. § 930.204; 17 C.F.R. § 200.14

113. Lucia v. SEC, No. 15-1345, 2016 U.S. App. LEXIS 14559, at *9 (D.C. Cir. Aug. 9, 2016).

114. Peter J. Henning, *S.E.C. Faces Challenges Over the Constitutionality of Some of Its Court Proceedings*, N.Y. TIMES (Jan. 27, 2015, 8:58 AM), http://dealbook.nytimes.com/2015/01/27/s-e-c-faces-challenges-over-the-constitutionality-of-some-of-its-court-proceedings/?_r=0 [https://perma.cc/V4UH-ZKQK].

example, uses ALJs in much the same manner as the SEC does and CFTC ALJs have nearly equivalent powers as do SEC ALJs.¹¹⁵ The CFTC's administrative practice is relatively new, and it does not yet appear to have been challenged in federal court. However, former CFTC Chairman William T. Bagley characterized the administrative scheme in which "the Commission itself is a rule maker, policeman, grand jury, prosecutor, judge and jury with de novo powers in the same case at virtually the same time" as "undue process."¹¹⁶

The Federal Trade Commission, which also employs ALJs, has taken a different path in response to constitutional challenges brought under the Appointments Clause. On September 14, 2015, the FTC denied a respondent's motion to dismiss an FTC administrative proceeding, holding that, under *Landry*, its ALJs are not inferior officers because their initial decisions are reviewed by the FTC Commissioners before becoming final.¹¹⁷ Nevertheless, the FTC Commissioners ratified the ALJ's appointment to "put[] to rest any possible claim that this administrative proceeding violates the Appointments Clause."¹¹⁸

While an appellate ruling that the ALJ appointment process is unconstitutional would create problems for the SEC, such a ruling would not be fatal. Final administrative decisions would not be subject to attack because even when an adjudicator lacks the power to decide a case, the presumption in favor of finality means that once a judgment has become final, the issue cannot be raised collaterally.¹¹⁹ Administrative proceedings

115. Indeed, many CFTC ALJs may actually be SEC ALJs themselves. Since the CFTC's Director of Enforcement recently announced that the CFTC intends to start using administrative proceedings for enforcement cases after a number of years in which it never did so, the CFTC has been "borrowing" ALJs from other areas of the government. Jean Eaglesham, *CFTC Turns Toward Administrative Judges*, WALL ST. J., Nov. 9, 2014, <http://www.wsj.com/articles/cftc-turns-toward-administrative-judges-1415573398> [<https://perma.cc/5XC8-Y453>]. Much like SEC administrative proceedings, CFTC administrative proceedings may be more challenging for respondents than federal court proceedings because of the lack of depositions and the limits on third party discovery. 17 C.F.R. § 10.42-44. Compare 17 C.F.R. § 10.8 (describing the functions and responsibilities of CFTC ALJs) with 17 C.F.R. § 200.14 (describing the functions and responsibilities of SEC ALJs).

116. Dan M. Berkovitz, *The Resurrection of CFTC Administrative Enforcement Proceedings: Efficient Justice or a Biased Forum?*, 35 No. 2 FUTURES & DERIVATIVES L. REP. 1 (2015), quoting William T. Bagley, *Introduction: A New Body of Law in an Era of Industry Growth*, 27 EMORY L.J. 849, 851 (1978).

117. In the Matter of LabMD, Inc., No. 9357, 2015 WL 5608167, at *1, *2 (F.T.C. Sept. 14, 2015).

118. *Id.* at *2.

119. Peter D. Hardy, Carolyn H. Kendall, & Abraham J. Rein, *The Appointment of SEC Administrative Law Judges: Constitutional Questions and Consequences for Enforcement Actions*, 47 SEC. REG. & L. REP. 1238 (BNA) (2015) (citing *Travelers Indem. Co. v. Bailey*,

that have already been brought but in which a decision is not yet final would likely be voided and vacated without prejudice, allowing the SEC to bring the action again at a later time in front of a properly appointed hearing officer.¹²⁰ A ruling that the ALJ appointment scheme is unconstitutional would likely be applied prospectively and stayed for a period to allow the agency to correct the constitutional violations, as the Supreme Court did when it declared the bankruptcy courts unconstitutional.¹²¹

III. COMMISSION RESPONSES

The SEC has responded to some of this criticism by adopting several proposed changes to its Rules of Practice and by promulgating guidance regarding the Enforcement Division's approach to forum selection in contested actions. In addition, evidence shows that the SEC may be easing its increased use of administrative proceedings.¹²² However, the SEC has refused to fix the Appointments Clause violation by having the full Commission ratify its ALJs' appointments.¹²³

557 U.S. 137, 154 (2009) (explaining the need for finality and noting that if the "law were otherwise, and courts could evaluate the jurisdiction that they may or may not have had to issue a final judgment, the rules of res judicata . . . would be entirely short circuited") (internal quotation marks omitted).

120. Hardy, Kendall, & Rein, *supra* note 119 (citing *United States v. L.A. Trucker Truck Lines*, 344 U.S. 33, 38 (1952) (holding that "a defect in the appointment of [an ALJ precursor] was, if properly raised, an irregularity which would invalidate a resulting order") (internal quotation marks omitted)).

121. *Northern Pacific Pipeline Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 87-88 (1982).

122. See Jean Eaglesham, *SEC Trims Use of In-House Judges*, WALL ST. J. (Oct. 11, 2015, 9:00 AM), <http://www.wsj.com/articles/sec-trims-use-of-in-house-judges-1444611604> [<https://perma.cc/D2MD-B6ME>] (noting that over July, August, and September of 2015, the SEC proceeded administratively in only four of its thirty-six contested cases). The SEC has also proceeded in federal court for all twenty people against whom it has brought contested insider-trading charges since *Hill. Id.*

123. See Letter from the U.S. Department of Justice, Civil Division, Federal Programs Branch to The Honorable Richard M. Berman regarding *Duka v. SEC*, No. 15-cv-357 (RMB) (June 15, 2015), <http://blogs.reuters.com/alison-frankel/files/2015/06/dukavsec-secanswtoberman.pdf> [<https://perma.cc/UWR3-EVM7>] ("The government believes that the Commission should not act precipitously to modify its ALJ scheme. This is particularly the case when the SEC has over 100 litigated proceedings at various stages of the administrative process and the ALJ scheme has been in use for seven decades and is grounded in a highly-regulated competitive service system that Congress created for the selection, hiring and appointment of ALJs in the Executive Branch.").

A. *Adopting Amendments to the Rules of Practice*

On September 9, 2015, the SEC issued a press release announcing proposed amendments to “modernize” its Rules of Practice.¹²⁴ Primarily, the proposed rules sought to address the short period of time a respondent has to prepare for an administrative hearing and the absence of any real opportunity for a respondent to take discovery.¹²⁵ The Commission adopted the proposed amendments on July 13, 2016.¹²⁶

First, the amendments extend the deadline by which an ALJ must issue an initial decision.¹²⁷ Specifically, the amended Rule 360 implements a change in the deadline for the initial ALJ decision from 300 days from the date of service of the OIP to as much as 120 days from the completion of post-hearing or other dispositive briefing.¹²⁸ The amended Rule also provides a four to ten month range of time in which the administrative hearing must begin, thus more than doubling the current amount of time in which respondents may prepare for a hearing.¹²⁹ Further, the amended Rule creates a procedure for extending the initial decision deadline by up to thirty days.¹³⁰

While the SEC’s attempt to give respondents more time to prepare for administrative hearings is a step in the right direction, the amended rule does not materially increase the amount of time respondents have to prepare a meaningful defense. While under the amended rule respondents have up to an additional six months to prepare for a hearing, even ten months is often insufficient to fully review the SEC’s investigative record and prepare for a hearing, especially in an age of electronic discovery where the investigative file can include millions of electronic documents and other communications.¹³¹ A more reasonable timeline, such as a

124. Press Release, U.S. Securities and Exchange Commission, SEC Proposes to Amend Rules Governing Administrative Proceedings, Release No. 2015-209 (Sept. 24, 2015), <http://www.sec.gov/news/pressrelease/2015-209.html> [<https://perma.cc/R7SL-TXN6>].

125. *Id.*

126. Press Release, U.S. Securities and Exchange Commission, SEC Adopts Amendments to Rules of Practice for Administrative Proceedings, Release No. 2016-142 (July 13, 2016), <https://www.sec.gov/news/pressrelease/2016-142.html> [<https://perma.cc/T6RQ-VFS9>].

127. U.S. Securities and Exchange Commission, Amendments to Commission’s Rules of Practice, Exchange Act Release No. 34-78319, Rule 360 (July 13, 2016), <https://www.sec.gov/rules/final/2016/34-78319.pdf> [<https://perma.cc/2UAA-BWUR>] [hereinafter Amended Rules].

128. 17 C.F.R. 201.360.

129. *Id.*

130. *Id.*

131. In *Chau*, *supra* note 75, the SEC’s investigative file was reportedly larger than the

minimum of one year, would give respondents a better ability to assess their cases at an earlier stage and may prompt earlier settlement discussions and more useful Wells submissions.¹³² At any rate, ALJs should be able to grant motions requesting extensions greater than thirty days for good cause.

Second, the amendments attempt to provide respondents with a greater opportunity to develop arguments and defenses during discovery. While the pre-amendment rules did not provide for depositions, the amended Rule 233 permits each side to take up to three depositions in a single-respondent administrative proceeding, or up to five depositions in an administrative proceeding involving multiple respondents.¹³³ The amended Rule also permits the ALJ to allow up to an additional two depositions upon a showing of compelling need and allows a party to ask the ALJ to subpoena documents in connection with a deposition.¹³⁴ The amended rules also adopt processes related to depositions that are similar to the Federal Rules of Civil Procedure.¹³⁵ Separately, the amended rules clarify that hearsay evidence should be excluded if it is unreliable, although hearsay evidence may still be admitted if it is relevant, material, and bears satisfactory indicia of reliability so that its use is fair.¹³⁶

While the amended rules allow each respondent to gather from witnesses a modest additional amount of information beyond what is contained in the SEC's file, the permitted number of depositions is insufficient to level the playing field, especially in multi-respondent cases in which respondents may have divergent interests and may wish to depose different witnesses. Even if the respondents' interests were perfectly aligned, the number of relevant witnesses is likely to be greater than five or seven, especially since the rules contain no separate provision for expert witnesses and fact and expert witnesses are treated alike. Since the Enforcement Division can interview an unlimited number of witnesses over a number of years, allowing respondents between three and seven depositions does not provide respondents with a significant procedural protection. Whatever the number of permitted depositions is, ALJs should be given discretion to allow a respondent to take more than two additional depositions for good cause.

entire printed Library of Congress. In re Harding Advisory and Wing F. Chau, Adm. Proc. File. No. 3-15574, at 2 (Jan. 24, 2014).

132. After the Commission sends a letter to an entity informing it that the Commission is planning to bring an enforcement action against it (a "Wells Notice"), the potential respondent may "submit a written statement to the Commission setting forth their interests and position with regard to the subject matter of the investigation." 17 C.F.R. § 202.5(c).

133. Amended Rules, Rule 233.

134. *Id.*

135. *Id.*

136. Amended Rules, Rule 320.

While clarifying that “unreliable” hearsay is inadmissible is a positive for respondents, the amended rules give no guidance as to what hearsay is reliable and what hearsay is unreliable. The Rules of Practice should adopt the Federal Rules of Evidence and its hearsay exceptions, at least in cases involving non-regulated entities, so that the SEC cannot forum shop to ensure that its preferred evidence is admissible. Overall, while the amendments to the Rules of Practice are a step in the right direction, respondents still have too little time to prepare for hearings, respondents still have too little opportunity to develop defenses through discovery and depositions, and the SEC may still rely on hearsay evidence.

B. *Issuing Guidance Regarding Forum Selection*

The Commission has also promulgated guidance laying out its approach to forum selection in contested actions, perhaps in an effort to prevent Equal Protection challenges.¹³⁷ While noting that there is “no rigid formula dictating the choice of forum,” the Commission will recommend the forum that “will best utilize the Commission’s limited resources to carry out its mission.”¹³⁸ The guidance lays out four relevant considerations. First, the Enforcement Division will consider the availability of desired claims, legal theories, and forms of relief in each forum.¹³⁹ Some actions can only be pursued administratively, such as where the Commission charges failure to supervise, while others, such as control person liability, must be brought in federal district court.¹⁴⁰ Likewise, only a federal district court can issue emergency relief, such as temporary restraining orders, asset freezes, and document preservation orders.¹⁴¹

137. *Gupta v. S.E.C.*, 796 F. Supp. 2d 503, 506-07 (S.D.N.Y. 2011), provides an example of when a decision to proceed administratively rather than in federal court may raise equal protection issues. In response to the infamous Raj Rajaratnam and Galleon Group insider-trading scheme, the SEC filed 28 of its 29 enforcement actions in the Southern District of New York, but initially pursued its case against former Goldman Sachs and Procter & Gamble board member Rajat Gupta administratively. *Id.* After Gupta filed a complaint in the Southern District of New York alleging that “the SEC’s unjustified decision to deprive Gupta, alone, of the opportunity to contest these allegations in federal court singles him out for uniquely unfavorable treatment in violation of the Equal Protection Clause of the Constitution,” the SEC dismissed the administrative proceeding and filed suit in federal district court. *Id.*

138. U.S. Securities and Exchange Commission, *Division of Enforcement Approach to Forum Selection in Contested Actions*, at 1, www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf [https://perma.cc/5VGL-P2WC].

139. *Id.*

140. *Id.*

141. *Id.*

Second, the Division will consider whether any charged party is a registered entity or an individual associated with a registered entity.¹⁴² Regulated entities have long been subject to administrative proceedings and ALJs may have expertise and experience in certain issues that frequently arise involving such entities, both of which favor bringing charges against regulated entities administratively.¹⁴³

Third, the Division will consider the cost-, resource-, and time-effectiveness of litigation in each forum.¹⁴⁴ Consideration of efficient and effective use of the Commission's limited resources weighs in favor of bringing cases administratively, where actions are heard more quickly, but the ability to seek relief against multiple diverse parties in a single proceeding weighs in favor of federal district court.¹⁴⁵ Efficiencies associated with motions for summary judgment weigh in favor of federal district court if the disputed issues can be decided at that stage, since motions for summary judgment in federal district court can address a broad range of issues while motions for summary disposition in administrative proceedings are much more limited.¹⁴⁶ However, the longer time frame and larger amount of available pretrial discovery in federal district court present a number of efficiency costs.¹⁴⁷

Finally, and most controversially, the Division will consider which forum leads to the most fair, consistent, and effective resolutions of securities law issues and matters.¹⁴⁸ Since ALJs and the Commission have extensive knowledge and experience concerning the federal securities laws and complex or technical securities industry practices and products, "if a contested matter is likely to raise unsettled and complex legal issues under the federal securities laws, or interpretation of the Commission's rules," the Commission will consider whether obtaining a Commission decision on those issues will "facilitate development of the law."¹⁴⁹ If state law or another specialized area of federal law is at issue, federal district court may be more appropriate.¹⁵⁰

While the guidance is helpful in attacking the perception that the Commission is simply taking its tougher cases to its ALJs, the guidelines put the Commission's own efficiency interests above all else and do not give weight to how a particular forum will affect the rights of a respondent.

142. *Id.* at 2.

143. *Id.*

144. *Id.*

145. *Id.*

146. *Id.* at 3.

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

The fourth consideration is by far the most significant. By seeking to bring more cases with complex and unsettled legal issues in-house, the Commission exacerbates the criticism voiced by Judge Rakoff and others that the Commission should expose novel applications of the securities law to de novo judicial review.¹⁵¹ The Commission's indication that it will "send[] the toughest cases to its own judges to develop the law as it prefers rather than using federal district judges, who may be less amenable to its arguments," takes on particular weight under *Chevron*.¹⁵² Given the considerable deference that SEC interpretations enjoy, the check that judicial review purportedly provides on the SEC may not be particularly meaningful.

Justice Scalia questioned whether the SEC's interpretations of the securities laws are actually owed such deference, especially when a violation can result in criminal prosecution in addition to civil charges.¹⁵³ According to Justice Scalia, federal appellate deference to the SEC's interpretations of statutory provisions to which criminal prohibitions are attached, such as Section 10(b) of the Securities Exchange Act of 1934, means that the SEC "can in effect create (and uncreate) new crimes at will, so long as they do not roam beyond ambiguities that the laws contain."¹⁵⁴ Essentially, the SEC's guidance suggests that the Commission should shape the law before it reaches a federal appeals court, at which point appellate judges should defer to the Commission's expertise in deciding what constitutes a violation.

Overall, the proposed guidance does not meaningfully constrain the scope of the Enforcement Division's discretion in seeking a particular venue, but rather affirms the Commission's view that forum selection is within its broad discretion without meaningful limitations.

CONCLUSION

One defense attorney has aptly summed up the perceived conflict of interest that arises when the SEC brings cases administratively:

The SEC makes the rules, interprets the rules, revises the rules without public notice and comment, reverses the rules on

151. See Rakoff, *supra* note 45 (noting the author's concern that the SEC may be becoming a "law unto itself").

152. Peter J. Henning, *Choosing the Battlefield in S.E.C. Cases*, N.Y. TIMES (May 11, 2015), http://www.nytimes.com/2015/05/12/business/dealbook/choosing-the-battlefield-in-sec-cases.html?_r=0 [https://perma.cc/6CEF-SLWY].

153. *Whitman v. United States*, 135 S. Ct. 352, 353 (2014) (mem.) (Scalia, J., joined by Thomas, J., concurring in denial of certiorari) ("[L]egislatures, not executive officers, define crimes.").

154. *Id.*

occasion, enforces the rules, and prosecutes alleged violators of the rules with its own attorneys. It hires and pays its own judges, has its own judges hear most of the cases based on their own rules of evidence and decides 90 percent of those cases in its favor. It hands out the punishments and penalties, and it hears all appeals of its judges' decisions. And all of this takes place before a federal court has any involvement in the process.¹⁵⁵

The SEC must act quickly to reverse this perception. The simple fix to the Appointments Clause issue is for the SEC to reappoint its existing ALJs using a constitutionally appropriate procedure, such as direct appointment by the Commissioners. However, the SEC has not undertaken this fix, and it will likely continue to resist doing so either because it does not want to concede a point to the defense bar or because its Commissioners cannot agree on the necessity of doing so. In the alternative, the SEC could induce potential respondents to waive the constitutional issue before commencing new proceedings, but that strategy would likely cost the Commission at the bargaining table.

While five federal circuit courts of appeals have now ruled in favor of the SEC on the jurisdictional issue, the circuits are evenly split on the merits of the Appointments Clause question. Respondents seeking to challenge the constitutionality of the SEC ALJ appointment procedure should first pursue their claims through to the conclusion of the administrative process before raising the issue in federal court. However, once the administrative process is complete, respondents turning to a non-D.C. Circuit federal court of appeals should find success. Over the next several years, as enforcement actions wind through the administrative process and subsequent appeals properly reach the federal appellate courts, there is a strong likelihood that several appellate courts will side with the Tenth Circuit and recognize that SEC ALJs are inferior officers who trigger the protections of Article II. While the Supreme Court denied certiorari in *Bebo*, it may choose to have the last word on the matter now that a circuit split has developed.

Even if it ameliorates the Appointments Clause issue, the SEC must still take concrete steps to restore public trust. First, the SEC should reverse its policy of bringing cases involving complex facts or novel legal issues administratively. Such a step would assuage the concern that the Commission is bringing difficult cases in-house to increase its chance to win or to ensure that the securities laws are developed in its favor. Second, the SEC should publish *concrete* guidance relating to its forum decisions, which would allow potential respondents to advocate more effectively in

155. Steve Howard, *Perez v. Mortgage Bankers Association and its Implications for the SEC*, 21 No. 20 WESTLAW J. DERIVATIVES 1, 7 (2015).

the Wells process for selection of one forum or the other. The Commission could also move away from its new policy of requiring certain respondents to admit wrongdoing, rather than allowing them to settle while neither admitting nor denying wrongdoing, which would lessen the sting of administrative proceedings for some respondents.¹⁵⁶

Since Congress created the administrative scheme, it may need to provide the remedy by legislation either significantly curtailing the SEC's discretion in choosing a forum or increasing the procedural protections available to administrative respondents. Federal judges should also force the SEC's hand, at least regarding the Article II issue, by holding that the appointments of SEC ALJs must comply with the United States Constitution. However change is instituted, it must take place soon to protect both the SEC's legitimacy and the rights of individuals and entities accused of wrongdoing.

156. See Mary Jo White, Chair, U.S. Securities and Exchange Commission, Remarks at the Council of Institutional Investors Fall Conference in Chicago, IL: Deploying the Full Enforcement Arsenal (Sept. 26, 2013), <http://www.sec.gov/News/Speech/Detail/Speech/1370539841202> [<https://perma.cc/T8NW-78HF>] (explaining that no-admit-no-deny policies lead to a higher likelihood of settling, which in turn will “eliminate all litigation risk, resolve the case, return money to victims more quickly, and preserve our enforcement resources”).

