

MAY 19, 2017



## Tenth Circuit strikes a blow to constitutionality of SEC in-house judges

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The Tenth Circuit Court of Appeals recently denied the SEC's request for rehearing by a larger panel of the court, affirming the court's three-judge panel holding that SEC in-house administrative law judges are unconstitutional.

Notably, the SEC's loss at the Tenth Circuit comes after the full court of the D.C. Circuit decided to rehear a panel decision that reached the opposite conclusion—upholding the constitutionality of the SEC's administrative law judges. The D.C. Circuit's upcoming en banc hearing is scheduled for May 24, 2017, and its decision will either create a circuit split by affirming the panel's decision, or join the Tenth Circuit in rebuking the SEC's administrative law judges.

### Background

Since Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) in 2010, the SEC increasingly uses administrative proceedings before agency administrative law judges (ALJs) to pursue enforcement actions, rather than in the federal courts. As previously discussed in our prior alerts<sup>1</sup>, these in-house proceedings provide far fewer protections to defendants, such as limited preparation time, restrained access to discovery, inapplicability of the Federal Rules of Evidence and no access to jury trials. Moreover, the ALJs presiding over these proceedings are appointed and employed by the SEC, not by the president with advice and consent of the Senate as required for "inferior officers" under the Constitution's Appointments Clause.

As more defendants are subjected to these in-house administrative enforcement proceedings, the constitutionality of the presiding agency-appointed ALJs has come under fire. However, prior to the Tenth Circuit's decision, no Circuit Court had ruled against the SEC on the constitutionality of its ALJs. The D.C. Circuit was the first circuit court to reach the issue, and upheld the

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<sup>1</sup> See our prior alerts, "D.C. Appellate Court Rejects Challenge to SEC Administrative Proceedings," available [here](#), and "SEC Changes to its administrative 'in-house' proceedings fail to protect fundamental fairness," available [here](#).

constitutionality of the ALJs (in a decision that was subsequently vacated for rehearing en banc). The Tenth Circuit disagreed.

## **The Tenth Circuit says no to the SEC**

On May 3, 2017, the Tenth Circuit denied the SEC's petition to reconsider the court's recent ruling in *Bandimere v. Securities and Exchange Commission*, 884 F.3d 1168 (10th Cir. 2016). In 2012, the SEC brought an enforcement action against David Bandimere, a Colorado businessman, alleging he operated as an unregistered broker in selling unregistered investments in two Ponzi schemes. The ALJ found that Bandimere was liable and barred him from the securities industry, ordered him to cease and desist from violating securities laws, imposed civil penalties and ordered disgorgement. Bandimere sought review of the proceeding by the SEC, which reached a similar result in a separate opinion. *Id.* Ultimately, the matter was appealed to the Tenth Circuit Court of Appeals, which held that the SEC's ALJs are not "employees" but are "inferior officers" that must be appointed by the president in accordance with the Appointments Clause. *Id.* at 1181. Accordingly, the court decided that the ALJ presiding over the in-house enforcement proceeding against Bandimere held the office unconstitutionally, and the administrative body's opinion was set aside. *Id.* at 1188.

In its decision, the Tenth Circuit disagreed with the D.C. Circuit's ruling in *Raymond J. Lucia Cos., Inc. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016), *reh'g en banc granted, judgment vacated* (Feb. 16, 2017). The D.C. Circuit panel had held in *Lucia* that the SEC's ALJs are "employees" and not "inferior officers." The Tenth Circuit noted that the holding in *Lucia* was based on the court's conclusion that the SEC ALJs cannot render final decisions. *Bandimere*, 884 F.3d at 1182 (citing *Lucia*, 832 F.3d at 285). However, the Tenth Circuit disagreed, finding that final decision-making power is not dispositive of the question of constitutionality of the SEC's ALJs. *Id.*

The Tenth Circuit found similar issues addressed by the Supreme Court in *Freytag v. Commissioner of Internal Revenue*, 501 U.S. 868 (1991). The Tenth Circuit applied the same three key characteristics described by the Court in *Freytag* to SEC ALJs in this instance: "(1) the position of the SEC ALJ was established by law, (2) the duties, salary, and means of appointment . . . are specified by statute, and (3) SEC ALJs exercise significant discretion in carrying out . . . important functions." *Id.* at 1179 (internal quotations omitted). To the court, these characteristics demonstrate that SEC ALJs are not simply employees, but instead are "inferior officers" under the Appointments Clause.

## **A Supreme Court challenge on the horizon?**

In addition to the SEC's loss in the Tenth Circuit, the SEC faces potential problems in the D.C. Circuit where it previously obtained a favorable decision. As noted above, on February 16, 2017, the D.C. Circuit granted a petition to rehear its decision in *Lucia*, leaving open the possibility that the D.C. Circuit could change course and join the Tenth Circuit in rendering the SEC in-house proceedings unconstitutional. That upcoming decision will greatly drive the next stage of this ongoing dispute between the SEC and defendants, as a ruling to confirm *Lucia* will create a circuit split—potentially setting up a future Supreme Court challenge. Or, should the D.C. Circuit overturn its prior panel decision, the SEC's position will be further weakened, as two of the nation's circuit courts will have rendered the process unconstitutional.

We will continue to follow these SEC proceedings carefully and provide further updates.

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