

Securities Litigation Update: Constitutional Challenges to SEC's Administrative Courts Gain Momentum

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Constitutional attacks against the Securities Exchange Commission's (the "SEC") use of administrative proceedings have grown in strength as securities respondents across the country have filed federal complaints contending that, among other things, SEC Administrative Law Judges ("ALJs") are acting in violation of Article II of the Constitution. Two district judges have found the constitutional challenges meritorious, while other courts have held that federal courts lack jurisdiction to decide the constitutional issues raised in the complaints. The SEC has recently weighed in, rejecting challenges to the constitutionality of its use of ALJs. And last week, after hearing oral argument, the Second Circuit stayed an administrative proceeding while it considers the merits of an appeal raising these issues. If the constitutional challenges ultimately prevail, it could call into question past administrative proceedings against securities respondents and also have implications for other federal agencies' use of administrative proceedings.

SEC Administrative Proceedings After Dodd-Frank

The constitutional challenges to the SEC's administrative proceedings arise from changes implemented by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"). Previously, the SEC could not seek civil penalties against unregistered individuals in administrative proceedings; instead, the SEC would have to file a complaint in federal court. Dodd-Frank authorizes the SEC to seek civil penalties against unregistered individuals in administrative proceedings, and the SEC has taken advantage of this new option. As such, and because proceedings before SEC ALJs are thought to be more favorable towards the SEC, respondents facing civil charges in front of ALJs have levied constitutional challenges in federal court seeking to enjoin the administrative proceedings against them.

The Constitutional Challenges

Constitutional challenges against SEC administrative proceedings have been asserted under various theories, including that Dodd-Frank—by giving the SEC authority to bring civil cases against non-registered individuals in administrative or federal court—violates the nondelegation doctrine of Article I; that the use of administrative proceedings violates a respondent's Seventh Amendment right to a jury trial; and that the current administrative structure improperly inhibits the President from exercising the "Executive power" over inferior officers in violation of the separation of powers.

The argument that has the most traction in federal courts, however, focuses on the technical requirements of the Appointments Clause in Article II. The Appointments Clause provides that the President shall appoint Officers of the United States, but that Congress may vest the appointment of inferior officers "in the President alone, in the Courts of Law, or in the Heads of Departments." Respondents have argued that SEC ALJs are inferior officers, and because SEC ALJs are not appointed by SEC Commissioners, the President, or a court, they have been appointed in violation of the Appointments Clause.

Plaintiffs Have Found Some Success in Federal Court

These constitutional challenges have been met with varying responses by district courts, appellate courts, and by the SEC itself. As a threshold matter, many of the courts faced with federal suits filed by respondents in SEC proceedings have held that they lack jurisdiction to decide the constitutional issues presented by the complaints. These courts dismiss the complaints without addressing the merits of the constitutional arguments because, among other reasons, plaintiffs will eventually receive meaningful review of their claims through administrative adjudication and the statutory review scheme and do not require immediate access to federal courts. *See, e.g., Bebo v. SEC*, No. 15-1511, 2015 WL 4998489 (7th Cir. Aug. 24, 2015); *Tilton v. SEC*, No. 15-CV-2472 (RA), 2015 WL 4006165 (S.D.N.Y. June 30, 2015); *Spring Hill Capital Partners, LLC v. SEC*, No. 15-CV-4542, Dkt. 23 (S.D.N.Y. June 29, 2015).

Other courts have found that there is no jurisdictional impediment to their reaching the constitutional challenges and have ruled that plaintiffs' constitutional challenges have merit. In *Hill v. SEC*, No. 1:15-CV-1801-LMM, 2015 WL 4307088 (N.D. Ga. June 8, 2015), District Judge Leigh May held that Hill had shown a substantial likelihood of success on the merits of his Appointments Clause claim and preliminarily enjoined the SEC's administrative proceeding against him. The SEC has appealed the decision in *Hill* to the Eleventh Circuit. On August 4, 2015, Judge May similarly enjoined SEC proceedings on Appointments Clause grounds in *Gray Financial Group, Inc. v. SEC*, 15-cv-492-LMM, Dkt. 56 (N.D. Ga. Aug. 4, 2015). But Judge May declined to issue a similar injunction in *Timbervest, LLC v. SEC*, No. 15-cv-2106-LMM, Dkt. 25 (Aug. 4, 2015), because, unlike the plaintiffs in *Hill* and *Gray*, the plaintiffs in *Timbervest* waited to bring their federal action seeking an injunction until after the SEC ALJ had issued its decision and their case was before the SEC. Even though Judge May did not issue an injunction because plaintiffs were late in bringing suit, Judge May again found that the court had jurisdiction to hear the claims and that the *Timbervest* plaintiffs were likely to succeed on the merits of their Appointments Clause claim.

Similarly, in *Duka v. SEC*, No. 15 Civ. 357 (RMB) (SN), 2015 WL 4940083 (S.D.N.Y. Aug. 12, 2015), District Judge Richard Berman preliminarily enjoined the administrative proceeding against Duka because he found that SEC ALJs are inferior officers and that their appointments likely violated the Appointments Clause. On September 17, 2015, Judge Berman denied the SEC's motion to stay its ruling enjoining the SEC's administrative proceedings pending the SEC's appeal. *Duka v. SEC*, No. 15 Civ. 357 (RMB) (SN), Dkt. 71 (S.D.N.Y. Sept. 17, 2015).

The SEC, for its part, has also recently addressed the merits of the constitutional challenges to its administrative proceedings. Unsurprisingly, on September 3, 2015, it decided that SEC ALJs are not inferior officers subject to the Appointments Clause and ruled that the constitutional challenges lack merit. *In re Lucia Cos., Inc.*, Admin. Proc. No. 3-15006 (Sept. 3, 2015).

Significantly, Lynn Tilton has appealed the dismissal of her complaint, and, on September 17, 2015, the Second Circuit enjoined the SEC administrative proceedings against her while the court considers whether the district court properly concluded that it did not have jurisdiction to address the merits of Tilton's constitutional challenges. *Tilton v. SEC*, No. 15-2103, Dkt. 77 (2d Cir. Sept. 17, 2015). Therefore, as of this date, federal courts have stayed four administrative proceedings: *Hill*, *Gray*, *Duka*, and *Tilton*.

The Implications of Successful Challenges Are Uncertain

It is unclear whether a ruling against the SEC will have a major impact on SEC proceedings going forward. If the rulings are limited to the Appointments Clause issue, the SEC may cure the deficiency by having the SEC commissioners ratify the ALJs' appointments. As Judge May suggested in *Hill*: "[T]he ALJ's appointment could easily be cured by having the SEC Commissioners issue an appointment or preside over the matter themselves." 2015 WL 4307088, at *20. Judge Berman also invited the SEC to

cure any constitutional deficiencies in *Duka* by delaying the injunction for seven days in order to give the SEC an opportunity to cure. The SEC declined to do so, standing by its position that SEC ALJs are not inferior officers subject to the Appointments Clause.

Although there might be a remedy available to the SEC going forward, if plaintiffs ultimately prevail on their Appointments Clause challenges to SEC administrative proceedings, then the constitutionality of prior administrative proceedings might be called into question. Respondents in prior administrative proceedings will likely move to reopen their cases. Additionally, the arguments levied against the SEC ALJs will also apply to other federal agencies, and, if successful, could require them to adjust their appointments processes as well.

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