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## Reforming SEC ALJ Proceedings

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## REFORMING SEC ALJ PROCEEDINGS

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Joanna Howard\*

*This Note considers the current constitutional challenges to SEC administrative proceedings and suggests process reforms to enhance fairness for respondents. Challenges have developed since the Dodd-Frank Act expanded the SEC's ability to use administrative proceedings. Arguments that there is a pre-existing flaw in the method of appointing administrative law judges provide the most potential for success. The Tenth Circuit's December 2016 decision against the SEC in *Bandimere* has created a split, diverging from the D.C. Circuit's analysis of that question in *Lucia*.<sup>1</sup> Resolution by the Supreme Court may be inevitable. Even if the challengers do ultimately succeed, this will not improve substantially the fairness or efficiency of the process. The SEC's recent rule changes consist of only limited reform of its rules of practice governing administrative proceedings. This Note suggests addressing fairness and efficiency issues directly, by reforming the SEC's criteria for selecting cases to pursue in front of its administrative law judges, introducing a right of removal where the SEC alleges fraud, and establishing an affirmative obligation to ensure that the SEC identifies material and potentially undermining evidence to respondents.*

### TABLE OF CONTENTS

INTRODUCTION .....	796
I. CONSTITUTIONAL CHALLENGES TO SEC ALJs .....	799
A. <i>Jurisdictional issues</i> .....	799
B. <i>Inferior officers</i> .....	803
C. <i>Removals</i> .....	811
D. <i>Appointments</i> .....	813
II. PROCESS REFORM .....	816
A. <i>Developing the law</i> .....	816
B. <i>Right of removal for fraud</i> .....	821
C. <i>Disclosure obligations</i> .....	826

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\* J.D. Candidate, 2017, University of Michigan Law School, and former lawyer in the Enforcement Division of the UK Financial Conduct Authority. Although my prior experience conducting investigations did involve close cooperation with the SEC and other U.S. authorities, it is my personal view of the investigation process in general that informs my suggestions for SEC reform in Part II. With thanks to Professor Adam C. Pritchard, Professor William J. Novak, and the editors of the Michigan Journal of Law Reform for advice and assistance in the preparation of this Note.

1. *Bandimere v. SEC*, 844 F.3d 1168 (10th Cir. 2016); *Raymond J. Lucia Cos. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016). On February 16, 2017, the D.C. Circuit ordered rehearing en banc in *Lucia*. Order Granting Rehearing En Banc, 832 F.3d 277. As this Note went to print, the SEC had been granted an extension of time to file a petition for rehearing in *Bandimere*, but no petition had yet been filed. Order Granting Extension of Time, 844 F.3d 1168.

III. CONCLUSION .....	829
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### INTRODUCTION

The SEC faces a number of challenges to its use of Administrative Law Judges (SEC ALJs), which it has relied on increasingly since the Dodd-Frank Act (DFA) expanded the SEC's ability to use administrative proceedings.<sup>2</sup> These challenges have ranged from equal protection claims in specific cases to arguments that the whole SEC ALJ scheme is unconstitutional. The greatest focus has been on arguments predicated on the contention that SEC ALJs are "inferior officers."<sup>3</sup> These arguments are two-fold: first, following the Supreme Court's decision in *Free Enterprise Fund v. PCAOB*,<sup>4</sup> ALJs, as inferior officers, should not be insulated by more than one layer of tenure protection. Second, and more convincingly, the appointments process violates Article II—as inferior officers, SEC ALJs should only be appointed by the President, the Courts, or a Head of Department (*i.e.* the SEC Commissioners); this is not currently the case.<sup>5</sup>

It has been a long road for the challengers, some of whom commenced their constitutional claims during SEC ALJ proceedings, making interlocutory applications to the district courts. The challengers achieved some early success. In *Hill* and *Duka*, district courts in the Northern District of Georgia and Southern District of New York issued preliminary injunctions temporarily halting the SEC's administrative proceedings, finding sufficient likelihood of success on the merits of the argument that the process for hiring ALJs at the SEC violated the Appointments Clause.<sup>6</sup> But other challenges were defeated by a jurisdictional hurdle. Certain district courts, citing a lack of subject-matter jurisdiction, declined to opine on the merits of the constitutional claims. Those courts found that the statutory regime correctly designates the courts of appeal as the appropriate level of review, but only after the conclusion of the ALJ proceedings and review by the SEC.<sup>7</sup>

2. See Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 929P(a), 124 Stat. 1376, 1862-64 (2010) (codified at 15 U.S.C. § 780).

3. See *infra* Part I.B.

4. 561 U.S. 477.

5. See, e.g., *Hill v. SEC*, 114 F. Supp. 3d 1297, 1304-05 (N.D. Ga. 2015), *vacated*, 825 F.3d 1236 (11th Cir. 2016). SEC ALJs are appointed internally by the SEC's Office of Administrative Law Judges. See *infra* note 125 and accompanying text.

6. *Hill*, 114 F. Supp. 3d at 1320-21; *Duka v. SEC*, 103 F. Supp. 3d 382, 385 (S.D.N.Y. 2015).

7. See, e.g., *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015).

The district court cases have been circulating for some time. Appeals from interlocutory applications on the jurisdictional issue were rejected by the courts of appeal in four circuits.<sup>8</sup> As of yet, the Supreme Court has not accepted a petition for certiorari from this strand of the attack,<sup>9</sup> and it is unlikely these appeals will result in an opinion on the merits of the constitutional claims. But this is not the only route of challenge. The same constitutional arguments are also being raised in cases progressing through the statutory regime—through ALJ proceedings, consideration by the SEC Commissioners, and then on appeal to the federal circuit courts. The D.C. Circuit has already rejected one such case.<sup>10</sup> The Tenth Circuit, however, recently held that an SEC ALJ was unconstitutionally appointed, creating a circuit split ripe for resolution by the Supreme Court.<sup>11</sup>

Concerns about the SEC's processes not addressed by resolution of these constitutional issues still remain. If the appointments argument does succeed at the Supreme Court, or if the SEC decides to amend the appointments process such that it is squarely within constitutional limits,<sup>12</sup> this would neither solve the whole problem nor prevent further challenges. Issues have been raised relating to the fairness of the administrative process<sup>13</sup> and potential bias of ALJs.<sup>14</sup> These issues are separate from the constitutional challenges relating to the appointments and removals process.

The choice of using the administrative process rather than bringing a case in district court is a decision for the SEC alone, and the use of the administrative process is seen as favoring the SEC.<sup>15</sup> This gives rise to an impression of bias.<sup>16</sup> Critics argue the process unfairly favors the SEC, which has control over the timescales during

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8. Decisions have been issued by appeals courts in *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015); *Jarkesy v. SEC*, 803 F.3d 9 (D.C. Cir. 2015); *Tilton v. SEC*, 824 F.3d 276 (2d Cir. 2016); and *Hill v. SEC*, 825 F.3d 1236 (11th Cir. 2016).

9. The Supreme Court has denied petitions for writs of certiorari from *Bebo* and *Gordon Brent Pierce*. *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015), *cert. denied*, 136 S. Ct. 1500 (2016); *Pierce v. SEC*, 786 F.3d 1027 (D.C. Cir. 2015), *cert. denied*, 136 S. Ct. 1713 (2016).

10. *Raymond J. Lucia Cos. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016).

11. *Bandimere v. SEC*, 844 F.3d 1168 (10th Cir. 2016).

12. Some, however, have suggested this would not be solution enough. *See, e.g., Kent Barnett, Resolving the ALJ Quandary*, 66 VAND. L. REV. 797, 801 (2013).

13. Alan Lieberman, *Major Developments in SEC Enforcement*, in *NEW DEVELOPMENTS IN SECURITIES LITIGATION*, (2015 ed.), 2015 WL 2407608, at \*3 (describing problematic aspects of the procedures “that reward trial by ambush”).

14. *See, e.g., Duka v. SEC*, 2015 U.S. Dist. LEXIS 124444, at \*20–22 (S.D.N.Y. Sept. 17, 2015).

15. *See infra* note 145. *See also* Jean Eaglesham, *SEC Wins With In-House Judges*, WALL STREET J. (May 6, 2015), <http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803>.

16. *See, e.g., Eaglesham, supra* note 15.

the investigation phase and ample means to gather evidence through the use of subpoenas, while respondents in the administrative process are time pressured and have limited discovery tools to assist with responding to the SEC's case.<sup>17</sup> Critics also claim that unfairness follows from the lack of an independent arbiter: the decision to commence an investigation, the conduct of the investigation, the choice of forum, the decision of the ALJ and review by the Commission, are all matters internal to the SEC.<sup>18</sup> Judicial review is then available in the circuit courts, but the courts employ a deferential standard.<sup>19</sup>

The SEC has reviewed its procedures to some extent, but further changes could be made to improve the fairness of proceedings and to ensure that a consistent policy is applied when the SEC determines whether to use its administrative procedures rather than filing in federal court. The SEC amended its rules of practice governing administrative proceedings in July 2016, but these changes were limited.<sup>20</sup> Although respondents have been given longer to prepare and greater ability to take depositions in complex cases,<sup>21</sup> this does not fundamentally alter the balance. Critics compare the due process protection in the amended rules of practice with the safeguards available in federal court, and still find the ALJ process wanting.<sup>22</sup>

Part I of this Note sets out the background to the SEC ALJ challenges and the main arguments raised to date. Part I also assesses in more detail the inferior officer arguments, which gained the most traction while the cases were percolating through the lower courts. Part I concludes that the Appointments Clause argument should succeed, as the Tenth Circuit held in *Bandimere*.<sup>23</sup> Part II suggests specific reforms to improve the fairness and efficiency of the SEC's

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17. See, e.g., Letter from David M. Zornow, Christopher J. Gunther & Chad E. Silverman, Comment Letter on Proposed Rule: Amendments to the Commission's Rules of Practice 3 (Dec. 4, 2015), <https://www.sec.gov/comments/s7-18-15/s71815-6.pdf>.

18. See *id.*

19. See *Raymond J. Lucia Cos. v. SEC*, 832 F. 3d 277, 289–90 (D.C. Cir. 2016) (explaining that the question for the court is whether there was substantial evidence to support the SEC's determination, requiring only "such relevant evidence as a reasonable mind might accept as adequate to support a conclusion," and allowing the SEC's conclusions "to be set aside only if arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law" (internal citations omitted)).

20. Amendments to the Commission's Rules of Practice, 81 Fed. Reg. 50, 212 (July 29, 2016) (to be codified at 17 C.F.R. § 201).

21. Press Release, SEC, SEC Adopts Amendments to Rules of Practice for Administrative Proceedings (July 13, 2016), <https://www.sec.gov/news/pressrelease/2016-142.html>.

22. See Margaret A. Dale & Mark D. Harris, *SEC Adopts Amendments to Rules for Administrative Proceedings*, 256 N.Y. L.J., Issue 28 Aug. 10, 2016, at 3.

23. *Bandimere v. SEC*, 844 F.3d 1168, 1170 (10th Cir. 2016).

administrative process, which may have the added benefit for the SEC of heading off criticism of its use of ALJs.

## I. CONSTITUTIONAL CHALLENGES TO SEC ALJs

### A. *Jurisdictional issues*

This Part sets out the background to the SEC ALJ challenges, including the reasons why these challenges have emerged in recent times, the arguments raised, and the jurisdictional hurdles that have delayed judicial consideration of the merits. This Part goes on to consider in more detail the arguments that have gained the most traction—challenges based on the contention that SEC ALJs are “inferior officers,” are impermissibly protected from removal, and/or are unconstitutionally appointed.

The SEC’s authority to use administrative proceedings was expanded by the Dodd-Frank Act (DFA), which enabled the SEC to impose penalties on non-regulated persons or entities without resorting to the federal district courts.<sup>24</sup> Prior to the DFA’s enactment, the SEC could only use the administrative procedure for imposing penalties on regulated persons (those registered with the SEC).<sup>25</sup> This development has been the catalyst for a number of challenges to the use of SEC ALJs, based on a range of constitutional issues which relate to the method of delegation of decision-making authority, political accountability for ALJ decisions, and fairness and due process concerns largely focused on the SEC’s discretion to choose the ALJ process over proceeding in district court.

Challengers have argued that:

- Congress’s delegation of authority to the SEC to use its administrative proceedings violates the delegation doctrine under Article I of the Constitution;<sup>26</sup>
- the SEC’s administrative proceedings violate Article II of the Constitution, as the ALJs are inferior officers under Article

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24. See Pub. L. No. 111-203, § 929P(a), 124 Stat. 1376, 1862-64 (2010); see also *Duka v. SEC*, 103 F. Supp. 3d 382, 386 (S.D.N.Y. 2015); see also *Hill v. SEC*, 114 F. Supp. 3d 1297, 1301-02 (N.D. Ga. 2015).

25. *Hill*, 114 F. Supp. 3d at 1302 (“[T]he earlier version of the statute allowed the SEC to pursue unregistered individuals like Plaintiff for civil penalties only in federal court where these individuals could invoke their Seventh Amendment right to jury trial.”).

26. *Id.* at 1305.

II and are protected from removal by two layers of tenure protection;<sup>27</sup>

- the method used by the SEC to appoint its ALJs is in violation of the Appointments Clause of Article II of the Constitution, again because the ALJs are inferior officers;<sup>28</sup>
- the use of ALJs by the SEC violates the Seventh Amendment, as the SEC has the sole discretion to determine whether a subject of enforcement proceedings will be entitled to a jury trial;<sup>29</sup> and
- the SEC's use of ALJs violates equal protection or due process rights.<sup>30</sup>

These arguments have been raised in the federal district courts prior to the completion of the SEC's administrative proceedings on an interlocutory basis.<sup>31</sup> A number of these challenges, however, have been dismissed for lack of subject-matter jurisdiction by the federal courts. As summarized by the Seventh Circuit Court of Appeals in *Bebo*, the relevant jurisdictional question is whether Congress intended to provide an exclusive statutory review scheme. In relation to an SEC ALJ's decision, this involves appeal from a final order of the Commission to the relevant circuit court.<sup>32</sup> In *Free Enterprise*, the Supreme Court decided the review scheme set out in the Securities and Exchange Act was not intended to be exclusive in all cases and applied a three-factor analysis. The Court explained that "it would not presume that Congress intended to strip district courts of jurisdiction where (1) a finding of preclusion could foreclose all meaningful judicial review, (2) the suit was wholly

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27. *Bebo v. SEC*, 799 F.3d 765, 768 (7th Cir. 2015); *Hill*, 114 F. Supp. 3d at 1304; *Duka*, 103 F. Supp. 3d at 388; *Tilton v. SEC*, 15-CV-2472 (RA), 2015 U.S. Dist. LEXIS 85015, at \*5–6 (S.D.N.Y. June 30, 2015).

28. *Hill*, 114 F. Supp. 3d at 1305; *Duka v. SEC*, 15 Civ. 357 (RMB) (SN), 2015 U.S. Dist. LEXIS 100999, at \*2, (S.D.N.Y. Aug. 3, 2015); *Tilton*, 2015 U.S. Dist. LEXIS 85015, at \*5.

29. *See, e.g., Hill*, 114 F. Supp. at 1304–05.

30. *Gupta v. SEC*, 796 F. Supp. 2d 503, 506 (S.D.N.Y. 2011); *Bebo*, 799 F.3d at 768; *Chau v. SEC*, 72 F. Supp. 3d 417, 420 (S.D.N.Y. 2014); *Jarkesy v. SEC*, 48 F. Supp. 3d 32, 35 (D.D.C. 2014).

31. Constitutional challenges may also reach the circuit courts on petition for review from orders of ALJs and the SEC pursuant to the statutory review scheme. *See, e.g., Raymond J. Lucia Cos. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016).

32. *Bebo*, 799 F.3d at 768–69. The relevant circuit court is either the D.C. Circuit or the Court of Appeals for the circuit in which he resides or has his principal place of business. 15 U.S.C. § 78(y) (2012).

collateral to a statute's review provisions, and (3) the plaintiffs' claims were outside the agency's expertise."<sup>33</sup>

Bebo argued the application of this test in *Free Enterprise* supported her position that the federal district court could hear broad constitutional attacks.<sup>34</sup> The Seventh Circuit rejected Bebo's arguments on the basis that the Supreme Court's further guidance in *Elgin v. Dep't of Treasury*<sup>35</sup> provided a narrower reading of the standard. Specifically with regard to the first and third *Free Enterprise* factors, the existence of a facial constitutional challenge did not on its own lead to the conclusion that the district courts had jurisdiction. Nor was the court persuaded by the inability of the SEC to hold §929P(a) of the DFA unconstitutional, or the possibility that the constitutional issues fell outside the agency's expertise.<sup>36</sup> Meaningful judicial review in the circuit courts was not precluded by the fact-finding capacities of the ALJs or SEC, even if fact-finding is more limited than in the district courts.<sup>37</sup> And the possibility that the constitutional claims might never be heard by an Article III court (if Bebo prevailed in the administrative proceeding) did not mean the statutory review scheme was inadequate.<sup>38</sup>

The Seventh Circuit did not determine the second *Free Enterprise* factor—whether Bebo's constitutional claims were wholly collateral to the statutory review scheme—and there is a lack of consistency in how courts have answered this question.<sup>39</sup> But the court did categorize the approaches of the various district courts involved in considering jurisdiction questions in challenges to SEC ALJs. The first approach it identified was based on the lack of connection between the merits of the constitutional claim and the allegations against the individual, which the court described as the relationship of claims approach and led to findings that the district courts had jurisdiction to hear the distinct constitutional claims in *Hill*, *Duka*, and *Gupta*. The second approach centered on whether the constitutional claims were merely brought as a vehicle to challenge the agency action during the proceeding, which the court described as the mechanism of review approach and led to the conclusion that subject-matter jurisdiction was lacking in both *Tilton* and in the

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33. *Bebo*, 799 F.3d at 769 (citing *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 489 (2010), which in turn cited *Thunder Basin Coal Co. v. Reich*, 510 U.S. 200, 212–13 (1994)).

34. *Bebo*, 799 F.3d at 770–71.

35. 132 S. Ct. 2126 (2012).

36. *Bebo*, 799 F.3d at 773.

37. *Id.*

38. *Id.*

39. *Id.* at 774.

lower court in *Bebo*.<sup>40</sup> The court considered that both approaches had support, but that this factor would not be determinative.<sup>41</sup>

Although the court did not determine whether the constitutional issue was wholly collateral, the court decided there was still fairly discernable Congressional intent that *Bebo* should proceed through the statutory scheme because it did provide meaningful judicial review.<sup>42</sup> The key difference between *Bebo*'s situation and that of the petitioner in *Free Enterprise* was that there was already an enforcement proceeding ongoing that would, if the outcome was unfavorable to *Bebo*, give rise to a right of appeal. This was not the exceptional case where a plaintiff had to risk a violation in order to obtain a right of review under the statutory scheme.<sup>43</sup> The court rejected *Bebo*'s counter-argument that being subjected to an unconstitutional proceeding itself precluded meaningful review. Relevant precedent indicated the expense and disruption of defending administrative proceedings did not entitle a plaintiff to pursue judicial review in the district courts.<sup>44</sup> Rather than opening the floodgates across administrative law claims, the court held district court review should only be available in exceptional cases.<sup>45</sup> The Seventh Circuit therefore affirmed the district court's judgment, dismissing the case for lack of subject-matter jurisdiction.

The Seventh Circuit's decision was soon followed by the D.C. Circuit Court's confirmation that the D.C. District Court lacked jurisdiction to hear a due process and equal protection challenge to the SEC's decision to use an ALJ in *Jarkesy*.<sup>46</sup> The Second Circuit also rejected jurisdiction in *Tilton*,<sup>47</sup> as did the Eleventh Circuit in *Hill*.<sup>48</sup>

The district courts had, however, accepted jurisdiction to hear challenges to SEC ALJs in three notable cases: *Hill* (in the Northern District of Georgia), *Duka*, and *Gupta* (both in the Southern District of New York). *Hill* and *Duka* were both able to obtain preliminary injunctions on the basis that there was sufficient likelihood that

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40. *Id.* at 773–74.

41. *Id.* at 774.

42. *Id.*

43. *Id.* *Bebo*'s case can be contrasted with the petitioners in *Free Enterprise*, who challenged the constitutionality of the Public Company Accounting Oversight Board prior to the completion of an investigation, see *Bebo*, 799 F.3d at 769, and to the case of *McNary v. Haitian Refugee Center, Inc.*, 498 U.S. 479 (1991), in which undocumented aliens could only obtain judicial review in a court of appeals by voluntarily surrendering themselves for deportation.

44. *Bebo*, 799 F.3d at 775.

45. *Id.*

46. *Jarkesy v. SEC*, 803 F.3d 9, 12 (D.C. Cir. 2015).

47. *Tilton v. SEC*, 824, F.3d 276, 279 (2d Cir. 2016).

48. *Hill v. SEC*, 825 F.3d 1236, 1237–38 (11th Cir. 2016).

their arguments—which stated that the SEC ALJs were inferior officers appointed in violation of Article II—would succeed. Gupta’s challenge, based on an equal protection argument, passed the motion to dismiss stage but did not progress further after the SEC moved its case to the district court.<sup>49</sup> Both strands raise important issues: (1) if the appointments argument is correct, it has broad consequences for the use of ALJs by the SEC and potentially other agencies; and (2) while the equal protection argument may be fact specific, it raises questions about the SEC’s policy in deciding whether to institute proceedings administratively or by filing in district court.

The challengers’ arguments have also been percolating through the statutory route of review. Circuit courts have now begun to consider the substance of the claims. The challengers’ ability to develop their arguments and react to counter-arguments during the earlier proceedings has been useful, and the issues have now been narrowed. This Part goes on to explain the arguments that have had the most traction to date, and to identify the issue most likely to be considered by the Supreme Court.

### B. *Inferior officers*

The Appointments Clause in Article II of the Constitution gives the President, with the advice and consent of the Senate, the authority to appoint certain named officers, and “all other Officers of the United States.”<sup>50</sup> Separately, the Excepting Clause gives Congress the authority to vest 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.”<sup>51</sup> Challengers to the SEC’s administrative proceedings characterize SEC ALJs as “inferior officers,” while the government maintains that ALJs exercise insufficient authority to be designated as such.<sup>52</sup> Challengers’ subsequent arguments regarding appointments and removals are contingent upon the “inferior officer” question—if SEC ALJs are “inferior officers,” then challengers can argue that their appointment must comport with Article II, and that any protection they have against being removed from office must not impede the President’s ability

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49. See SEC v. Gupta, 2013 U.S. Dist. LEXIS 102274, at \*1, 5 n.3 (July 17, 2013).

50. U.S. CONST. art. II.

51. *Id.*

52. See, e.g., Hill v. SEC, 114 F. Supp. 3d 1297, 1317–18 (N.D. Ga. 2015).

to perform his constitutional duty.<sup>53</sup> These subsequent questions raise issues relating to the delegation of authority to, and accountability over decision-making by, ALJs and the SEC.

SEC ALJs should be considered inferior officers for the purposes of Article II because this accords with existing Supreme Court precedent. Yet there is some debate on this issue, as reflected in two decisions involving challenges against judges whose roles had been created by statute. In *Freytag*, the Supreme Court held that a Special Trial Judge appointed by the Tax Court was an inferior officer, and in *Landry*, the D.C. Circuit Court of Appeals applied *Freytag* in determining that an ALJ used by the Federal Deposit Insurance Corporation (FDIC) was not.<sup>54</sup> The SEC's position is that *Landry* was correctly decided, and that the D.C. Circuit's reasoning should be extended to an analysis of the status of SEC ALJs, a view accepted by the D.C. Circuit, which is bound by *Landry*.<sup>55</sup> There is, however, another reading of *Freytag*. The concurrence in *Landry* explained that the majority had misunderstood the Supreme Court's reasoning in *Freytag*. On this reading, explained in more detail below, it appears clear that SEC ALJs are inferior officers.<sup>56</sup> Indeed, the Tenth Circuit adopted this approach in *Bandimere*.<sup>57</sup>

First, by way of background, it is important to understand the earlier cases in order to see the inconsistency that emerges. *Freytag* concerned a challenge by several petitioners whose tax arrangements had been reviewed by a Special Tax Judge (STJ), who concluded that a tax shelter scheme resulting in federal income tax deductions of approximately \$1.5 billion in losses had consisted of sham transactions.<sup>58</sup> The Court of Appeals for the Fifth Circuit affirmed.<sup>59</sup> On appeal, the Supreme Court held, as a preliminary issue, that the STJ, who had been appointed by the Chief Judge of the Tax Court, was an inferior officer.<sup>60</sup>

Congress had authorized the Tax Court to appoint STJs to assist by hearing certain specified proceedings (in which the STJs could hear, report, and rule on a case), and could also hear "any other proceeding which the chief judge may designate."<sup>61</sup> In this latter

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53. See *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 508 (2010); see also *Morrison v. Olson*, 487 U.S. 654, 691 (1988).

54. *Freytag v. Comm'r of Internal Revenue*, 501 U.S. 868, 882 (1991); *Landry v. FDIC*, 204 F.3d 1125, 1134 (D.C. Cir. 2000).

55. *Raymond J. Lucia Cos. v. SEC*, 832 F.3d 277, 284–89 (D.C. Cir. 2016).

56. See *Landry v. FDIC*, 204 F.3d 1125, 1142–43 (D.C. Cir. 2000).

57. *Bandimere v. SEC*, 844 F.3d 1168 (10th Cir. 2016).

58. *Freytag*, 501 U.S. at 871.

59. *Id.* at 872.

60. *Id.* at 882.

61. I.R.C. § 7443A(b)(4).

category—which had applied in the petitioners’ case—the STJ only had authority to hear the case and prepare proposed findings and an opinion.<sup>62</sup> In evaluating the claim, the Court’s starting point was the standard stated in *Buckley v. Valeo*, that “[a]ny appointee exercising significant authority pursuant to the laws of the United States is an ‘Officer of the United States’, and must, therefore, be appointed in the manner prescribed by § 2, cl. 2, of [Article II].”<sup>63</sup> More specifically, the Court noted prior decisions holding that STJs are “inferior officers,”<sup>64</sup> and agreed with those decisions on the basis that (1) the office of STJ was established by law, and that the duties, salary, and means of appointment were provided in the underlying statute, and therefore STJs could be contrasted with other more episodic appointments such as the role of special master; and (2) STJs exercise significant discretion by taking testimony, ruling on the admissibility of evidence, and enforcing discovery orders.<sup>65</sup>

In the alternative, even if the duties of the STJ were less significant, the Court would have relied on the authority of STJs to render the decisions of the Tax Court in specified proceedings. The proceedings at issue in *Freytag* fell under the category of “any other proceedings” designated by the Chief Judge, which meant the STJ only had authority to recommend rather than decide.<sup>66</sup> But in relation to the proceedings specified by statute in which STJs had decision-making authority, the Commissioner of Internal Revenue conceded the STJs were acting as inferior officers exercising independent authority. The Court did not divide the role of the STJs in two—STJs sitting in specified proceedings versus STJs sitting on a case designated by the Chief Judge—as suggested by the petitioners. If the STJs were inferior officers in relation to specified proceedings, they were inferior officers for all purposes.<sup>67</sup>

The Court in *Freytag* went on to determine that the STJs were validly appointed by the Chief Tax Judge because the Tax Court, although created under Article I rather than Article III, was a “court of law” for the purposes of the Appointments Clause.<sup>68</sup> The judgment of the Court rejected the petitioners’ contention that the

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62. § 7443A(c).

63. *Freytag*, 501 U.S. at 881 (internal citation omitted).

64. Including the Second Circuit’s decision in *Samuels, Kremer & Co. v. Comm’r of Internal Revenue*, 930 F.2d 975, 985 (2d Cir. 1991); *Freytag*, 501 U.S. at 881.

65. *Freytag*, 501 U.S. at 881.

66. *Freytag v. Comm’r of Internal Revenue*, 904 F.2d 1011, 1015 (5th Cir. 1990); *see Freytag*, 501 U.S. at 873.

67. *Freytag*, 501 U.S. at 881.

68. *Id.* at 891.

Tax Court was a department within the meaning of Article II, relying on the Court's definition of that term "for more than a century" as referring to "a part or division of the executive government, as the Department of State, or of the Treasury, expressly created and given the name of a department."<sup>69</sup> Justice Scalia (joined by Justices O'Connor, Kennedy, and Souter) concurred in the judgment, but disagreed on this point, finding that the Tax Court, as a free-standing, self-contained entity in the Executive Branch, was indeed a Department.<sup>70</sup>

The concurrence in *Freytag* reserved the right of the Court to determine that independent agencies, including the SEC, also had the status of a Department, even though it consists of a body "at the farthest remove from Cabinet status."<sup>71</sup> In reaching this conclusion, however, Justice Scalia relied on the notion that the STJs were exercising executive power, noting in passing that "[t]oday, the Federal Government has a corps of administrative law judges numbering more than 1,000, whose principal statutory function is the conduct of adjudication under the Administrative Procedure Act (APA). They are all executive officers."<sup>72</sup>

Nine years later, and despite the conclusions of the Supreme Court in *Freytag* (and the concurrence's comments), the D.C. Circuit Court of Appeals decided that an administrative law judge who had recommended a decision to the FDIC Board was not an inferior officer for the purposes of Article II's Appointments Clause.<sup>73</sup> *Landry* concerned a challenge to an ALJ's recommendation that led to an FDIC Board decision to remove Landry from his position at First Guaranty Bank and prohibit him from participation in the operations of a federally insured depository institution.<sup>74</sup> The main issue for review was Landry's argument that the ALJ had not been appointed in accordance with the Appointments Clause.<sup>75</sup> Landry argued that the ALJ was an inferior officer, but not appointed by the head of a "department."<sup>76</sup> The ALJ in question, appointed under the Federal Institutions Reform, Recovery, and Enforcement Act (FIRREA),<sup>77</sup> had been hired by the Office of Thrift Supervision

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69. *Id.* at 886 (internal citations omitted).

70. *Id.* at 915, 922.

71. *Id.* at 916.

72. *Id.* at 910 (internal citations omitted).

73. *Landry v. FDIC*, 204 F.3d 1125, 1134 (D.C. Cir. 2000).

74. *Id.* at 1128.

75. *Id.*

76. *Id.* at 1130.

77. *Id.*

and assigned to the case by the Office of Financial Institution Adjudication.<sup>78</sup> The FDIC initially opposed the Appointments Clause argument on the basis that the ALJ had been appointed by a department (conceding that the ALJ was an inferior officer). But the FDIC switched positions, waiving its defense that the ALJ had been appointed by a “department” without explanation, and thus the question became whether the ALJ was an inferior officer.<sup>79</sup>

The *Landry* court’s analysis began by conveying the lack of clarity around the definition of inferior officer. “The line between ‘mere’ employees and inferior officers is anything but bright.”<sup>80</sup> The court referred to the standard in *Buckley v. Valeo*: “[i]n attempting to clarify the inquiry, the Court has often said that ‘any appointee exercising significant authority pursuant to the laws of the United States is an ‘Officer of the United States.’”<sup>81</sup> The court further explained that the application of that standard requires assessment of the roles of others in the precedent.<sup>82</sup>

The *Landry* court selected *Freytag* as the most analogous case, although it distinguished the Supreme Court’s holding that the STJ was an inferior officer. First, the court drew a distinction between the STJ and ALJ in terms of the availability of review and deference given to their recommendations. The Tax Court was required to defer to the STJ’s factual findings unless clearly erroneous, whereas the ALJ’s findings were subject to de novo review.<sup>83</sup>

Second, of the three reasons relied on by the Court in *Freytag* (statutory basis for the office, significant discretion, and, in the alternative, authority to make a decision), the court in *Landry* selected the last as being the most important:

[T]he Court relied on authority of the STJs not matched by the ALJs here. In particular, the Court noted that STJs have the authority to render the final decision of the Tax Court in declaratory judgment proceedings and in certain small-amount tax cases. But the ALJs here can never render the decision of the FDIC.<sup>84</sup>

The court in *Landry* did agree that many of the features noted in *Freytag* were present—namely, the statutory basis for the office and

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78. *Id.* at 1143.

79. *Id.* at 1133 n.2, 1143.

80. *Id.* at 1132.

81. *Id.* at 1133 (internal citation omitted).

82. *Id.*

83. *Id.*

84. *Id.* at 1134 (internal citations omitted).

authority to exercise significant discretion.<sup>85</sup> And the court considered that the power to render a final decision played an “uncertain” role in the Supreme Court’s reasoning.<sup>86</sup> “[T]he Court introduced mention of the STJs power to render final decisions with something of a shrug.”<sup>87</sup> But the court went on to characterize the power to render a final decision as being critical to the holding in *Freytag*: “[n]onetheless, in another way the Court laid exceptional stress on the STJ’s final decision making power.”<sup>88</sup> The majority explained that the Court in *Freytag* had emphasized that the powers of the STJ proved beyond doubt that the STJ was an inferior officer—and those powers were not present in Landry’s case.

All this explanation [of decision making authority] would have been quite unnecessary if the purely recommendatory powers were fatal in themselves. Accordingly, we believe that the STJs’ power of final decision in certain classes of cases was critical to the Court’s decision. As the ALJs hired pursuant to §916 of FIRREA have no such powers, we conclude that they are not inferior officers.<sup>89</sup>

Judge Randolph’s concurrence in *Landry* explained the problem with the majority’s application of *Freytag*. Randolph rejected both attempts to distinguish *Freytag*. First, he noted that the level of deference argument was irrelevant, as this emanated from an internal rule of procedure, and that the rule had been irrelevant to the Supreme Court’s analysis in *Freytag*.<sup>90</sup> The fact that the ALJ’s work was subject to review did not mean they were not inferior officers. In support, Randolph cited a further Supreme Court case, *Edmond v. United States*, 520 US 651 (1997), in which the Court stated: “[w]e think it evident that ‘inferior officers’ are officers whose work is directed and supervised at some level by others who were appointed by Presidential nomination with the advice and consent of the Senate.”<sup>91</sup>

Second, the concurrence felt that the third reason given in support of the Court’s decision in *Freytag* (decision-making authority)

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85. *Id.* at 1133–34.

86. *Id.* at 1133.

87. *Id.* at 1134.

88. *Id.*

89. *Id.*

90. *Id.* at 1141–42.

91. *Id.* at 1142.

was clearly an alternative holding.<sup>92</sup> The Court in *Freytag* had already concluded the STJ was an inferior officer before reaching that reason. This interpretation was confirmed by the Supreme Court's approval of a Second Circuit decision which held that a special trial judge was an inferior officer without referring to decision-making authority as a relevant factor.<sup>93</sup> Randolph also compared the role of ALJs with magistrate judges, who have long been held to be inferior officers who have a recommendatory role.<sup>94</sup> The concurrence could not conclude the ALJ was properly appointed, as the FDIC had waived its argument in defense that the ALJ was appointed by a "department." Nevertheless, the concurrence concluded that there was no prejudice to Landry, as there had been a thorough review by the FDIC; any error was harmless.<sup>95</sup>

A close reading of these cases therefore reveals that *Landry* was wrongly decided. It is apparent, as Judge Randolph described, that the majority applied the Supreme Court's reasoning in *Freytag* incorrectly, minimizing the similarities between the ALJ and STJ, and thereby avoiding a finding that the ALJ was an inferior officer.

This has implications for the current challenges to the SEC ALJs, as courts have a sound basis to conclude that SEC ALJs are inferior officers. The Tenth Circuit took this approach in *Bandimere*, finding that *Freytag* controlled the result of the case.<sup>96</sup> The Court found the characteristics identified as relevant in *Freytag* were present with respect to the SEC ALJ<sup>97</sup>—the role was established by law in the Administrative Procedure Act, and there is a statutory basis for the SEC ALJ's duties, salaries, and means of appointment.<sup>98</sup> The court also concluded that the SEC ALJs exercised "significant discretion" in performing "important functions" commensurate with the STJs' functions described in *Freytag*.<sup>99</sup>

The dissent in *Bandimere* (and the D.C. Circuit, which reached the contrary result in *Lucia*), stressed that the nature of the SEC ALJs' discretion can be distinguished from *Freytag*, following the reasoning in *Landry*.<sup>100</sup> The Tenth Circuit's opinion rejects that position by analyzing the nature and extent of discretion found in the

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92. *Id.*

93. *Id.* (internal citation omitted).

94. *Id.* at 1143.

95. *Id.* at 1143–44.

96. *Bandimere v. SEC*, 844 F.3d 1168, 1174, 1178 (10th Cir. 2016).

97. *Id.* at 1179.

98. *Id.*

99. *Id.*

100. *Bandimere*, 844 F.3d at 1194–98 (McKay, J., dissenting).

ALJs' functions, rather than following the *Landry* court's approach.<sup>101</sup> The Tenth Circuit's opinion includes a catalogue of key actions within the ALJs' authority:

authority to shape the administrative record by taking testimony, regulating document production and depositions, ruling on the admissibility of evidence, ruling on dispositive and procedural motions, issuing subpoenas, and presiding over trial-like hearings. . . . [making] credibility findings to which the SEC affords "considerable weight" during agency review. . . . [issuing] initial decisions that declare respondents liable and impos[ing] sanctions. . . . enter[ing] default judgments, and otherwise steer[ing] the outcome of proceedings by holding and requiring attendance at settlement conferences. They also have authority to set aside, make permanent, limit, or suspend temporary sanctions that the SEC itself has imposed.<sup>102</sup>

The Tenth Circuit found it was not necessary for an inferior officer to have final decision-making power, even though it could be relevant to the analysis, noting that the Supreme Court "did not make final decision-making power the essence of inferior officer status. Nor do we."<sup>103</sup>

The D.C. Circuit has issued a contrary decision on the constitutionality of SEC ALJs consistent with *Landry*, in *Lucia*.<sup>104</sup> This creates a circuit split. However, the Tenth Circuit is not the only court to conclude that SEC ALJs are inferior officers. In *Hill* and *Duka*, the district courts also relied on *Freytag* to reach the same result.<sup>105</sup> Additionally, Judge Randolph of the D.C. Circuit, who did not sit on the panel in *Lucia*, subsequently reaffirmed the view he expressed in *Landry* in a separate case involving a challenge to a decision of the Consumer Financial Protection Bureau, opining that an ALJ hearing the case was an "inferior officer" and that this conclusion should have followed from *Freytag*.<sup>106</sup>

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101. Bandimere, 844 F.3d at 1179–82.

102. *Id.* at 1179–81.

103. *Id.* at 1184.

104. Raymond J. Lucia Cos. v. SEC, 832 F.3d 277, 284–89 (D.C. Cir. 2016).

105. *Hill* v. SEC, 114 F. Supp. 3d 1297, 1317–19 (N.D. Ga. 2015); *Duka* v. SEC, 15 Civ. 357 (RMB) (SN), 2015 U.S. Dist. LEXIS 100999, at \*17–18, (S.D.N.Y. Aug. 3, 2015).

106. *PHH Corp. v. CFPB*, 839 F.3d 1, 55–56 (D.C. Cir. 2016) (also noting that the ALJ had been assigned to the case by the SEC's Chief Administrative Law Judge, pursuant to an agreement between the CFPB and the SEC). The majority's main holding in *PHH Corp.* was that the structure of the CFPB is unconstitutional. This may make Supreme Court review of the case more likely. En banc rehearing is scheduled in both *PHH Corp.* and *Lucia* on May 24,

Further, the dissent in *Free Enterprise* concluded that the 1,584 ALJs it had identified in over 25 administrative agencies were inferior officers.<sup>107</sup> As Barnett notes, the dissenters in *Free Enterprise* plus the concurrence in *Freytag* considered that ALJs were “executive officers,” suggesting that half of the current Supreme Court would consider SEC ALJs to be inferior officers, if the current challenges reach that level of review.<sup>108</sup>

The addition of a ninth Justice to the Supreme Court could affect things significantly. At the time this Note went to print, Judge Gorsuch had been nominated and his confirmation hearing had been scheduled to begin on March 20, 2017.<sup>109</sup> His views on the SEC ALJ question are at this time unknown, but his discussion of the separation of powers and the administrative state in an unrelated decision issued last year indicates he may not be the most sympathetic towards the SEC’s arguments. In a concurrence that accompanied his own opinion, Judge Gorsuch commented at length on the founders’ design and what he saw as pressures created by judicial deference to agency interpretations.<sup>110</sup> It is this type of concern regarding separation of powers that feeds directly into the challengers’ arguments that SEC ALJs are unconstitutionally appointed, as explained further below.

### C. Removals

The challengers, based on the premise that SEC ALJs are inferior officers, initially argued that they are unconstitutionally protected from removal by the President. This argument attempted to track the reasoning in another Supreme Court decision, *Free Enterprise*.<sup>111</sup> In that case, the Supreme Court determined that the combination of removal protection over members of the Public Company Accounting Oversight Board contravened the Constitution’s

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2017, and the D.C. Circuit has requested that the parties in *PHH Corp.* brief them on how a decision that the ALJ in *Lucia* was an inferior officer would affect the outcome in *PHH*. Order Granting Rehearing En Banc, 839 F.3d 1; Order Granting Rehearing En Banc, 832 F.3d 277.

107. *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 542–43, 586 (2010).

108. Barnett, *supra* note 12, at 800 n.12 (citing the dissent in *Free Enterprise*—Breyer, J., joined by Stevens, J., Ginsburg, J. & Sotomayor, J.; and the concurrence in *Freytag*—Scalia J., joined by O’Connor, J., Kennedy, J. & Souter, J.).

109. Richard Pérez-Peña, Hearing for Neil Gorsuch, Supreme Court Nominee, Is Set for March, (Feb. 16, 2017), <https://www.nytimes.com/2017/02/16/us/politics/neil-gorsuch-supreme-court-senate-hearing.html>.

110. *Gutierrez-Brizuela v. Lynch*, 834 F.3d 1142, 1149–58 (10th Cir. 2016).

111. *Free Enter. Fund*, 561 U.S. at 477.

separation of powers.<sup>112</sup> Although the Court had previously upheld good cause tenure protections for inferior officers whose superiors were removable at will by the President,<sup>113</sup> the question of whether the combination of tenure protections at two levels was permissible under Article II was one of first impression.<sup>114</sup> The good cause removals protections withdrew “from the President any decision on whether that good cause exists . . . . The result is a Board that is not accountable to the President, and a President who is not responsible for the Board.”<sup>115</sup> The Court held the provisions prevented the President from ensuring that the laws were faithfully executed, and prevented him from being held responsible for a Board member’s breach of faith.<sup>116</sup>

Challengers have argued that the SEC ALJs are also subject to two layers of good cause protection and, following *Free Enterprise*, such protection is impermissible.<sup>117</sup> This argument was rejected by the district court in *Duka*<sup>118</sup> and doubted in *Hill*.<sup>119</sup> The court in *Duka* focused on the functional nature of the test in *Free Enterprise*. The court determined that *Free Enterprise* did not stand for as broad a proposition as *Duka* contended.<sup>120</sup> The question was whether the ALJs could be seen as infringing on the President’s executive authority and, as the role of the ALJ was adjudicatory in nature, the court was unconvinced the removal restrictions were unconstitutional; it therefore held that *Duka* had failed to establish a likelihood of success on the merits of her claim for a preliminary injunction.<sup>121</sup>

To the extent that there is uncertainty about the application of *Free Enterprise*, this is unlikely to affect the outcome of the SEC ALJ challenges, as the arguments based on the appointment of ALJs is more straightforward, given that SEC ALJs are not appointed in accordance with Article II.

Even if challengers were to succeed on the removals argument, a revised removals process would not be helpful to those subject to

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112. *Id.* at 485, 492 (members of the Board could only be removed on limited good cause grounds by the Commissioners, who in turn could only be removed by the President for “inefficiency, neglect of duty, or malfeasance in office”).

113. *Id.* at 493–94 (citing *United States v. Perkins*, 116 U.S. 483 (1886) and *Morrison v. Olson*, 487 U.S. 654 (1988)).

114. *Id.* at 495.

115. *Id.*

116. *Id.* at 496.

117. *See, e.g.*, *Duka v. SEC*, 103 F. Supp. 3d 382, 393 (S.D.N.Y. 2015).

118. *Id.*

119. *Hill v. SEC*, 114 F. Supp. 3d 1297, 1319 n.12 (N.D. Ga. 2015).

120. *Duka*, 103 F. Supp. 3d at 395–96.

121. *Id.*

SEC administrative proceedings in future. As the court in *Duka* noted, if the second layer of tenure protection were removed, this would undermine the ALJs' adjudicatory role by removing a provision that helped guarantee their independence. Without that protection, the ALJs would be more susceptible to influence from the parties or other officials within the agency.<sup>122</sup>

#### D. Appointments

The second argument following the assertion that SEC ALJs are inferior officers is that they are not appropriately appointed under Article II. This argument is straightforward and has had the most traction to date. It was on this basis that the Tenth Circuit decided in *Bandimere's* favor, and that the plaintiffs in *Duka* and *Hill* were successful in obtaining preliminary injunctions.<sup>123</sup>

Article II permits Congress to vest the appointment of inferior officers in "the President alone, in the Courts of Law, or in the Heads of Departments."<sup>124</sup> SEC ALJs, however, are appointed 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."<sup>125</sup> The Tenth Circuit summarized the process as follows: "the OPM screens applicants, proposes three finalists to the SEC, and then leaves it to somebody at the agency to pick one." Once a court accepts that SEC ALJs are inferior officers, it will therefore inevitably conclude that the appointments process violates Article II. The court in *Hill* was the first to reach this conclusion in June 2015.

That decision was followed swiftly by the court in *Duka*, and the sequence of events is worth noting. The parties in *Duka* returned to court (in the Southern District of New York) after *Duka's* removals

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122. *Id.* at 396 (citing *Butz v. Economou*, 438 U.S. 478, 513–14 (1978)). The court also quoted an article written by Justice Kagan (when she was a visiting Professor at Harvard Law School), in which she argued generally in favor of the enhanced methods of presidential control of agency actions that have developed, but not in administrative proceedings because "[i]n this context [of agency adjudication], presidential participation in administration, of whatever form, would contravene procedural norms and inject an inappropriate influence into the resolution of controversies . . . . The consequence here is to disallow the President from disrupting or displacing the procedural, participatory requirements associated with agency adjudication, thus preserving their ability to serve their intended, special objectives." *Id.* (citing Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2363 (2001)).

123. *Hill*, 114 F. Supp. 3d at 1319; *Duka v. SEC*, No. 15 Civ. 357 (RMB) (SN), 2015 U.S. Dist. LEXIS 106605, at \*1 (S.D.N.Y. Aug. 12, 2015).

124. U.S. CONST. art. II.

125. *Hill*, 114 F. Supp. 3d at 1303.

argument was rejected by the district court.<sup>126</sup> Duka had filed an Amended Complaint dated June 10, 2015, which included a new ground of challenge based on the Appointments clause.<sup>127</sup> This came two days after the decision in *Hill*. The SEC then brought a motion to dismiss. After finding the SEC's ALJs to be inferior officers (following the reasoning in *Freitag*),<sup>128</sup> the court denied the SEC's motion and gave them a period of grace within which to cure any violation of the Appointments Clause.<sup>129</sup> The SEC took no such action, and the court awarded Duka a preliminary injunction, finding that the appointment of SEC ALJs was likely unconstitutional.<sup>130</sup>

Notwithstanding the SEC's appeal to the Second Circuit, the parties returned to the district court to consider the SEC's motion to stay the preliminary injunction pending its appeal.<sup>131</sup> The court denied the SEC the relief it sought, commenting in relation to the merits that "respectfully, the SEC will not, in the Court's view, be able to persuade the appellate courts that ALJs are not 'inferior officers.'"

Therefore, the government rejected its opportunity to cure the Article II violation and has maintained an aggressive litigation stance. This is no doubt in part because the government fears the wide-ranging implications of accepting that ALJs are inferior officers, which would have consequences for ALJs not just within the SEC, but potentially for many other agencies. Justice Breyer, dissenting in *Free Enterprise*, noted that "the Federal Government relies on 1,584 ALJs to adjudicate administrative matters in over 25 agencies."<sup>132</sup> It could be argued that any change in position would need to be accompanied by a consistent approach across agencies. This issue was seized upon by the dissent in *Bandimere* as being particularly important, although the court's opinion noted that these broad questions had not been presented or briefed, and the concurrence was skeptical of the dissent's conclusions, stating that "the dissent's dire predictions about hypothetical consequences of the majority's holding are exaggerated."<sup>133</sup>

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126. *Duka v. SEC*, 15 Civ. 357 (RMB) (SN), 2015 U.S. Dist. LEXIS 100999 (S.D.N.Y. Aug. 3, 2015).

127. *Id.* at \*2.

128. *Id.* at \*5.

129. *Id.* at \*8.

130. *Duka v. SEC*, 15 Civ. 357 (RMB) (SN), 2015 U.S. Dist. LEXIS 124444, at \*65, (S.D.N.Y. Sep. 17, 2015) (Ex. C, Order of the Court dated Aug. 12, 2015).

131. *Id.*

132. *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 542–43 (2010).

133. *Bandimere*, 844 F.3d at 1188; *Bandimere*, 844 F.3d at 1189–90 (Briscoe, J., concurring); *Bandimere*, 844 F.3d at 1199–1201 (McKay, J., dissenting).

But what prevented the government from cutting its losses and revising the ALJ appointment process at an early stage, especially since Supreme Court precedent does not support its interpretation? Perhaps the government considered that, even with the risk that a challenge could succeed, the arguments would be extinguished over time. Four circuits denied jurisdiction to hear interlocutory appeals from district court decisions, so those constitutional challenges were delayed.<sup>134</sup> Cases brought following the conclusion of administrative proceedings have now started to percolate through the system, and it will take time for these issues to be considered fully, potentially in other circuits. But the Tenth Circuit's decision in *Bandimere*, which creates a circuit split with the D.C. Circuit, increases the likelihood of review by the Supreme Court. The SEC may yet have to alter its appointment process.

The Tenth Circuit emphasized the importance of the appointments clause issue from a structural perspective, in that the clause separates power between different branches, and also “promotes public accountability by identifying the public officials who appoint officers.”<sup>135</sup> But an additional wrinkle to the SEC's ALJ conundrum is that if the appointment of SEC ALJs did clearly comport with Article II, this would not necessarily benefit persons subject to SEC administrative proceedings. If the ALJs were appointed by the Commission as head of the department, this would not address concerns over the partiality of ALJs.<sup>136</sup> It has also been suggested that appointment by the President might create due process concerns of impartiality.<sup>137</sup> This tends to suggest that appointment by the courts of law would be most appropriate, particularly in light of the adjudicatory role of ALJs.<sup>138</sup> This does, however, present a substantial conceptual change, and would require significant statutory amendment.

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134. *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015); *Jarkesy v. SEC*, 803 F.3d 9 (D.C. Cir. 2015); *Tilton v. SEC*, No. 15-2103, 2016 U.S. App. LEXIS 9970 (2d Cir. Jun. 1, 2016); *Hill v. SEC*, No. 15-12831, No. 15-13738, 2016 U.S. App. LEXIS 10946 (11th Cir. June 17, 2016).

135. *Bandimere v. SEC*, 844 F.3d 1168, 1172 (10th Cir. 2016).

136. For example, in *Duka*, Judge Berman noted there had been allegations of undue pressure on ALJs to make SEC-favorable rulings, and hoped that the “flap at the SEC” would be duly investigated. *Duka v. SEC*, 15 Civ. 357 (RMB) (SN), 2015 U.S. Dist. LEXIS 124444, at \*20–22 (S.D.N.Y. Sept. 17, 2015).

137. Barnett, *supra* note 12, at 825–27.

138. Barnett proposes such an inter-branch appointment remedy, suggesting the D.C. Circuit court would be an appropriate appointer. *Id.* at 832.

## II. PROCESS REFORM

### A. *Developing the law*

Even if the challengers succeed in their constitutional arguments, this will not change some of the objections that have been raised against ALJs in the current debate. These concerns have come from various sides, most notably Judge Rakoff. In a keynote address at the PLI Securities Regulation Institute in November 2014, Judge Rakoff summarized various problems with the SEC's increased use of administrative proceedings.<sup>139</sup> This critique encompassed procedural differences with the process used in the federal courts, including limitations on discovery, admissibility of evidence precluded by the Federal Rules of Evidence such as hearsay, and the absence of a jury trial.<sup>140</sup> This comparison is relevant, as the SEC has discretion to bring its cases either in federal district court or by using its administrative proceedings.<sup>141</sup> It is therefore the SEC's choice to proceed in federal court with significant procedural tools and protections, or to limit these safeguards by proceeding before an ALJ.

Importantly, Judge Rakoff commented that the increased use of ALJs "hinders the balanced development of the securities laws," which he explained was particularly significant in light of the judge-made law which has developed under the anti-fraud provisions of the 1933 and 1934 Acts.<sup>142</sup> The SEC might be more likely to bring novel or complex cases under its administrative procedures where its chances of success are higher and where its interpretations would not be subject to *de novo* review. According to Judge Rakoff, "[w]hatever one might say about the SEC's quasi-judicial functions, this is unlikely, I submit, to lead to as balanced, careful, and impartial interpretations as would result from having those cases brought in federal court."<sup>143</sup>

In attempting to address the procedural differences with federal court process, the SEC has adopted new rules to amend certain procedures, including adjusting certain time limits and permitting depositions as part of discovery.<sup>144</sup> This may improve matters for

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139. Judge Jed S. Rakoff, PLI Securities Regulation Keynote Address: Is the SEC Becoming a Law unto Itself? (Nov. 5, 2014), <https://securitiesdiary.files.wordpress.com/2014/11/rakoff-pli-speech.pdf>.

140. *Id.* at 7.

141. See 15 U.S.C. §§ 77h-1, 77t(b), 78u, 78u-2, 78u-3, 78v, 80b-9 (2012).

142. Rakoff, *supra* note 139, at 7-8.

143. *Id.* at 11.

144. Press Release, SEC, SEC Adopts Amendments to Rules of Practice for Administrative Proceedings (July 13, 2016), <https://www.sec.gov/news/pressrelease/2016-142.html>.

persons subject to SEC administrative proceedings, but it does not address the more substantive concern about the SEC's decision to use the administrative procedure in the first place. Following the criticism by Judge Rakoff and a subsequent article in the Wall Street Journal, the SEC published a memorandum describing its rationale for deciding where to bring proceedings.<sup>145</sup> However, this did not address Judge Rakoff's substantive concern. In fact, the SEC announced that in order to achieve "fair, consistent, and effective resolution of securities law issues and matters," its policy where

a contested matter is likely to raise unsettled and complex legal issues under the federal securities laws, or interpretation of the Commission's rules, consideration should be given to whether, in light of the Commission's expertise concerning those matters, obtaining a Commission decision on such issues, subject to appellate review in the federal courts, **may facilitate development of the law.**<sup>146</sup>

This was precisely the point Judge Rakoff warned against, and former senior SEC personnel have suggested the SEC should instead "develop objective criteria to guide the choice of forum."<sup>147</sup>

By relying on the development of the law as a factor in determining the appropriate forum, the SEC is creating an issue sounding in fundamental rule of law principles regarding fairness in adjudications and certainty of the law.<sup>148</sup> The decision-making of the SEC is naturally influenced by its interpretation of statutes, rules, and regulations, but in deciding to choose the administrative forum in order to develop the law, the implication is that the SEC seeks to go further.

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145. William McLucas & Matthew Martens, Opinion, *How to Rein in the SEC*, WALL STREET J. (June 2, 2015, 6:55 PM), <http://www.wsj.com/articles/how-to-rein-in-the-sec-1433285747> ("On May 7, The Wall Street Journal reported that the SEC has a 'home-court advantage' and 'won against 90% of defendants before its own judges in contested cases from October 2010 through March of this year.' The next day, the SEC's Division of Enforcement issued a four-page memo identifying criteria for selecting one forum versus the other."); *see also* SEC, DIVISION OF ENFORCEMENT APPROACH TO FORUM SELECTION IN CONTESTED CASES, <http://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf>.

146. SEC, *supra* note 145 (emphasis added).

147. McLucas & Martens, *supra* note 145 (suggesting that the SEC should develop objective criteria).

148. *See, e.g.*, Robert A. Stein, *The Rule of Law*, in *THE RULE OF LAW IN THE 21ST CENTURY* 13 (Robert A. Stein & Richard J. Goldstone consulting eds., 2015) ("[T]he law must be known and predictable so that persons will know the consequences of their actions. The law must be sufficiently defined and government discretion sufficiently limited to ensure the law is applied in a non-arbitrary manner.").

There is a danger of upsetting the current balance of interpretation between the SEC and the courts. In general, Congress, through the APA, determined that the courts would have the upper hand in interpretation by providing that a reviewing court shall set aside agency conclusions found to be “not in accordance with the law.”<sup>149</sup> The courts modified this approach by allowing agency expertise to play a greater role in certain circumstances; if Congress has delegated broadly to an agency and left ambiguity in a statute, the courts will grant deference based on the *Chevron* doctrine.<sup>150</sup> This doctrine is not, however, without limitation. It is unclear whether SEC determinations made in adjudicatory proceedings are entitled to such deference,<sup>151</sup> and courts may grant less deference where an agency’s position has changed over time.<sup>152</sup>

Therefore, another implication of the SEC’s suggestion that it is appropriate to choose the administrative forum in order to develop the law is that the agency’s interpretation of the law should be favored more broadly than it already is under the APA and the *Chevron* doctrine. The SEC’s internal policy on forum selection is not the appropriate method to create this shift. As noted by the district court in *Chau*, any decision regarding the “proper or wise allocation of interpretive functions between the Commission and the courts . . . are policy matters committed to the legislative and executive branches of government.”<sup>153</sup>

A counter example—where an ALJ has pushed back on the SEC’s insider trading theories on the basis of Second Circuit precedent—may illustrate this point. One actionable theory of insider trading occurs where (1) an insider gives a tip of material non-public information to another person (the “tippee”) in breach of a fiduciary duty, (2) the tippee knows or should know of the insider’s breach of duty, and (3) the tippee uses that information to trade, thus participating in the insider’s breach.<sup>154</sup> This theory has been used in criminal and civil insider trading cases relating to tipping chains (involving an insider, one or more tippers, and an end trader), which can present difficult evidentiary questions. In recent years a legal question has also arisen—what precisely must the

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149. Administrative Procedure Act of 1946, 5 U.S.C. § 706 (2012).

150. *Chevron U.S.A., Inc. v. NDRC, Inc.* 467 U.S. 837, 843 (1984) (holding that in the case of silence or ambiguity “the court does not simply impose its own construction on the statute . . . the question for the court is whether the agency’s answer is based on a permissible construction of the statute”).

151. *See, e.g., Chau v. SEC*, 72 F. Supp. 3d 417, 436 n.157 (S.D.N.Y. 2014) (noting conflict between Second Circuit decisions on this point).

152. Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2378 (2001).

153. *Chau*, 72 F. Supp. 3d at 436–37.

154. *Dirks v. SEC*, 463 U.S. 646, 659–61 (1983).

trader know about the insider's breach of duty? In 2014, the Second Circuit held the trader must know the insider disclosed confidential information and that he did so in exchange for a "personal benefit."<sup>155</sup> There has been some tension between the Second and Ninth Circuits over the definition of that term, which the Supreme Court has recently addressed to some extent.<sup>156</sup>

The controversy seeped into the SEC's administrative proceedings, and ALJs have had to grapple with the different judicial decisions, which have diverged from the SEC's theories.<sup>157</sup> In the case of *Ruggieri*, an SEC ALJ found the SEC's Enforcement Division had not satisfied its burden of establishing that Ruggieri had been tipped for a personal benefit, on the ALJ's interpretation of the Second Circuit's decision in *Newman*.<sup>158</sup> The ALJ dismissed the proceedings against Ruggieri, and the Division of Enforcement filed a petition for review of the ALJ's initial decision with the Commission, one ground of challenge being the ALJ's interpretation of the law.<sup>159</sup> A decision by the Commission following its review is still awaited as this Note goes to print, but this case highlights the SEC's willingness to use the ALJ forum to pursue development of the law even where it can be interpreted as conflicting with judicial precedent.

Shifting the balance in favor of the SEC also implicates problems of transparency and accountability by effectively moving additional policymaking responsibility into the agency without clear delegation or mandate. Although the SEC's expertise means that it may be best suited to evaluate and advise on policy decisions, it is possible to criticize the role of bureaucratic experts as decision makers on policy questions. For example, Justice Kagan has written that "[b]ureaucracy is the ultimate black box of government," and that

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155. *United States v. Newman*, 773 F.3d 438, 442 (2d. Cir. 2014).

156. *Salman v. United States*, 137 S. Ct. 420, 428 (2016) (resolving a narrow issue, the Court explained that to the extent the Second Circuit sought to impose an additional requirement that a tipper must receive something of a "pecuniary or similarly valuable nature" in exchange for a gift to family or friends, that requirement was inconsistent with earlier Supreme Court precedent).

157. Joseph C. Ruggieri, Initial Decision Release No. 877, 2015 WL 5316569 (Sept. 14, 2015).

158. *Id.*; Joseph C. Ruggieri, Order Denying Motion for Summary Affirmance, Granting Petitions for Review, and Scheduling Briefs, Administrative Proceedings File No. 3-16178, Securities Act of 1933, Release No. 9985, Securities Exchange Act of 1934, Release No. 76614 (Dec. 10, 2015).

159. Joseph C. Ruggieri, Order Denying Motion for Summary Affirmance, *supra* note 158, at 1-2.

“agency experts have neither democratic warrant, nor special competence to make the value judgments—the essentially political choices—that underlie most administrative policymaking.”<sup>160</sup>

The SEC has also been strongly criticized for pursuing novel theories by Mark Cuban, who was himself investigated for insider trading.<sup>161</sup> Cuban emphasized the monetary and personal costs of defending protracted proceedings in amicus briefs filed with the Supreme Court in connection with Bebo’s petition for certiorari, and in connection with the insider trading case heard in October 2016.<sup>162</sup> Cuban argues that there is a risk that where the SEC pursues novel insider trading theories, individuals may be tempted to settle with the SEC even if they do not believe they violated the law, rather than “mount an expensive and time-consuming defense that is likely to take years to resolve.”<sup>163</sup> This risk is heightened where the SEC proceeds through its internal administrative process. Cuban points out that he was fortunate enough to be able to afford to defend himself.<sup>164</sup> His case was heard in district court, and he was able to bring a motion to dismiss, which was granted by the district court, but vacated and remanded by the Fifth Circuit.<sup>165</sup> Ultimately, he was found not guilty following a jury trial.<sup>166</sup> This example illustrates that insider trading is a particularly relevant category, implicating the concern over the SEC’s ability to develop the law through novel theories.

In summary, the SEC should remove the development of the law as one of its criteria in favor of pursuing administrative proceedings for reasons of fairness, consistency, and maintaining the balance of interpretation between the agency and the courts. If not persuaded by this reasoning, the SEC should change its position as a matter of pragmatism—to fend off some of the criticism and the level of challenge it currently faces.

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160. Kagan, *supra* note 152, at 2378, 2353.

161. Brief for Mark Cuban as Amicus Curiae Supporting Petitioner at 1, *Salman v. United States*, 137 S. Ct. 420 (2016) (No. 15-628).

162. Brief for Mark Cuban as Amicus Curiae Supporting Petitioner at 1, *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015), *cert. denied*, 136 S. Ct. 1500 (2016) (No. 15-997); Brief for Mark Cuban, *supra* note 161, at 1.

163. Brief for Mark Cuban, *supra* note 161, at 1.

164. *Id.*

165. *SEC v. Cuban*, 620 F.3d 551, 552–53, 558 (5th Cir. 2010).

166. Brief for Mark Cuban, *supra* note 161, at 1.

*B. Right of removal for fraud*

Challengers seeking to question the SEC's exercise of discretion in choosing the forum face a high threshold. Challenges based on equal protection arguments have generally failed, except in the most acute case. In *Gupta v. SEC*, Rajat Gupta challenged the SEC's decision to issue an internal Order Instituting Public Administrative and Cease-and-Desist Proceedings, which alleged he had knowingly disclosed material, non-public information to Raj Rajaratnam, principal of Galleon Management, LP ("Galleon"), who subsequently traded on the basis of that inside information.<sup>167</sup> This was one in a long line of cases brought by the SEC in relation to the Galleon-related insider-trading ring, and the SEC had previously filed complaints against 28 other defendants in federal district court, alleging similar violations of the federal securities laws and seeking similar remedies.<sup>168</sup> Gupta argued that the SEC had singled him out for "uniquely unfavorable treatment in violation of the Equal Protection Clause of the Constitution."<sup>169</sup>

The Court denied the SEC's motion to dismiss, finding that it had jurisdiction to hear Gupta's equal protection claim, but noted that fear of allowing diversionary tactics by subjects of SEC enforcement actions in the future would be cabined by potential dismissal for failure to state a claim under the *Iqbal* standard.<sup>170</sup> The Court pointed to the evidence supporting Gupta's argument, stating that there was "already a well-developed public record of Gupta being treated substantially disparately from 28 essentially identical defendants, with not even a hint from the SEC, even in their instant papers, as to why this should be so."<sup>171</sup> The equal protection claim was never decided, as the SEC subsequently filed a complaint against Gupta in the district court.<sup>172</sup> But the judgment suggests the claim would have at least progressed beyond the motion to dismiss stage, and would "turn entirely on extrinsic evidence of whether the SEC's decision to treat Gupta differently from the other Galleon-related defendants was irrational, arbitrary, and discriminatory."<sup>173</sup>

Therefore, there appears to be limited recourse for challengers to object to the SEC's discretion to determine which process it will

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167. *Gupta v. SEC*, 796 F. Supp. 2d 503, 506 (S.D.N.Y. 2011).

168. *Id.*

169. *Id.*

170. *Id.* at 514.

171. *Id.*

172. *See SEC v. Gupta*, 11 Civ. 7566 (JSR), 2013 U.S. Dist. LEXIS 102274, at \*1, 5 n.3 (July 17, 2013).

173. *Gupta v. SEC*, 796 F.Supp. 2d 503, 514 (S.D.N.Y. 2011).

follow. It has, however, been suggested that Congress should consider providing a right of removal to individuals facing the SEC's administrative process in certain cases.<sup>174</sup> Determining an appropriate balance between retaining an administrative process that is effective, reduces unnecessary burden on the federal courts, and provides a fair procedure to those facing SEC proceedings is the key question.

In opining on proposals for a right of removal, Professor Grundfest has considered both (1) pending legislation which proposes a right of removal in all cases in which the SEC proposes to use its administrative proceedings to seek a cease and desist order and financial penalty, and (2) an approach which attaches different rights to distinct categories of cases.<sup>175</sup> Under the latter approach, he suggests a model where no right of removal would attach to technical or pro forma cases, an unqualified right of removal would attach to certain cases where Congress determined federal court proceedings provide necessary safeguards, and a residual category would exist in which parties would have the right to petition a federal court for a right of removal.<sup>176</sup> This approach clearly strikes a better balance than a blanket right of removal, which would render the administrative process meaningless in significant cases.<sup>177</sup>

Categorizing those cases to which an unqualified right of removal should attach would be the most difficult question for Congress if it did adopt such an approach. Professor Grundfest suggested that this category "might include alleged violations of the insider trading laws or of the anti-bribery provisions of the Foreign Corrupt Practices Act."<sup>178</sup>

For the subjects of SEC investigations, there may be certain types of allegations where the option of federal court and a jury determination is more relevant. It could be argued that specialist administrative law judges are better equipped than a jury at handling technical questions, but where allegations of fraud are made by the SEC, the subject's state of mind is under scrutiny and a jury trial may be more appropriate.<sup>179</sup>

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174. Joseph A. Grundfest, *Fair or Foul? SEC Administrative Proceedings and Prospects for Reform Through Removal Legislation* 17–21 (Rock Center for Corporate Governance, Working Paper Series 212, 2015). The Republican Party has indicated a plan to replace the Dodd-Frank Act with legislation including an immediate right of removal for respondents in administrative proceedings. Jeb Hensarling, Remarks to the Economic Club of New York (June 7, 2016), [http://business.cch.com/srd/hensarling\\_ny\\_econ\\_club\\_speech\\_june\\_7\\_2016.pdf](http://business.cch.com/srd/hensarling_ny_econ_club_speech_june_7_2016.pdf).

175. Grundfest, *supra* note 174, at 19–20.

176. *Id.* at 20.

177. *Id.* at 19.

178. *Id.* at 20.

179. Consistent with the jury's traditional role in making these types of determinations.

To illustrate the evidentiary burdens on the SEC in such cases, consider *Lucia*, where the SEC found violations of the anti-fraud provisions of the Investment Advisers Act.<sup>180</sup> The case arose from presentations of a “Buckets of Money” investment strategy given at retirement planning seminars.<sup>181</sup> In order to support its conclusion that a violation had occurred, the SEC had to demonstrate (i) that misleading statements were made (either because there was a misstatement or an omission of a fact necessary to clarify the statement), (ii) that those misstatements or omissions were material, and (iii) that those statements were made with scienter.<sup>182</sup> “Scienter” is a mental state embracing intent to deceive, manipulate or defraud.<sup>183</sup> This element may also be satisfied by demonstrating “extreme recklessness,” which can incorporate what the respondent knew or should have known.<sup>184</sup> This is “not merely a heightened form of ordinary negligence but an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”<sup>185</sup> On review, the D.C. Circuit held that the record provided substantial evidence to support the SEC’s determination.<sup>186</sup> Specifically, the petitioners knew certain facts about the assumptions made in their analyses that were not disclosed to investors.<sup>187</sup> The SEC determined this presented an obvious risk of misleading investors.<sup>188</sup>

However, this example highlights different ways of establishing scienter in a fraud case—through intent, knowledge, or obviousness of risk. At an abstract level, these questions tend to involve more difficult or close evidentiary questions. Therefore, arguments relating to the need for the federal rules of evidence to govern admissibility, and the option of having a jury to make determinations of credibility, are at their most relevant where allegations of fraud are at play.

These procedural aspects have protective qualities. For example, the rules of evidence applicable in district court can operate to exclude pieces of evidence that might be helpful to the SEC in a fraud case, including character evidence, which might be used to show a

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180. Raymond J. Lucia Cos. v. SEC, 832 F.3d 277, 280 (D.C. Cir. 2016).

181. *Id.* at 282.

182. *Id.* at 290.

183. *Id.* at 294.

184. *Id.*

185. *Id.* (internal citations omitted).

186. *Id.* at 293–94.

187. *Id.*

188. *Id.* at 294.

propensity for dishonesty.<sup>189</sup> Evidence of prior bad acts would also be excluded if relied on for the same purpose.<sup>190</sup> Similarly, if the SEC brought a case in district court and the defendant testified, there are rules that govern how the defendant's credibility as a witness could be challenged.<sup>191</sup> The court could also consider whether unfair prejudice, confusion, or undue delay that might ensue from items of evidence the SEC might seek to admit.<sup>192</sup>

It could be argued that the Federal Rules of Evidence should be extended to cover SEC ALJ proceedings. SEC ALJs do not, however, have day-to-day experience with considering evidentiary motions, and there may be limited prospect of evidentiary rulings being analyzed in detail by the Commission on review of an ALJ's decision.

In the wake of criticism over its use of ALJs, the SEC did amend its rules of practice, such that the SEC must now consider the reliability of evidence and may only admit hearsay evidence if it is relevant, material, and reliable.<sup>193</sup> But this reform does not provide equivalent protections to those available to defendants facing the SEC's claims in district court, such as the rules of evidence discussed above. Allegations of fraud also give rise to more acute reputational concerns, and so allowing these additional protections for investigation subjects could be the most effective change in procedure in terms of limiting challenges to the SEC's administrative process.

There are parallels in other proceedings that also support providing the option of a jury trial in cases where fraud is at issue. For example, in proceedings in federal court, allegations of fraud must be pleaded with particularity.<sup>194</sup> It is also interesting to draw a comparison between the use of jury trials in the U.S. and England; the influence of clause 39 of the Magna Carta, guaranteeing that no person "will be imprisoned . . . or in any way ruined . . . save by judgment of his peers and the law of the land," gave rise to a right to a jury trial in specific circumstances (civil and criminal) in both

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189. See FED. R. EVID. 404.

190. *Id.*

191. See FED. R. EVID. 608, 609.

192. See FED. R. EVID. 403.

193. Press Release, SEC, SEC Adopts Amendments to Rules of Practice for Administrative Proceedings (July 13, 2016), <https://www.sec.gov/news/pressrelease/2016-142.html>.

194. FED. R. CIV. P. 9(b). This applies both to private civil actions and to those brought by the SEC. See, e.g., SEC v. One or More Unknown Traders in the Secs. of Onyx Pharms., Inc., 13-CV-4645 (JPO), 2014 U.S. Dist. LEXIS 137448, at \*12 (S.D.N.Y. Sep. 29, 2014) (alleging insider trading); SEC v. Garber, 959 F. Supp. 2d 374, 378 (S.D.N.Y. 2013) (alleging fraudulent penny stock scheme); SEC v. Morton, 10 Civ. 1720 (LAK) (MHD), 2011 U.S. Dist. LEXIS 36487, at \*56-57 n.16 (S.D.N.Y. Mar. 31, 2011) (alleging fraudulent misrepresentations in connection with an investment scheme).

jurisdictions.<sup>195</sup> Acts of the legislature in both jurisdictions can, however, determine the extent of the right to a jury trial—in England owing to principles of parliamentary sovereignty, and in the U.S. through acts of Congress interpreted in accordance with the Seventh Amendment.<sup>196</sup> The trend in the UK has been to narrow significantly the circumstances in which a jury trial is available,<sup>197</sup> but interestingly the right to a jury trial in civil cases involving allegations of fraud remains.<sup>198</sup> Attempts by the government to remove the right in cases of complex criminal fraud cases have been defeated in Parliament (by the House of Lords), reflecting concerns about the protection of individual liberty and also questions over the availability of inadmissible evidence to the judge ruling on the case.<sup>199</sup> The latter concern is equally relevant to persons facing allegations of fraud by the SEC.

Therefore, individuals facing SEC administrative proceedings should be guaranteed a right of removal in cases involving fraud allegations. This is similar to Professor Grundfest's suggestion, as this proposal would include insider-trading cases, which he had identified as a relevant category for removal.<sup>200</sup> This category is particularly sensitive due to recent controversy over the elements required to demonstrate a violation in some circumstances. An insider trading case also illustrates the point regarding difficult questions of evidence arising where fraud allegations are made. In *Ruggieri*, discussed above at Part II.A, the SEC's Division of Enforcement also sought review of the ALJ's initial decision on a factual

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195. Lord Neuberger of Abbotsbury, *Magna Carta and the Rule of Law*, in *THE RULE OF LAW IN THE 21ST CENTURY* 63 (Robert A. Stein and Richard J. Goldstone, consulting eds., 2015).

196. See *id.* at 66. As to the U.S. position, see *Hill v. SEC*, 114 F. Supp. 3d 1297, 1315 (N.D. Ga. 2015) (citing *Atlas Roofing Co. v. Occupational Safety & Health Review Comm'n*, 430 U.S. 442, 460 (1977)) (“[T]he United States could . . . validly opt for administrative enforcement, without judicial trials.”).

197. See Michael J. Beloff QC, *Magna Carta in the Twentieth and Twenty First Centuries*, 27 DENNING L.J. 1, 19–21 (2015). The first criminal trial of a serious offence without a jury in England was approved in 2009, pursuant to powers under sections 44 and 46 of the Criminal Justice Act 2003 c.44, which allows for trial by judge alone where there is a real and present danger of jury tampering. *First Trial Without Jury Approved*, BBC NEWS (June 18, 2009, 6:19 PM), [http://news.bbc.co.uk/2/hi/uk\\_news/8106590.stm](http://news.bbc.co.uk/2/hi/uk_news/8106590.stm).

198. Senior Courts Act 1981 c. 54 § 69(1), this is subject to judicial discretion where “the court is of the opinion that the trial requires any prolonged examination of documents or accounts or any scientific or local investigation which cannot conveniently be made with a jury.”

199. 20 Mar. 2007 Parl Deb HL 2007 col. 1149–50 (Lord Goldsmith, explaining attempts to pass an affirmative resolution of both Houses); 20 Mar. 2007 Parl Deb HL 2007 col. 1152–55 (Lord Kingsland, explaining the arguments against removing the right to a jury trial in complex fraud cases).

200. See Brief for Mark Cuban, *supra* note 161, at 1.

basis, arguing that the ALJ “drew impermissible inferences from the facts, including that [the tipper]—risking his career—repeatedly tipped Ruggieri to valuable inside information without any expectation of receiving a benefit in return.”<sup>201</sup> Difficulties in drawing inferences over a person’s state of mind affect respondents and the SEC alike.

The proposed right of removal for fraud cases could also include certain allegations relating to bribery (as suggested by Professor Grundfest), although the administrative procedure is normally used by the SEC to impose sanctions following a settlement offer in the anti-bribery context, where a right of removal would not be relevant.<sup>202</sup>

But the proposal would include other cases, for example, those involving allegations of fraudulent misstatements made to investors.<sup>203</sup> So a case such as *Lucia* would be included in the proposal, and in a future case, a respondent would have the right to remove to federal court.

The proposal would ensure cases involving allegations of fraud—which bring with them greater reputational risks, potentially require the most difficult evidentiary calls, and where questions of admissibility may be at their most acute—would be dealt with in a fairer way, by giving the respondent the choice of forum.

### C. Disclosure obligations

As discussed above, limitations on the ability of respondents in administrative proceedings to use discovery mechanisms that would be available in federal court is one of the criticisms raised by challengers to the SEC’s use of ALJs. The SEC counters that its disclosure obligations are sufficient, as it is required to produce “documents obtained by the Division prior to the institution of proceedings, in connection with the investigation leading to the Division’s recommendation to institute proceedings,”<sup>204</sup> including

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201. Joseph C. Ruggieri, Order Denying Motion for Summary Affirmance, *supra* note 158, at 2 (internal citations omitted).

202. See, e.g., Jose Hurtado, Administrative Proceeding File No. 3-17232; Securities Exchange Act of 1934 Release No. 77729 (April 27, 2016), 2016 SEC LEXIS 1656.

203. See, e.g., James A. Winkelman Sr. and Blue Ocean Portfolios, LLC, Administrative Proceeding File No. 3-17253, Securities Act of 1933 Release No. 10080; Securities Exchange Act of 1934 Release No. 77862; Investment Advisers Act of 1940 Release No. 4389; Investment Company Act of 1940 Release No. 32118 (May 19, 2016), 2016 SEC LEXIS 1892.

204. 17 C.F.R. §201.230(a)(1) (2004).

all *Brady* and Jencks Act material (in other words, exculpatory evidence and witness evidence).<sup>205</sup> The range of documents disclosed by the SEC is therefore broad.

Two issues do arise from the SEC's disclosure obligations. First, the SEC may obtain and disclose a vast amount of data and documents, creating problems both for recipients of SEC subpoenas and subjects of SEC ALJ proceedings. This issue has been raised in the current challenges to the ALJ process; for example *Chau* featured complaints about the SEC's production of 22 million documents.<sup>206</sup> In that case, plaintiffs argued that "SEC Rule 230, governing the production of documents, was defective because it allegedly permitted the SEC to produce documents in an unorganized and unsearchable manner."<sup>207</sup> In this case, however, the ALJ was unsympathetic: "Given the manner in which the Division has produced the investigative files . . . and given the representations the Division has made regarding them, Respondents should be able to meaningfully prioritize their review."<sup>208</sup> The objections were dismissed by the ALJ and the court.<sup>209</sup> But even if the manner of disclosure allows for searches of relevant material by the subjects of proceedings, there is a broader concern of inefficiency in the document gathering process. Critics have raised this issue against the SEC, owing to the costs of securing, producing, and reviewing documents, which will be incurred whether or not the SEC subsequently takes action. For example, in a proposal for reform of the SEC's investigation process, the Center for Capital Markets Competitiveness suggested a pressing need to improve efficiency: "[w]hen one recognizes that the vast majority of SEC investigations are closed without action, it means that companies that have done nothing wrong have been required to produce tens of millions of irrelevant documents, at a substantial cost to the company."<sup>210</sup>

Second, there is no positive duty on the SEC to identify documents material to its case, or helpful to the subject of

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205. *Examining the SEC's Agenda, Operations, and FY 2016 Budget Request*, Hearing Before the H. Comm. on Financial Services, 114th Cong. 25 (2015) (evidence of Mary Jo White, SEC Chair); 17 C.F.R. §201.230(a)(1)(iv) (requiring disclosure of transcripts and other documents); 17 C.F.R. §201.230(b)(2) (providing that the SEC cannot "withhold, contrary to the doctrine of *Brady v. Maryland*, 373 U.S. 83, 87 (1963), documents that contain material exculpatory evidence.").

206. *See Chau v. SEC*, 72 F. Supp. 3d 417, 427 (S.D.N.Y. 2014).

207. *Id.*

208. *Id.* (citing ALJ decision).

209. *Id.*

210. CENTER FOR CAPITAL MARKETS COMPETITIVENESS, EXAMINING U.S. SECURITIES AND EXCHANGE COMMISSION ENFORCEMENT: RECOMMENDATIONS ON CURRENT PROCESSES AND PRACTICES 41-42 (2015).

investigation.<sup>211</sup> This causes an issue because, where the amount of material disclosed is voluminous, as in *Chau*, this creates unfairness to respondents who will have a limited time available for review.

As noted above, the SEC is obliged to provide a broad amount of disclosure—producing “documents obtained . . . in connection with the investigation”<sup>212</sup>—without needing to categorize the material. This can be compared with the more specific requirements used in another regime, by the UK financial services regulators, who are required to allow persons against whom they take action access to two categories of material: “the material on which it relied in taking the decision [to take action],” and material considered or obtained by the regulator, which, “in the regulator’s opinion, might undermine that decision.”<sup>213</sup>

As a practical matter, this puts the onus on the regulator to make determinations about the material it considered or obtained during the course of its investigation. The greater the amount of material obtained, the more onerous these determinations become. There are many ways to structure an investigation and the approach used will vary depending on the circumstances of the case. This Note does not suggest disclosure obligations are a driving factor in that regard. But in the absence of an obligation to make such a determination, there is no check on requiring the production of vast swathes of material, rather than taking a more focused approach.

Placing an affirmative duty on the SEC to specifically identify the evidence obtained during the course of its investigation which (1) is material to the SEC’s case, or (2) might tend to undermine the SEC’s case, would enhance the fairness of the SEC’s proceedings. The threshold for materiality could be evidence upon which the SEC relied in making its decision to institute proceedings. The threshold for the latter category would need to be low to avoid the SEC taking a narrow interpretation of what might be undermining.<sup>214</sup> Retaining the broad disclosure obligation that the SEC already has would leave it open for respondents to challenge the

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211. See David F. Bandimere & John O. Young, Administrative Proceedings Release No. 759, 2013 SEC LEXIS 746, at \*1, \*3 (Mar. 12, 2013).

212. See *supra* note 204.

213. Financial Services and Markets Act 2000, c. 8 § 394(1), (6) (Eng.).

214. This is especially the case considering the SEC’s interpretation of what constitutes Brady material may be narrower than that of other agencies. Justin Goetz, Note, *Hold Fast the Keys to the Kingdom: Federal Administrative Agencies and the Need for Brady Disclosure*, 95 MINN. L. REV., 1424, 1436–37 (contrasting the prohibition on the SEC from withholding “material exculpatory evidence” with the CFTC’s more generous approach of disclosing “any information that is either favorable to the respondent’s theory of the case or would tend to undermine the Division’s case”).

SEC's determinations, ensuring that the SEC would act with care in the review and selection of potentially undermining documents.

If the SEC had such an affirmative duty in its rules of practice, enforcement staff would need to consider their obligations during the document gathering process and ensure an appropriate review of material prior to commencing proceedings. This would limit overly broad requests for documents and other material, as enforcement staff would need to consider the process for reviewing the material in detail during the course of the investigation. This approach would not hinder the SEC's enforcement efforts. The SEC's powers to require documents would not be curtailed, even though a more modest method of document gathering would hopefully be encouraged. Investigators could choose to target key documents in the first instance, seeking incremental productions to expand their searches. Additionally, requiring preservation of broader categories of documents reduces the possibility of evidence being lost or destroyed.

### III. CONCLUSION

Constitutional challenges to SEC ALJs will be considered further in due course, potentially by other circuit courts, or by the Supreme Court if it is asked to resolve the split between the Tenth and D.C. Circuits. The highest potential for success comes from the argument that SEC ALJs are inferior officers appointed in violation of Article II. If courts do reach that determination, the consequences will be felt not only by the SEC, but potentially by other administrative agencies. The government has refused to act to change the appointments process, even with knowledge of the widespread uncertainty this creates. Combined with criticism over the fairness of administrative proceedings at the SEC and the SEC's policy that it will use administrative proceedings to develop the law in novel and complex cases, this still presents a significant risk for the SEC in the medium term. Recent changes to the rules governing the conduct of SEC ALJ proceedings do not go far enough, and the SEC would be advised to implement a modified approach to forum selection to stave off further criticism and challenges in order to shore up its credibility in exercising its discretion to pursue cases in-house. The SEC should also implement further procedural safeguards. Respondents to SEC proceedings should be guaranteed a right of removal to federal district court where allegations of fraud are at issue. Finally, the process for providing investigation material should be revised by establishing an affirmative duty in the SEC's rules of

practice to specifically identify evidence obtained during the course of its investigation that is either material or potentially undermining to the SEC's case. This would enhance the fairness of the SEC's administrative proceedings and, in the longer term, would improve the efficiency of SEC investigations.