Securities and Exchange Commission's Administrative Forum: Background and Selected Legal Challenges

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March 31, 2016

Congressional Research Service
7-....
www.crs.gov
R44280

CRS REPORT
Prepared for Members and
Committees of Congress

Summary

The Securities and Exchange Commission's (SEC's) increased use of its in-house administrative forum to resolve charges against persons alleged to have violated federal securities laws has generated several court decisions, as well as congressional and media attention. Section 929P(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which gave the SEC the authority to impose civil money penalties, as well as cease-and-desist orders, on almost any person, is often stated as the reason that the SEC has increased its use of the administrative forum, instead of taking alleged wrongdoers to court.

Plaintiffs in several cases are challenging the SEC's administrative forum as violating their due process and equal protection rights and as violating the Constitution's Appointments Clause in the way that the SEC chooses its administrative law judges (ALJs). The SEC has stated that it intends to use the administrative forum aggressively to charge alleged securities wrongdoers and to appeal opinions that strike down the agency's use of the administrative forum.

In three decisions, *Jarkesy v. SEC*, *Wing F. Chau v. SEC*, and *Bebo v. SEC*, federal district courts have held that the plaintiffs had to exhaust their administrative remedies (i.e., reach a final administrative decision within the SEC) before they could bring their constitutional challenges of due process and equal protection violations to a federal court of appeals. Federal courts of appeals have affirmed the district court decisions in two of these cases—*Jarkesy* and *Bebo*. The decisions did not address the constitutional challenges but, instead, required that the plaintiffs abide by the statutory procedural scheme for agency proceedings before bringing any court challenges. The Supreme Court denied *certiorari* in Bebo's challenge to the constitutionality of the SEC's in-house administrative forum.

In contrast to the decisions dealing with due process and equal protection claims, two federal district court decisions challenging the constitutionality of the SEC ALJ selection process, *Hill v. SEC* and *Duka v. SEC*, held that the plaintiffs could proceed in federal district court with their constitutional challenges because of the likelihood of their success. However, another decision on a challenge to the constitutionality of the SEC ALJ selection process, *Tilton v. SEC*, appeared to criticize *Hill* and held that the plaintiffs could not go to court until the SEC reached finality in the administrative proceeding.

A definitive court decision (e.g., a U.S. Supreme Court decision) on the constitutionality of plaintiffs' due process and equal protection claims and/or on the constitutionality of the appointment and tenure protections of SEC ALJs may be necessary to resolve these issues. It is possible that such a decision could have an impact on the administrative forums or the ALJs of agencies in addition to the SEC.

This report will be updated as events warrant.

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Introduction

The Securities and Exchange Commission's (SEC's) increased use of its in-house administrative forum to resolve charges against persons alleged to have violated federal securities laws is receiving considerable attention. Congressional hearings have discussed the issue;[1] several cases are challenging the SEC's authority to use the forum; and the press has widely covered the issue.[2] This report will take a brief look at the administrative law process in general; the likely reason for the increased use by the SEC of the administrative forum; selected cases challenging the SEC's use of the administrative forum on the bases of constitutional violations of due process and equal protection and of unconstitutional selection of the SEC's administrative law judges; possible implications of these cases; and congressional interest in the issue.

Administrative Law Process: Brief Overview

After Congress has enacted legislation, federal agencies typically issue rules, to the extent permitted by the statutes, to implement the legislation.[3] Although issued by an administrative agency, these rules have the force of law. It is not unusual for an agency to interpret the details of federal statutes, which may have been written in a somewhat general way. This ability to interpret the statutes often gives agencies considerable discretion in issuing rules. However, the agency must have been given the authority by statute to act in this discretionary rule-making manner. The general antifraud provision of the Securities Exchange Act,[4] Section 10(b),[5] in its use of the language "as the Commission may prescribe as necessary or appropriate," is an example of this discretionary authority given by statute. Congress has enacted statutes such as the Administrative Procedure Act (APA)[6] to set out the process by which agencies issue these rules.

In general, when a person wishes to challenge in court an action brought by an agency in an administrative forum, such as a charge of rule violation, he must first exhaust the administrative remedies; that is, the agency's action must have reached finality.[7] Administrative actions may

[1] *Legislative Proposals to Improve the U.S. Capital Markets, Hearing Before the Subcomm. on Capital Markets and Government Sponsored Enterprises of the H. Comm. on Financial* Services, 114th Cong. (Dec. 2, 2015); *Oversight of the SEC's Division of Enforcement, Hearing Before the Subcomm. on Capital Markets and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 114th Cong. (March 19, 2015).

[2] *See, e.g.*, Ryan, *The SEC as Prosecutor and Judge*, WALL STREET JOURNAL (Aug. 4, 2014), located at http://www.wsj.com/articles/russell-g-ryan-the-sec-as-prosecutor-and-judge-1407195362.

[3] Some of this paragraph derives from CRS Report R43562, *Administrative Law Primer: Statutory Definitions of "Agency" and Characteristics of Agency Independence*, by (name redacted) and (name redacted) (May 22, 2014). For more on administrative law, see this CRS report.

[4] 15 U.S.C. §§78a *et seq*.

[5] 15U.S.C. §78j(b). Section 10(b) states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> ...
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered ... any manipulative or deceptive device or contrivance *in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors* [emphasis added].

[6] 5 U.S.C. §§551 *et seq*.

[7] Charles H. Koch, Jr., ADMINISTRATIVE LAW AND PRACTICE §12.20 (3d ed. 2010).

include hearings, findings, and decisions by administrative law judges (ALJs). An ALJ is a judge and trier of fact within an agency; the ALJ presides over trials within the agency and adjudicates claims and disputes. ALJs are appointed according to statute.[8] Often, a defendant may not challenge an agency action in court until an ALJ has rendered an opinion.

Section 929P(a) of Dodd-Frank

In the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Penny Stock Act),[9] the SEC received broad authority to seek in court civil money penalties in enforcement actions.[10] With respect to imposing civil penalties on persons in administrative actions, however, the Penny Stock Act limited the SEC's authority to persons in regulated or registered entities, such as brokerage firms, investment advisers, and investment companies.[11]

Section 929P(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),[12] titled "Authority to Impose Civil Penalties in Cease and Desist Proceedings," eliminated the limitation on the SEC's authority to impose civil money penalties in administrative actions. This provision of Dodd-Frank amended Section 8A[13] of the Securities Act, Section 21B(a)[14] of the Securities Exchange Act, Section 9(d)(1)[15] of the Investment Company Act, and Section 203(i)(1)[16] of the Investment Advisers Act to allow the SEC to impose civil money penalties, as well as cease-and-desist orders, on almost any person involved with securities. Section 929P(a) essentially provides the SEC a choice of either proceeding in federal district court or of

[8] *See e.g.,* 5 U.S.C. §§556 and 3105.

[9] P.L. 101-429, 104 Stat. 931 (1990).

[10] Section 101 of the Penny Stock Act states:

> Whenever it shall appear to the Commission that any person has violated any provision of this title ... , the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation.

[11] Section 102(c)(2) of the Penny Stock Act states:

> This subsection [on cease-and-desist proceedings] shall apply only to a respondent that acts, or, at the time of the alleged misconduct acted, as a broker, dealer, investment adviser, investment company, municipal securities dealer, government securities broker, government securities dealer, or transfer agent, or is, or was at the time of the alleged misconduct, an associated person of, or a person seeking to become associated with, any of the foregoing.

[12] P.L. 111-203, 124 Stat. 1376 (2010).

[13] 15 U.S.C. §77h-1. The Dodd-Frank amendment to this section, which is representative of Dodd-Frank's amendments to the other federal securities law provisions on cease-and-desist proceedings, states:

> In any cease-and-desist proceeding under subsection (a), the Commission may impose a civil penalty on a person if the Commission finds, on the record, after notice and opportunity for hearing, that—
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> (A) such person—
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> (i) is violating or has violated any provision of this subchapter, or any rule or regulation issued under this subchapter; or
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> (ii) is or was a cause of the violation of any provision of this subchapter, or any rule or regulation thereunder; and
>
> (B) such penalty is in the public interest. 15 U.S.C. §77h-1(g).

[14] 15 U.S.C. §78u-2(a).

[15] 15 U.S.C. §80a-9(d)(1).

[16] 15 U.S.C. §80b-3(i)(1).

conducting its own administrative enforcement proceedings against almost any person charged with securities violations.

This provision of Dodd-Frank appears to have been a strong incentive for the SEC to bring more administrative actions, instead of going to court. There appear to be both advantages and disadvantages of administrative hearings. Possible advantages of administrative hearings over court proceedings include expedited procedure and the use of hearing examiners with expertise in the complexities of federal securities laws. However, despite a mandate of having fair and impartial hearing examiners, it may be argued that an administrative hearing provides a kind of home-court advantage for the agency. One commenter believes that this Dodd-Frank change has created significant disadvantages for defendants, such as the following:

> (1) administrative actions go to hearing on an accelerated schedule in which a hearing must be completed and an initial decision rendered by an administrative law judge within 270 days of the filing of the Commission's complaint; (2) there is no discovery in administrative proceedings; (3) there is no right of trial by jury; and (4) factual findings by the SEC in an administrative proceeding can only be reversed on appeal if the defendant shows that the findings failed to meet the "substantial evidence" test.[17]

An SEC official, however, has described its use of the administrative forum as having benefits for both the agency and for respondents:

> There are a number of benefits to using the administrative forum that can lead us to file cases there. First, administrative actions produce prompt decisions....
>
> Second, administrative proceedings have the benefit of specialized factfinders....
>
> Third, the rules governing administrative hearings provide that ALJs should consider relevant evidence....
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> I should note that these features of the administrative forum can also benefit the respondents. Either side can benefit when witnesses' recollections are fresher. And the relaxed rules of evidence may likewise give them more flexibility in offering evidence.[18]

Selected Cases Challenging the SEC Administrative Forum

Several cases are challenging the SEC's use of the administrative forum as violating the U.S. Constitution. As mentioned in the "Introduction," plaintiffs have brought suit against the SEC's administrative forum as violating their due process[19] and equal protection[20] rights and as violating the Constitution's Appointments Clause[21] in the way that the SEC chooses its administrative law judges. In addition to defending cases brought against its use of the administrative forum, the SEC has responded to these challenges by issuing in December 2014 a Commission Opinion[22]

[17] Gibson Dunn, *The Dodd-Frank Act Reinforces and Expands SEC Enforcement Powers* (July 21, 2010), located at http://www.gibsondunn.com/publications/pages/Dodd-FrankActReinforcesAndExpandsSECEnforcementPowers.aspx.

[18] Andrew Ceresney, Director, SEC Division of Enforcement, "Remarks to the American Bar Association's Business Law Section Fall Meeting," Nov. 21, 2014, located at http://www.sec.gov/News/Speech/Detail/Speech/1370543515297.

[19] U.S. CONST., amend. V and amend. XIV, §1.

[20] U.S. CONST., amend. XIV, §1.

[21] U.S. CONST., art. II, §2, cl. 2.

[22] In the Matter of John P. Flannery and James D. Hopkins, SEC Admin. Proc. File No. 3-14081 (Dec. 15, 2014), located at https://www.sec.gov/litigation/opinions/2014/33-9689.pdf.

indicating that it intends to continue to use the administrative forum aggressively to charge alleged securities wrongdoers and to appeal court opinions that strike down the agency's use of its administrative forum.

Jarkesy v. Securities and Exchange Commission[23]

In this case, the plaintiffs charged the SEC with violating their constitutional rights of due process, jury trial, and equal protection and with usurping a legislative prerogative, thereby violating the constitutional separation of powers.

The SEC chose to bring an administrative action, instead of an injunction action in federal court, against George Jarkesy, a Houston hedge fund manager, and at least two others (referred to here as co-respondents), charging them with defrauding investors in two hedge funds and with steering unnecessary fees to a brokerage firm. Charges included violations of the antifraud provisions of the Securities Act of 1933 (Section 17(a))[24] and the Securities Exchange Act of 1934 (Section 10(b)), as well as various sections of the Investment Advisers Act[25] and SEC regulations. The co-respondents made an offer of settlement, consenting to a finding that they aided, abetted, and caused the manager's and adviser's breaches of fiduciary duties to the hedge funds.[26] Jarkesy brought suit in the U. S. District Court for the District of Columbia, alleging that, in accepting the settlement offer, the SEC "entered detailed and unqualified findings of fact and conclusions of law against plaintiffs, including finding that plaintiffs engaged in fraudulent conduct," thereby violating plaintiffs' constitutional rights.

On June 10, 2014, the district court issued a memorandum opinion dismissing the plaintiffs' complaint for lack of subject matter jurisdiction. The district court found that the statutory and regulatory framework applicable to the SEC precluded the court from exercising subject matter jurisdiction. Referring to Section 25 of the Securities Exchange Act,[27] the court stated that, if a person wishes to challenge a final order of the SEC, he may obtain review in the U.S. Court of Appeals. In the instant situation, the plaintiff, according to the court, did not receive a final SEC order and, even if he had, he would have to challenge it in the court of appeals, not in the district court. This is true, according to the district court, even though the plaintiff raised a constitutional due process claim. The court cited to a Supreme Court case, *Thunder Basin Coal Company v. Reich,*[28] which held that a litigant with an agency grievance can seek relief in district court if he can show that the "claims considered [are] wholly collateral to a statute's review provisions and outside the agency's expertise, particularly where a finding of preclusion could foreclose all meaningful judicial review." Jarkesy, like the plaintiff in *Thunder Basin,* was unable, according to the district court, to satisfy this requirement.

On August 12, 2014, Jarkesy asked the U.S. Court of Appeals for the District of Columbia Circuit (D.C. Circuit) to review the district court's dismissal of his complaint. In April 2015, the D.C.

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[23] 48 F. Supp. 3d 32 (D.D.C. 2014).

[24] 15 U.S.C. §77q(a).

[25] 15 U.S.C. §§80b-1 *et seq*.

[26] It is understood that Jarkesy is the manager and adviser referenced in the settlement agreement.

[27] 15 U.S.C. §78y. This provision states in pertinent part:

> A person aggrieved by a final order of the Commission entered pursuant to this chapter may obtain review of the order in the United States Court of Appeals for the circuit in which he resides or has his principal place of business, or for the District of Columbia Circuit, by filing in such court, within sixty days after the entry of the order, a written petition requesting that the order be modified or set aside in whole or in part.

[28] 510 U.S. 200 (1994).

Circuit heard oral argument,[29] and on September 29, 2015, the D.C. Circuit held[30] that Jarkesy had to exhaust his administrative remedies before bringing a constitutional challenge to the administrative forum in a federal court of appeals.

Like the district court, the D.C. Circuit turned to the *Thunder Basin* decision for guidance. It looked to the two-part approach that *Thunder Basin* set out for determining the procedure that a litigant must use through a statutory scheme of administrative and judicial review. According to *Thunder Basin*, if (1) congressional intent is "fairly discernible in the statutory scheme" and (2) the litigant's claims are of the type that Congress intended to be reviewed within the statutory structure, then the statutory structure is the exclusive means by which the litigant can obtain administrative and judicial review.

As for the first part—that there be a fairly discernible congressional intent in the statutory scheme—the D.C. Circuit found that the federal securities laws have a comprehensive structure for the adjudication of securities violations in administrative proceedings. In addition, according to the court, the Securities Exchange Act clearly provides that, once an SEC proceeding reaches a final order, an aggrieved party may seek court review in a federal court of appeals. Given the detail that Congress used in setting out the review process by a court of appeals, the D.C. Circuit opined:

> Congress, though, gave *the SEC* the option to pursue violations in district court. Congress did not thereby necessarily enable *respondents in administrative proceedings* to collaterally attack those proceedings in court. In other words, Congress granted the choice of forum to the Commission, and that authority could be for naught if respondents like Jarkesy could countermand the Commission's choice by filing a court action.[31]

As for the second part—that the litigant's claims are the type that Congress intended to be reviewed within the statutory structure—the D.C. Circuit looked to the Supreme Court's discussion in *Free Enterprise Fund v. Public Company Accounting Oversight Board*[32] of three situations in which it may be presumed that Congress wanted the district court to remain open to a litigant's claims: (1) a finding of preclusion (i.e., not allowing district court review) could foreclose all meaningful judicial review, (2) the suit is wholly collateral to a statute's review provisions, and (3) the claims are outside the agency's expertise.

The D.C. Circuit found no basis in the *Jarkesy* case for allowing district court review per any of the three *Free Enterprise* criteria: (1) Jarkesy's constitutional claims, if the SEC's final order finds him at fault, can be later challenged in a federal court of appeals; (2) Jarkesy's constitutional claims are not outside the SEC administrative enforcement scheme; rather, the claims arise from actions that the SEC took in the administrative scheme, thereby not being collateral to the securities laws' review provisions; and (3) the majority of Jarkesy's challenges are within the SEC's "ordinary course of business" and not outside its areas of expertise.

The D.C. Circuit concluded that for these reasons the federal securities laws provide an exclusive avenue for review and that Jarkesy cannot bypass this exclusive avenue by filing suit in federal district court. It therefore affirmed the district court's decision dismissing the case for lack of subject matter jurisdiction. At this time, there does not appear to be information about whether Jarkesy will appeal the decision.

[29] No. 14-5196 (D.C. Cir. April 13, 2015).

[30] 803 F. 3d 9 (D.C. Cir. 2015).

[31] *Id.* at 17.

[32] 561 U.S. 477 (2010).

Wing F. Chau v. Securities and Exchange Commission[33]

In October 2013, the SEC filed an administrative case against Wing F. Chau and Harding Advisory, accusing them of fraud related to selecting securities linked to a synthetic collateralized debt obligation. Instead of accusing the SEC of prejudging by issuing findings against other defendants that implicated him in fraud, as Jarkesy alleged, the plaintiffs argued in court that the SEC filed three similar cases in federal district court but brought theirs before an administrative law judge and that that violated their due process by depriving them of certain procedural safeguards, such as discovery and the right to a trial by jury. The plaintiffs filed suit to enjoin the SEC from going forward with its administrative action.

In December 2014, the U.S. District Court for the Southern District of New York held that the court did not have jurisdiction to consider the plaintiffs' lawsuit to prevent the SEC's administrative action. The court found that the SEC has statutory authority and subject matter expertise to decide in the administrative forum whether Chau and Harding violated the securities laws and that the administrative forum would not violate their constitutional guarantees of due process and equal protection. Only after the conclusion of the administrative proceedings, according to the court, might they file suit in federal court.

> The Court recognizes that the growth of administrative adjudication, especially in preference to adjudication by Article III courts and particularly in the field of securities regulation, troubles some....
>
> These concerns are legitimate, whether born of self-interest or of a personal assessment of whether the public interest would be served best by preserving the important interpretive role of Article III courts in construing the securities laws—a role courts have performed since 1933. But they do not affect the result in this case.
>
> This Court's role is a modest one. It is merely to determine whether the Court has the power to reach the merits of plaintiffs' constitutional claims.... [T]his Court holds that it does not. If plaintiffs lose before the Commission, they will have a full opportunity to present their arguments in a court of appeals. In reaching this conclusion, moreover, this Court has not considered any views concerning the proper or wise allocation of interpretive functions between the Commission and the courts. Those are policy matters committed to the legislative and executive branches of government.[34]

Bebo v. Securities and Exchange Commission[35]

Undeterred by the initial SEC victories in *Jarkesy* and *Chau*, plaintiff Laurie Bebo, formerly CEO of Assisted Living Concepts, Inc. (ALC), filed suit in early 2015 against the SEC for bringing an unconstitutional action against her in an administrative forum rather than in federal district court. In December 2014, the SEC alleged that Bebo and another person listed nonexistent occupants at senior residences in order to meet certain occupancy requirements and to avoid defaulting on leases. The SEC charged that a default would have required ALC to pay tens of millions of dollars of the remaining rent due on the leases, thereby defrauding shareholders. Bebo claimed that the SEC's "unlimited ability" to charge her administratively violated her constitutional equal protection and due process rights.

The U.S. District Court for the Eastern District of Wisconsin held that it did not have subject matter jurisdiction, stating:

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[33] 72 F. Supp. 3d 417 (S.D.N.Y. 2014).

[34] *Id.* at 436-437.

[35] No. 15-C-3 (E.D. Wis. March 3, 2015), 2015 U.S. Dist. LEXIS 25660.

> The Court Finds that Bebo's claims are compelling and meritorious, but whether that view is correct cannot be resolved here. This is so because Bebo's claims are subject to the exclusive remedial scheme set forth in the Securities Exchange Act. Bebo must litigate her claims before the SEC and then, if necessary, on appeal to the Court of Appeals for the Seventh Circuit.

Bebo appealed to the U.S. Court of Appeals for the Seventh Circuit (Seventh Circuit), which affirmed[36] the district court's dismissal of the case for lack of subject matter jurisdiction. The Seventh Circuit emphasized that courts have consistently required plaintiffs to use the administrative review schemes that Congress has established before being allowed to challenge agency decisions in court. With respect to Section 929P(a) of Dodd-Frank, the Seventh Circuit found "no evidence from the statute's text, structure, and purpose that Congress intended for plaintiffs like Bebo who are already subject to ongoing administrative enforcement proceedings to be able to stop those proceedings by challenging the constitutionality of the enabling legislation or the structural authority of the SEC."[37]

In arriving at its decision, the Seventh Circuit looked at which of two Supreme Court decisions controlled Bebo's constitutional challenges to the SEC's administrative forum: *Free Enterprise Fund v. Public Company Accounting Oversight Board*,[38] which plaintiff urged as allowing a direct route to federal district court to challenge an agency's administrative proceedings as unconstitutional, or *Elgin v. Department of the Treasury*,[39] which the SEC urged as cutting off a plaintiff's federal district court challenge if the plaintiff has an eventual chance to bring review of the agency's proceedings in a federal court of appeals. The Seventh Circuit ruled that the *Elgin* case governed because, as the federal district court stated in the above quote, the Securities Exchange Act has set out a statutory scheme by which a plaintiff must first go through the appropriate administrative proceedings and then only afterward may bring suit against the agency in a federal court of appeals.

On November 6, 2015, the Seventh Circuit declined Bebo's petition for rehearing en banc.[40] On March 28, 2016, the Supreme Court denied *certiorari* in Bebo's suit challenging the constitutionality of the SEC's in-house administrative forum.[41]

Hill v. Securities and Exchange Commission[42]

In contrast to the above cases, *Hill v. Securities and Exchange Commission* did halt an SEC enforcement proceeding and allowed the defendant's constitutional challenge to continue. In February 2015, the SEC brought an administrative proceeding against Charles Hill, a real estate developer, claiming that Hill had engaged in prohibited insider trading when he bought shares in a Georgia-based technology firm with the knowledge provided by a close friend that the firm would soon receive a buyout offer. Hill sued the SEC in federal district court, arguing, among other things, that the SEC's selection of ALJs violated the Constitution's Appointments Clause and that their statutory tenure protections[43] violated the executive appointment and removal

[36] 799 F. 3d 765 (7th Cir. 2015)..

[37] *Id*. at 774.

[38] 561 U.S. 477 (2010).

[39] 567 U.S. ___, 132 S. Ct. 2126 (2012).

[40] "7th Circ. Won't Rehear Challenge to SEC In-House Court," *see* http://www.law360.com/articles/724374/7th-circ-won-t-rehear-challenge-to-sec-in-house-court.

[41] Bebo v. Securities and Exchange Commission, *cert. denied* No. 15-997 (USSC March 28, 2015).

[42] 1:15-CV-1801-LMM (N.D. Ga. June 8, 2015), 2015 U.S. Dist. LEXIS 74822.

[43] *See, e.g.*, 5 U.S.C. §7521(a):

(continued...)

powers. Hill stated that, because the ALJs are "inferior officers" under the Appointments Clause but not appointed by "department heads" (in this case, the SEC commissioners) per the dictates of the clause, the SEC's in-house court is unconstitutional. (SEC ALJs are appointed by the SEC's Office of Administrative Law Judges, with input from other entities such as the Office of Personnel Management and the SEC's Chief Administrative Law Judge.)[44]

The district court issued a 45-page order in which it halted the SEC's administrative proceeding against Hill on the basis that the in-house forum was "likely unconstitutional" because of its belief that the SEC's appointment of ALJs is counter to the Appointments Clause.

The court first addressed the SEC's argument that the district court did not have subject matter jurisdiction because of the procedure set out by 15 U.S.C. Section 78y (i.e., after a final SEC order, a plaintiff may bring a challenge in a federal court of appeals). In response to this argument, the district court looked at the jurisdictional provision of 28 U.S. Section 1331, which provides that federal district courts "have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States." The district court found no congressional intent under Section 1331 to restrict the district court's statutory grant of jurisdiction. Instead, according to the district court:

> [T]he clear language [of 28 U.S.C. § 1331 and 78 U.S.C. § 78y, taken together,] provides a choice of forum, and there is no language indicating that the administrative proceeding was to be an exclusive forum. There can be no 'fairly discernible' Congressional intent to limit jurisdiction away from district courts when the text of the statute provides the district court as a viable forum. The SEC cannot manufacture Congressional intent by making that choice for Congress; Congress must express its own intent within the language of the statute.[45]

The district court went on to state that, even if the above argument is not dispositive of whether it can exercise jurisdiction in Hill's lawsuit, three additional reasons lead it to conclude that it does have jurisdiction:

> A court may "presume that Congress does not intend to limit jurisdiction" if (1) "a finding of preclusion could foreclose all meaningful judicial review"; (2) "if the suit is wholly collateral to a statute's review provisions"; and if (3) "the claims are outside the agency's expertise."[46]

The court discussed each of these three factors.

(...continued)

> An action may be taken against an administrative law judge appointed under section 3105 of this title by the agency in which the administrative law judge is employed only for good cause established and determined by the Merit Systems Protection Board on the record after opportunity for hearing by the Board.

[44] *See, e.g.*, 5 C.F.R. §930.204(a) and 15 U.S.C. §78d-1(a). The regulation states in pertinent part:

> An agency may appoint an individual to an administrative law judge position only with prior approval of OPM, except when it makes its selection from the list of eligibles provided by OPM.

The statute states in pertinent part:

> In addition to its existing authority, the Securities and Exchange Commission shall have the authority to delegate, by published order or rule, any of its functions to a division of the Commission, an individual Commissioner, an administrative law judge, or an employee or employer board, including functions with respect to hearing, determining, ordering, certifying, reporting, or otherwise acting as to any work, business, or matter.

See also 17 C.F.R. §200.30-10: Delegation of authority to Chief Administrative Law Judge.

[45] Hill v. SEC, 2015 U.S. Dist. LEXIS 74822, at 13.

[46] *Id*. at 14.

With respect to the finding that barring plaintiff's claims in the district court would preclude all meaningful judicial review, the district court stated that requiring the plaintiff to wait until the completion of the administrative process—a process that, in fact, the plaintiff claims is unconstitutional—could result in harm to the plaintiff that could not be remedied. Such a situation would have required the plaintiff to endure what may well be an unconstitutional process, thereby depriving him of *meaningful* judicial review.

As for the factor of whether the plaintiff's claims are wholly collateral to the SEC proceeding, the district court found that the claims are wholly collateral and not just a "vehicle" to shut down the SEC's administrative process. The district court emphasized that the plaintiff is not challenging an agency decision; instead, the plaintiff is challenging whether the agency has even the constitutional authority to make that decision.

> Plaintiff is not challenging an agency decision; Plaintiff is challenging whether the SEC's ability to make that decision was constitutional. What occurs at the administrative proceeding and the SEC's conduct there is irrelevant to this proceeding which seeks to invalidate the entire statutory scheme.... Accordingly, Plaintiff's constitutional claims are wholly collateral to the administrative proceeding.

As for the third factor—whether the plaintiff's constitutional claims are outside the agency's expertise—the district court found that they were outside the SEC's expertise. The constitutional claims that Hill brought against the SEC were not, according to the district court:

> part and parcel of an ordinary securities fraud case, and there is no evidence that (1) Plaintiff's constitutional claims are the type the SEC "routinely considers," or (2) the agency's expertise can be "brought to bear" on Plaintiff's claims.... [47]

The district court next turned, perhaps most importantly, to Hill's claim that the selection of the SEC's ALJs violated the Constitution's Article II Appointments Clause.

The plaintiff brought two claims under Article II: (1) the appointment of the ALJ violated the Appointments Clause because he was not appointed by the President, a court of law, or a department head and (2) the ALJ's tenure protection violated the Constitution's separation of powers (i.e., the President's ability to exercise power over his inferior officers). The district court stated that the success of both of these arguments depended on its finding that the SEC ALJ is an "inferior officer" under the Constitution.

As for whether the ALJ is an inferior officer for purposes of the Appointments Clause, the district court relied on the Supreme Court's decision in *Freytag v. Commissioner of Internal Revenue.*[48] In *Freytag*, the Court had to decide whether special trial judges in the Tax Court were inferior officers under Article II. The Court rejected the government's argument that the judges were mere functionaries who lacked real authority, stating that the government's argument:

> ignores the significance of the duties and discretion that special trial judges possess. The office of special trial judge is "established by Law," Art. II, § 2, cl. 2, and the duties, salary, and means of appointment for that office are specified by statute.... These characteristics distinguish special trial judges from special masters, who are hired by Article III courts on a temporary, episodic basis, whose positions are not established by law, and whose duties and functions are not delineated in a statute. Furthermore, special trial judges perform more than ministerial tasks. They take testimony, conduct trials, rule on the admissibility of evidence, and have the power to enforce compliance with

[47] *Id.* at 21-22.

[48] 501 U.S. 868 (1991).

> discovery orders. In the course of carrying out these important functions, the special trial judges exercise significant discretion.[49]

The district court found that SEC ALJs are like the special trial judges. The office is established by law; the duties, salary, and means of appointment are specified by statute; they are permanent employees; and they take testimony, conduct trials, rule on the admissibility of evidence, and can issue sanctions. Therefore, the district court found that *Freytag* requires that, like special trial judges, ALJs exercise significant authority and are inferior officers. The district court went on to state that, because SEC ALJs are inferior officers, they must be appointed by the President, department heads, or courts of law.

Because the ALJ in the *Hill* proceeding was not appointed by SEC commissioners, in accordance with the Constitution, his appointment, according to the district court, was likely unconstitutional. For this reason, the district court held that the plaintiff had shown a substantial likelihood of succeeding on the merits of his claim and granted a preliminary injunction to prevent the SEC from continuing with the administrative proceeding. The district court did not decide whether the ALJs' statutory tenure protections violated the executive appointment and removal procedures because of its finding that the plaintiff had already established a likelihood of success on the Appointments Clause claim.

The SEC has appealed the *Hill* decision to the U.S. Court of Appeals for the Eleventh Circuit.[50]

Duka v. Securities and Exchange Commission[51]

This decision, from the U.S. District Court for the Southern District of New York, also halted an SEC administrative proceeding. The SEC initiated an administrative proceeding against Barbara Duka, a former managing director at Standard & Poor's, alleging that she committed fraud with respect to S&P's misleading ratings of mortgage-backed securities. Duka brought suit against the SEC in federal district court to demand that the SEC's administrative proceedings against her be halted, claiming, like Hill, that the SEC's selection of ALJs was unconstitutional—in violation of the Appointments Clause—and that their statutory tenure protections violated Article II's executive appointment and removal powers.

The court preliminarily enjoined the SEC from proceeding against Duka. It held that it had subject matter jurisdiction because, among other reasons, the plaintiff should not have to suffer harm before having meaningful judicial review. As in the *Hill* decision, the court held that, since SEC ALJs are not directly appointed by the SEC commissioners:

> they were not appropriately appointed pursuant to *Article II* [and] their appointment is likely unconstitutional in violation of the *Appointments Clause*.[52]

Concerning Duka's second claim—that the ALJs' tenure protections violated Article II's executive appointment and removal powers—the court found no basis to reconsider its April decision and order, in which it did not conclude that the statutory restrictions concerning removal of the ALJs infringed the President's constitutional authority.

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[49] *Id.* at 881-82.

[50] Hill v. SEC, No. 15-12831 (11th Cir. filed July 2, 2015).

[51] 15 Civ. 357 (RMB) (SN) (S.D.N.Y. Aug 12, 2015), 2015 U.S. Dist. LEXIS 106605. This is the decision and order granting a preliminary injunction. Prior history: Duka v. Securities and Exchange Commission, 2015 U.S. Dist. LEXIS 100999 (S.D.N.Y. Aug. 3, 2105) and Duka v. Securities and Exchange Commission, 2015 U.S. Dist. LEXIS 49474 (S.D.N.Y. April 15, 2015).

[52] Duka v. SEC, 2015 U.S. Dist. LEXIS 106605, at 2.

In an August 3, 2015, order,[53] the court gave the SEC until August 10 "to allow the SEC the opportunity to notify the Court of its intention to cure any violation of the *Appointments Clause*" (i.e., to have the SEC commissioners directly appoint the ALJ in the proceeding against Duka). An August 10 letter from the Department of Justice stated the SEC's intention to decline the court's offer to announce a change in the process.[54]

On September 17, 2015, the U.S. District Court for the Southern District of New York denied the SEC's request to delay enforcement of the order barring its case against Duka.[55]

The SEC has appealed the *Duka* decision to the U.S. Court of Appeals for the Second Circuit.[56]

Tilton v. Securities and Exchange Commission[57]

In March 2015, the SEC brought an administrative cease-and-desist proceeding against Patriarch Partners, its CEO and founder Lynn Tilton, and affiliated companies, alleging that they violated the federal securities laws by fraudulently collecting $200 million in fees and expenses. The SEC alleged that Tilton and her firm hid poor performances of companies in which her funds had investments by failing to use the methodology laid out in the investment documents. This, according to the SEC, allowed Tilton and Patriarch to collect excessive management fees and to commit other fraudulent actions. Tilton brought suit for a preliminary injunction against the SEC in the U.S. District Court for the Southern District of New York to challenge the constitutional authority of the administrative proceeding on the basis of the unconstitutional scheme for appointing and removing the SEC's ALJs.

The June 30, 2015, decision, by a different judge in the same district court as the *Duka* decision, denied Tilton's motion for a preliminary injunction against the SEC. The court recognized that several courts had decided this issue in different ways:

> In recent months, district courts have reached different conclusions as to whether they have jurisdiction over claims similar to the ones Plaintiffs raise here, or whether jurisdiction is precluded by the statutory scheme.... Ultimately, this Court finds the arguments against jurisdiction more persuasive, and concludes that Plaintiffs have not established that Congress intended to exclude their claims from the designated statutory review scheme.

The court stated that the question of whether the SEC had the authority to bring an action in an administrative proceeding was not its decision to make and used the following language, which is similar to language used by courts in decisions such as *Jarkesy* and *Chau,* cases that challenged the use of the SEC's administrative forum principally on the bases of due process and equal protection:

> Congress has carefully delineated the distinct roles of the Commission and the courts in such cases as this. It rests first with the Commission to determine whether to commence an action at all, and if so, whether to do so in federal district court or in its own administrative tribunal. Having chosen the latter, it rests with an ALJ and then the Commission to rule on Plaintiffs' claims. That decision in turn is subject to appeal to a

[53] *See* footnote 46.

[54] Letter located at https://securitiesdiary.files.wordpress.com/2014/11/sec-response-to-judge-richard-berman-re-appointment-of-aljs.pdf.

[55] Duka v. SEC, No. 15-cv-00357, order (S.D.N.Y. September 17, 2015).

[56] "SEC Appeals Latest Loss over Admin Judges to 2nd Circ," located at http://www.law360.com/articles/696220/sec-appeals-latest-loss-over-admin-judges-to-2nd-circ.

[57] 15-CV-2472 (RA) (S.D.N.Y. June 30, 2015), 2015 U.S. Dist. LEXIS 85015.

> federal court of appeals. In this Court's view, there is no basis to allow Plaintiffs to bypass this congressionally created remedial scheme. Accordingly, this Court lacks subject matter jurisdiction over this action.[58]

Tilton has appealed the decision to the U.S. Court of Appeals for the Second Circuit.[59]

On September 17, 2015, the Second Circuit issued an order staying the SEC's administrative proceeding. This allows the court to have more time to consider Tilton's claim that the in-house forum is unconstitutional.[60]

In Re Timbervest LLC[61]

On June 8, 2015, Timbervest and its executives, ordered by an SEC ALJ to pay $1.9 million in disgorgement for violations of the Investment Advisers Act of 1940, argued before the SEC commissioners that the appointment of the SEC ALJs was unconstitutional as a violation of the Constitution's separation of powers. In a September 17, 2015, opinion, four members of the SEC unanimously stated that the hiring of the ALJs is constitutional and that their removal process does not violate presidential authority.[62] On November 13, 2015, Timbervest petitioned the D.C. Circuit for review of the SEC's final decision.[63]

The *Timbervest* case differs from other cases discussed in this report. The plaintiffs in *Timbervest* waited for a final administrative decision before taking their constitutional challenge to the court of appeals. This wait for a final administrative decision adheres to the statutory and regulatory procedure outlined by certain other courts as necessary before challenges in a federal court of appeals to the SEC's administrative forum and the selection of SEC ALJs may occur. At this time, the D.C. Circuit does not appear to have decided whether to accept the appeal of the SEC's final order.

Analysis

As described herein, the decisions in cases that have been brought to challenge the constitutionality of the SEC's administrative forum have sometimes validated the SEC's use of the forum and at other times have found in favor of the challenging plaintiff, thus halting the use of the administrative forum.

So far, it appears that the cases validating the forum have focused primarily on plaintiffs' due process and equal protection challenges. This is true in the *Jarkesy*, *Chau*, and *Bebo* cases. All three cases held that the plaintiffs had to exhaust their administrative remedies before they could challenge in a federal court of appeals the SEC's final action and thereby the agency's violation of their constitutional rights. These case decisions did not hinge on a discussion of the merits of plaintiffs' constitutional challenges. Instead, they focused on the statutory procedural scheme set out by such statutes as Section 25 of the Securities Exchange Act and Section 929P(a) of Dodd-Frank. The cases held that plaintiffs had to abide by this procedure before they could bring a court challenge.

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[58] *Id.* at 10.

[59] "Tilton, SEC Spar in 2nd Circ. over Agency's In-House Court," located at http://www.law360.com/articles/691587/tilton-sec-spar-in-2nd-circ-over-agency-s-in-house-court.

[60] *See* http://www.fa-mag.com/news/sec-loses-second-round-in-battle-over-in-house-judges-23167.html.

[61] SEC Admin. Proc. File No. 3-15519 (oral argument June 8, 2015).

[62] SEC Admin. Proc. File No. 3-15519 (Sept. 17, 2015).

[63] Timbervest LLC v. SEC, No. 15-1416 (D.C. Cir., petition for review Nov. 13, 2015).

In contrast, the *Hill* and *Duka* cases allowed plaintiffs to go forward with their lawsuits in federal district court, holding that their arguments concerning the unconstitutionality of the appointment of SEC ALJs likely had merit. The *Tilton* decision, however, appeared to criticize the reasoning in *Hill* and held that the plaintiff's argument about the unconstitutionality of the ALJ selection could not be brought in court until the SEC reached finality in the administrative proceeding. *Tilton* used language similar to the language used by the courts in *Jarkesy*, *Chau*, and *Bebo*. *Timbervest* differs from *Jarkesy*, *Chau*, and *Bebo* because the plaintiff waited for a final administrative decision before petitioning a federal court of appeals to accept his case challenging the constitutionality of the SEC's administrative forum. At this time, there does not appear to be a decision by the D.C. Circuit as to whether to accept the appeal of the SEC's final order.

Bebo and *Jarkesy* are the only cases to have been decided by federal courts of appeals, the Seventh Circuit and the D.C Circuit respectively. Other cases discussed in this report, decided by federal district courts, are on appeal to federal courts of appeals. With attacks on two fronts to the SEC's administrative forum—due process and equal protection challenges on one front and selection and tenure protection of SEC ALJs on the other front—there is the possibility of different holdings on the different issues by different circuit courts. If there are different opinions in the federal circuit courts, or even if there is not a split in the circuits, the U.S. Supreme Court may decide to grant *certiorari* in order to decide the constitutionality of the SEC administrative forum.

A Supreme Court decision could be written broadly enough that it would have an impact on the administrative forum in other agencies. For example, should a Supreme Court decision hold unconstitutional the SEC's statutory and regulatory framework requiring exhaustion of administrative remedies before bringing a court of appeals challenge to the SEC's final order, whether constitutional or otherwise, a similar statutory and regulatory framework in other federal agencies could be in jeopardy. At this time, the challenges to the SEC's administrative forum based on due process and equal protection appear to have been unsuccessful. However, challenges to the constitutionality of the forum based on selection procedure and tenure protection have met with some success. Should the plaintiffs in *Hill* and *Duka* be ultimately successful, the result could have an impact on agencies in addition to the SEC.

Possible Broad Impact of *Hill* and *Duka*

The constitutionality of the way in which ALJs are appointed in other federal agencies is beyond the scope of this report. However, the ALJ appointment "quandary" has been discussed for some time.[64]

If SEC ALJs are actually determined to be inferior officers, the appointment of ALJs in some agencies other than the SEC may be improper. The APA gives agencies a certain amount of discretion in the manner in which they appoint ALJs.[65] If ALJs have not, for example, been appointed by department heads—the argument made in *Hill* and *Duka*—they may face a constitutional Appointments Clause problem.

As mentioned in the discussion of the *Hill* decision, the Supreme Court in *Freytag v. Commissioner of Internal Revenue* found that special trial judges appointed by the Chief Judge of the U.S. Tax Court exercised significant powers and were therefore to be considered inferior officers requiring appointment by the department head. So too, according to *Hill*, are SEC ALJs inferior officers who must be appointed by the department head. If this line of reasoning is

[64] *See, e.g.*, Kent Barnett, *Resolving the ALJ Quandary*, 66 VAND. L. REV. (2013).

[65] 5 U.S.C. §3105.

followed by the courts with respect to the appointment of ALJs of all federal agencies, so too, it might be argued, must all ALJs be appointed by department heads. That may not currently be the situation in agencies other than the SEC.

Nevertheless, it is not certain that all ALJs are inferior officers who must be appointed by the department head. For example, the APA refers to ALJs as "presiding employee[s],"[66] although, as mentioned by one scholar, "this reference might be understood as a lingering indignity from the ALJs' 'hearing examiner' past."[67] In addition, the U.S. Court of Appeals for the District of Columbia Circuit held in *Landry v. Federal Deposit Insurance Corporation*[68] that ALJs appointed by the Office of Thrift Supervision were not inferior officers:

> [W]e 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.

With respect to the argument made by *Hill* and *Duka* concerning the unconstitutionality of the tenure protections afforded SEC ALJs—an argument not addressed by either of the courts—Justice Breyer in his dissent in *Free Enterprise Fund v. Public Company Accounting Oversight Board* stated that the decision in the *Free Enterprise Fund*[69] case could result in:

> sweeping hundreds, perhaps thousands of high-level Government officials within the scope of the Court's holding, putting their job security and their administrative actions and decisions constitutionally at risk.[70]

Justice Breyer went on to state that the officials and their decisions swept out by the *Free Enterprise* holding could include ALJs:

> My research reflects that the Federal Government relies on 1,584 ALJs to adjudicate administrative matters in over 25 agencies. See Appendix C, infra; see also Memorandum of Juanita Love, Office of Personnel Management, to Supreme Court Library (May 28, 2010) (available in Clerk of Court's case file). These ALJs adjudicate Social Security benefits, employment disputes, and other matters highly important to individuals. Does every losing party before an ALJ now have grounds to appeal on the basis that the decision entered against him is unconstitutional? Cf. ante, ("[O]ur holding also does not address" this question).

This discussion is not to suggest that a Supreme Court case on SEC ALJs is forthcoming—much less that, should there be a decision, the Court would strike down the SEC ALJ selection process or tenure protections or that a decision would have an impact on ALJs in other agencies. Instead, the discussion is intended to set out only *possible* ramifications of a definitive decision on the constitutionality of SEC ALJ appointments and tenure protections.

Congressional Interest

As mentioned in this report's "Introduction," at least two congressional hearings have discussed the issue. On December 2, 2015, the Subcommittee on Capital Markets and Government

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[66] 5 U.S.C. §557(b).

[67] *See* Barnett, 66 VAND. L. REV. at 812.

[68] 204 F.3d 1125 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 924 (2000).

[69] *Free Enterprise Fund* invalidated Congress's use of two layers of tenure protection for members of the Public Company Accounting Oversight Board: (1) Section 107 of Sarbanes-Oxley (P.L. 107-204 (2002)) allowed removal of the PCAOB members by the SEC only for significant cause and not at-will. (2) The parties in the case agreed that the President could remove the SEC commissioners only for inefficiency, neglect of duty, or malfeasance in office.

[70] Free Enterprise Fund, 561 U.S. 476, 540-41 (2010).

Sponsored Enterprises of the House Committee on Financial Services held a hearing titled "Legislative Proposals to Improve the U.S. Capital Markets." One of the legislative proposals discussed in the hearing was H.R. 3798, 114th Congress, titled the "Due Process Restoration Act of 2015." H.R. 3798 would allow a defendant in an SEC administrative proceeding involving a cease-and-desist order and a penalty to require the SEC to terminate the proceeding. After the required termination, the SEC may bring a civil action against the person for the same remedy. The bill would also require that in an administrative proceeding the SEC must show by clear and convincing evidence, instead of the commonly used "preponderance of the evidence" standard, that a person has violated the relevant securities law.

On March 19, 2015, the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Committee on Financial Services held a hearing titled "Oversight of the SEC's Division of Enforcement." In his comments, Representative Garrett, chairman of the subcommittee, expressed concern about the possible infringement of constitutional protections for persons charged with securities violations in SEC administrative forums. He stated in part:

> [W]hale the SEC is first and foremost a disclosure agency. I support a strong enforcement function of the SEC. This enforcement function, however, must be used in an evenhanded, non-political manner that preserves the due-process rights of issuers, regulated entities, and their employees....
>
> While bringing more cases through the administrative proceedings can lead to lower costs for the agency and increases in efficiency, it is important to realize that those benefits come with a cost.
>
> The cost is less due-process protections for defendants. Because the SEC administrative proceedings use the SEC's procedural rules, respondents are forced to operate on a condensed timeframe, and do not have the benefit of many of the fundamental due-process protections provided under the Federal Civil Procedures Act, and the Federal Rules of Evidence, such as full discovery rights, the right to a jury trial, and the exclusion of hearsay evidence.
>
> Moreover, initial appeals of administrative law judge (ALJ) rulings must be made to the full Commission, an ALJ's employer, rather than Federal district court. While the Commission's decision may be appealed to the D.C. Circuit Court of Appeals, the SEC's interpretation of the security laws generally will be given significant deference. Appealing an administrative decision is a time-consuming and expensive proposition....
>
> So this, coupled with the SEC's 100% success rate—which is a pretty good success rate—100% success rate from the year 2014 illustrates a very troubling pattern of the SEC's attempting to stack the rules and process in a way that the outcome of the case is, well, predetermined. This is not appropriate in a country that values appropriate due process for its citizens. Due process is a fair process, and fair process is fair play.

Andrew Ceresney, the Director of the Division of Enforcement of the SEC and the sole witness at this hearing, defended the SEC's use of the administrative hearing. He stated in part:

> Administrative proceedings is a procedure that is available to us. And we try to use it when it is appropriate to protect investors. And we look at a whole bunch of factors to determine whether an administrative proceeding is appropriate....
>
> We use a number of facts and circumstances. First, there are certain proceedings we can only bring as administrative proceedings. So that includes failures to supervise and causing violations.
>
> Second, in cases where we need quick relief, where we want to get a bar very quickly, or we want to get investors relief quickly, administrative proceedings can be much quicker than district court actions. District court actions will often take years to get a resolution

in. APs, we can get a decision within 300 days of the institution of the action. So that is important.

And another important point is where we have technical rules, where we have complicated rules, some of our rules are very complicated, we have sophisticated fact-finders who are the ALJs; whereas with a jury, it would be much more difficult for them to grasp those very, very complicated issues.

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