



## SEC Enforcement Matters

# D.C. Circuit Delivers Significant Victory for the SEC in Upholding the Use of Administrative Law Judges in Enforcement Proceedings

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On August 9, 2016, the U.S. Court of Appeals for the District of Columbia Circuit (D.C. Circuit) ruled in favor of the SEC, rejecting a challenge to the constitutionality of the agency's practice of bringing enforcement actions in front of administrative law judges (ALJs). In finding for the SEC in *Raymond J. Lucia Cos., Inc. v. SEC (Lucia)*, the D.C. Circuit ruled that ALJs that adjudicate contested administrative proceedings are not "officers" under the "Appointments Clause" of the U.S. Constitution; therefore, the hiring of ALJs by the SEC through the civil service process does not violate the U.S. Constitution.

In ruling for the SEC in *Lucia*, the D.C. Circuit validated a long-standing practice utilized by the SEC to try certain enforcement cases in administrative proceedings.

In addition to reviewing the D.C. Circuit's decision in *Lucia*, this article provides background on the SEC's history of bringing contested cases before ALJs, discusses some of the recent criticism surrounding these tribunals and explores ways the *Lucia* decision may influence the SEC's enforcement of hedge fund managers.

For additional discussion of the SEC's use of administrative proceedings, see "[Four Insider Trading Enforcement Trends with Direct Impact on Hedge Fund Trading Strategies \(Part One of Three\)](#)" (Nov. 13, 2014); and "[Compliance Obligations for Registered CPOs and CTAs, OTC Derivatives Trading, SEC Examinations of Private Fund Managers and the JOBS Act \(Part Two of Two\)](#)" (Feb. 6, 2014).

## Background on the SEC's Use of Administrative Proceedings

The SEC is authorized by statute to investigate violations or suspected violations of securities laws. In circumstances where the SEC believes that violations have occurred, it is generally permitted to institute an action in one of two forums: federal district court or an administrative proceeding.<sup>[1]</sup> With respect to contested cases brought by the SEC in administrative proceedings, both parties have the option to appeal an ALJ's adverse decision to the SEC and thereafter, to appeal an adverse SEC decision to a circuit court.

“When representing clients in these matters, based upon the nature of the allegations and underlying facts of the case, we often have a sense of which forum the SEC may select,” advised Stephen G. Topetztes, a litigation partner at K&L Gates, “but ultimately that decision is at the discretion of the SEC.” In some cases, a party might raise concerns with respect to the Division of Enforcement’s use of the administrative process in a contested case, he added, because of the more limited discovery rights and the manner in which considerations under the Federal Rules of Evidence may be applied in that context.

“The Commission recently amended its administrative processes to address some of these issues,” Topetztes continued. “But a district court will continue to be perceived by some defendants or respondents as presenting more certainty or additional avenues or arguments that might not be available in administrative proceedings.”

## **Increase in Administrative Proceedings**

Beginning in 2013, members of the SEC’s staff began to signal that the agency intended to bring more administrative proceedings than it had in prior years, including bringing cases in front of ALJs that historically had been referred by the Division of Enforcement to the district courts.

The increase in cases brought to this forum can be attributed to the enactment of the Dodd-Frank Act in 2010. Prior to that, the SEC could only obtain monetary penalties in administrative proceedings from respondents that were entities registered with the SEC or individuals associated with a registered entity. However, with the enactment of the Dodd-Frank Act, Congress granted the SEC authority to obtain penalties in administrative proceedings from respondents not registered with the SEC, thereby expanding the scope of cases that the SEC could refer to administrative proceedings.

## **SEC’s Use of Administrative Proceedings Comes Under Fire**

Not surprisingly, the trend of trying more litigated matters in front of ALJs has drawn scrutiny from a host of interested parties, including the press, defendants and members of the defense bar.<sup>[2]</sup> Many industry participants assume that the SEC has a “home-court advantage” in administrative proceedings. Since ALJs are hired and paid by the SEC, some believe that the SEC acts as both prosecutor and judge in these cases.

The assumptions of bias were reinforced by reports that the SEC enjoys a higher win rate in administrative hearings than in federal court, as well as allegations by a former ALJ who claimed that she was pressured to find in favor of the SEC in these proceedings.<sup>[3]</sup>

The SEC defends its practice of bringing contested cases in front of ALJs under the rationale of the need for greater efficiency. However, in the midst of the negative press, the SEC took several steps to assure the public that these proceedings were not rigged in favor of the SEC. First, in May 2015, the Division of Enforcement released a **memorandum** describing the considerations upon which it relies when evaluating the choice of forum for enforcement actions. Second, it appears that in the latter half of 2015, the SEC began sending fewer contested cases to its in-house courts.<sup>[4]</sup> Third, in January 2016, the SEC released a **report** by the Office of Inspector General that concluded that the evidence did not support allegations of improper influence by the SEC on ALJs. Finally, in July of this year, the SEC adopted **amendments** to its rules of practice governing administrative proceedings, which, among other things, provide parties with opportunities to conduct depositions and add flexibility to the deadlines to prepare for various stages of the administrative proceeding.

Notwithstanding these steps, the SEC's continued practice of litigating cases in front of ALJs has led to a number of constitutional challenges to the selection of this forum. Some respondents have sought injunctive relief from federal district courts while in the midst of an administrative proceeding. However, most federal judges are now taking the view that they lack jurisdiction over these matters until the parties have exhausted the review process under the statutory scheme.

A more promising challenge to the SEC's use of ALJs came in the form of a constitutional challenge that ALJs were inferior officers under the Appointments Clause of the U.S. Constitution and therefore had to be appointed in compliance with that clause. The D.C. Circuit in *Lucia* was the first circuit court to rule on this issue.

## Procedural and Factual Background of *Lucia*

Until December 2011, Raymond J. Lucia Companies, Inc. (RJC) was an SEC-registered investment adviser; Raymond J. Lucia (Lucia, and together with RJC, Petitioners) was a registered investment adviser representative. On December 6, 2013, after an administrative enforcement proceeding, an SEC ALJ **ruled** that RJC had violated, and that Lucia had aided and abetted and caused RJC's violation of, the antifraud provisions of **Sections 206(1), 206(2) and 206(4)** of the Investment Advisers Act of 1940 (Advisers Act) by misleading prospective clients about its "Buckets of Money" (BOM) retirement wealth management strategy.

In particular, the ALJ found that Petitioners falsely represented that they had performed two backtests on the BOM investment strategy. As opposed to using historical data for the backtest periods when testing their strategy, the ALJ found that Petitioners used their own inflation rates. The ALJ also concluded that the purported results of the backtesting were misleading; had Petitioners performed actual backtesting using historical data, the results would have shown that the strategy exhausted assets rather than the portfolio growing in value. In addition, the backtesting did not include reallocation of assets from riskier to safer buckets – "rebucketizing" in the Petitioners' jargon – an integral part of the BOM Strategy.

For more on backtested performance returns, see "**SEC Settles Enforcement Action and Pursues Company Over Use of Backtested Performance Data**" (Jan. 8, 2015); and "**Under What Conditions Can a Hedge Fund Manager Present Hypothetical Backtested Performance Results?**" (Feb. 1, 2013).

As sanctions for violating the antifraud provisions, the ALJ revoked Petitioners' investment adviser registrations; barred Lucia from the securities industry; ordered the Petitioners to cease and desist from future violations; and imposed \$300,000 in fines.

Petitioners appealed, and the Division of Enforcement cross-appealed, the ALJ's decision to the SEC. On September 3, 2015, the SEC **affirmed** the ALJ's decision<sup>[5]</sup> and imposed the same sanctions as the ALJ.

The Petitioners appealed the SEC's decision to the D.C. Circuit. As more fully discussed below, on August 9, 2016, the D.C. Circuit upheld the SEC's decision in all respects.

## Constitutional Challenge to the SEC's ALJ Regime

In their appeals to the SEC and the D.C. Circuit, Petitioners claimed that the administrative proceeding was unconstitutional because the ALJ who presided over the matter was not

appointed in accordance with the Appointments Clause of the U.S. Constitution, which states in relevant part:

[The President] shall nominate, and by and with the Advice and Consent of the Senate, shall appoint . . . Judges of the supreme Court, and all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law: but the Congress may by Law 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.

Petitioners contended that the ALJ that presided over their administrative proceeding was an officer within the meaning of the Appointments Clause and as such, should have been appointed in compliance with this provision. The SEC disagreed and argued that ALJs are employees; therefore, the fact that ALJs are hired by the SEC (as opposed to being appointed by the President, Court of Law or Commissioners of the SEC) does not violate the Appointments Clause.

## **Court's Analysis on Distinguishing Officers From Employees**

The Supreme Court previously stated that in determining whether an appointee is an officer, as opposed to an employee that falls beyond the reach of the Appointments Clause, it should be determined whether the individual exercises “significant authority pursuant to the laws of the U.S.”<sup>[6]</sup> The D.C. Circuit elaborated on this standard and stated that the main criteria for drawing the line between inferior officers and employees turn on “(1) the significance of the matters resolved by the officials, (2) the discretion they exercise in reaching their decisions, and (3) the finality of those decisions.”<sup>[7]</sup>

The parties were in agreement that ALJs met the first two prongs of the test – namely, that ALJs presided over matters of a significant nature and exercised discretion in doing so. Accordingly, the crux of the issue being considered by the D.C. Circuit was whether the decisions issued by ALJs were final.

In support of their theory that ALJs issued final decisions and thus were officers under the Appointments Clause, the Petitioners referred to [Section 78d-1](#) of the Securities Exchange Act of 1934 (Exchange Act), which grants the SEC the right to delegate any of its functions to certain third parties, including ALJs, and the “discretionary right to review the action” of any delegee. In addition, clause (c) of Section 78d-1 states in relevant part concerning the finality of delegated actions:

If the right to exercise such review [by the SEC] is declined, or if no such review is sought within the time stated in the rules promulgated by the Commission, then the action of any such division of the . . . administrative law judge . . . shall, for all purposes, including appeal or review thereof, be deemed the action of the Commission.

The Petitioners' argument centered on the last clause: “shall . . . be deemed the action of the Commission.” Petitioners claimed that “the statute contemplates that the ALJ's initial decision becomes final in at least some circumstances when Commission review is declined.”

The D.C. Circuit ultimately rejected this interpretation, however, reasoning that clause (c) has to be read in conjunction with the rest of that section, which gives the SEC the right to prescribe

rules for the ALJ process and to review ALJ decisions. The D.C. Circuit then reviewed the rules and processes adopted by the SEC.

Pursuant to 17 C.F.R. § 200.30-9, the SEC has delegated to ALJs the authority to conduct administrative hearings and the SEC retains discretion to review an ALJ's initial decision either upon its own initiative or upon a petition filed for review by a party. As noted in 17 CFR § 201.360, in circumstances where a party timely files a petition for review, or the SEC on its own initiative orders review of an ALJ decision, the initial decision issued by the ALJ shall not become final as to the parties.

Additionally, if a petition is not filed by a party to review an ALJ decision, and the SEC does not order review of the decision on its own initiative, 17 CFR § 201.360 states that the SEC "will issue an order that the [ALJ] decision has become final as to that party. The [ALJ] decision becomes final upon issuance of the order."

Accordingly, the D.C. Circuit reasoned that under the regulatory scheme adopted by the SEC, even when there is no appeal of an ALJ decision and the SEC does not order review, the "initial decision [of the ALJ] becomes final when, and only when, the [SEC] issues the finality order, and not before then. Thus, the SEC must affirmatively act – by issuing the order – in every case."

The D.C. Circuit goes on to state that "even when there is not full review by the Commission, it is the act of issuing the finality order that makes the initial decision [of the ALJ] the action of the Commission within the meaning of the delegation statute." The SEC "must affirmatively act" in every instance by issuing an order, and thus the D.C. Circuit states that "no initial decision of its ALJs is independently final."

Consistent with the foregoing, the D.C. Circuit rejected Petitioners' contention that the issuance of the finality order is "a ministerial formality, akin to a court clerk's automatic issuance of [a] mandate after the time for seeking appellate review has expired." The D.C. Circuit stated that Petitioners did not offer evidence to support that the finality order was merely a rubber stamp, nor "evidence that initial decisions of which the Commission does not order full review receive no substantive consideration as part of this process."

Accordingly, the D.C. Circuit concluded that ALJs are not officers within the meaning of the Appointments Clause; therefore, ALJs do not need to be appointed in compliance with the Appointments Clause.

Finally, in reviewing the SEC's findings that Petitioners violated the antifraud provisions of the Advisers Act, the D.C. Circuit found that there was "substantial evidence" to support the SEC's determination that the Petitioners made misrepresentations in violation of the antifraud provisions and rejected Lucia's challenge to his lifetime bar from the securities industry.

## The Significance of *Lucia*

As a technical matter, the ruling of the D.C. Circuit in *Lucia* is non-binding on courts in other circuits. However, the importance of *Lucia* should not be dismissed. "*Lucia* is a significant decision by a highly-respected court on a constitutional and administrative law question," explained Topetz. "For cases pending outside the D.C. Circuit that involve similar constitutional challenges, the *Lucia* decision likely will present another obstacle to be overcome by parties challenging the SEC's administrative hearing process. By itself, however, it is not likely to end the debate."

The other aspect of this decision that will unfold in the future is whether the SEC, now that this practice has been upheld by the D.C. Circuit, will begin to refer even more contested cases to ALJs, a practice which will surely continue to draw scrutiny from the defense bar and those in the crosshairs of the Division of Enforcement. “There is no doubt that *Lucia* is a meaningful victory for the SEC,” Topetzes advised, “but in my view, it is unlikely to alter substantially the SEC’s calculus in deciding whether to try a case in an administrative proceeding or a district court.”

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[1] It should be noted that certain claims can only be pursued in one of the respective forums. For example, charges of failure to supervise or causing another person’s violation can only be pursued in administrative proceedings, whereas liability as a controlling person or as a relief defendant can only be pursued in district court actions. Additionally, in situations where there is a need for emergency proceedings or relief, only a federal district court can grant these remedies.

[2] See, e.g., Jean Eaglesham, *SEC Wins With In-House Judges*, Wall Street Journal (May 6, 2015), available at <http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803>.

[3] See *id.*

[4] See Jean Eaglesham, *SEC Trims Use of In-House Judges*, Wall Street Journal (Oct. 11, 2015), available at <http://www.wsj.com/articles/sec-trims-use-of-in-house-judges-1444611604>.

[5] The SEC also found that RJC violated and Lucia aided and abetted and caused RJC to violate Advisers Act Rule 1(a)(5).pdf">206(4)-1(a)(5), which makes it unlawful for an investment adviser to distribute any advertisement containing any untrue statement of a material fact, or which is otherwise false or misleading.

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

[7] *Tucker v. Comm’r, Internal Revenue*, 676 F.3d 1129, 1133 (D.C. Cir. 2012).

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