

## Challenging the Power of SEC ALJs: A Constitutional Crisis or a More Nuanced Approach?

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The financial crisis which ended the first decade of the 21<sup>st</sup> Century compelled the U.S. Securities and Exchange Commission to redouble its efforts to police the stock markets and root out malefactors. That is common knowledge. What is not so common knowledge is those so accused by the SEC are fighting back, vigorously, by attacking the very infrastructure of the Commission. These challenges are aimed at the heart of the SEC's adjudicative process, administrative proceedings overseen by administrative law judges ("ALJs"), and implicate vital notions of the scope of federal court jurisdiction, and the availability of appellate review.

Lastly, this internecine conflict amongst the district courts has raised portentous constitutional questions pursuant to the Appointments Clause of Article II. By calling into question the very constitutionality of the power of ALJs to adjudicate SEC proceedings, opponents of agency action have invoked landmarks of constitutional law that weight heavily upon broader executive power.

In doing so, these Wall Street-centric battles have implications ranging far beyond mere securities regulation, important as that arena might be. In these few pages, we will set forth the constitutional and jurisprudential cornerstones in play, the disparate opinions of the lower courts interpreting same, and, finally, the broad constitutional implications of the pending

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controversy that cry out for circuit court rulings, if not an ultimate resolution by the U.S. Supreme Court.

### **The Supreme Court Landmarks**

As we have stated, the current spate of cases whereby the SEC adjudicative process is being challenged are cabined by high Court precedent. In the main, two Supreme Court cases provide the locus for the determination of the matters at hand. Given such, we shall posit these cornerstones first, as the foundation for our analysis.

Appropriately enough, the first crucial landmark is a case itself rooted in yet another financial crisis of recent vintage. *Free Enterprise Fund v. Public Company Accounting Oversight Board*<sup>1</sup> can be directly traced to the reforms made in the early 2000s after the scandalous doings of Enron, Worldcom, and similar nefarious corporations were revealed to an outraged investor class. To counteract the blatant trickery found in those ignominious cases, Congress promulgated the Sarbanes-Oxley Act (“Sarb-Ox”), for all intents and purposes, a massive accounting reform law calling for stricter oversight of the accounting profession. The legislation also created the defendant above named, the Public Company Accounting Oversight Board, the “PCAOB” (colloquially referred to as “Peek-A-Boo”), to administer Sarb-Ox’s new regime of registering all public accounting firms that audit publicly traded companies, regimenting their standards of practice, and imposing rigorous oversight to assure their compliance.

The PCAOB was not without its challengers, however, and these opponents set out to stop the Board in its tracks. The chosen form of attack was to invoke the Appointments Clause of Article II of the Constitution, which, *inter alia*, authorizes the President to appoint two classes of officers within the Executive Branch to assist in executing the laws of the United States. The first grouping of appointees is familiar, consisting of ambassadors, federal judges, and cabinet members, usually called “principal officers,” whom the President appoints *with* the advice and consent of the Senate.

The second set is comprised of so-called “inferior officers,” whose defining attributes are they exercise significant authority in executing the laws of the land, yet nonetheless remain accountable to the Oval Office—in plain English, the President can fire them at will. The latter point cannot be underestimated; placing these persons beyond the Chief Executive’s power to recall is an irredeemable constitutional error. Finally, we must point out an added nuance to the Appointments Clause, insofar that department heads (essentially, cabinet members and similar) and the federal courts enjoy a similar power to invest their own “inferior

officers” with authority to assist their principals in executing the laws of the land.

And here is where *Free Enterprise* found the fatal flaw in constituting the PCAOB’s membership. Chief Justice Roberts explained how the five Board members were selected by the SEC, not appointed by the President. Once in place, a Board member could only be removed “for cause.” Another key link in the chain for purposes of the Appointments Clause was that the Commissioners of the SEC itself, the ones who appoint the PCAOB members, likewise cannot be terminated, except “for cause.” Chief Justice Roberts characterized this as not just one, but two levels of “tenure,” shielding the PCAOB from dismissal by the Chief Executive.

This attribute of the PCAOB led to its downfall. The Appointments Clause is predicated upon the notion (as articulated by Founder James Madison while serving in the First Congress) that only the Chief Executive holds the executive power accorded by the Constitution, and part and parcel of her accountability to the people in exercising that power is the unrestricted ability to dismiss appointees who are inadequate to the task of executing the Nation’s laws. In other words, the Appointments Clause does not merely regulate the manner of appointments; it assures that those appointed shall be accountable to the President appointing them, and, *ergo*, the people who elected that President.

Accordingly, the *Free Enterprise* Court found the Sarb-Ox methodology for constituting the PCAOB antithetical to the rigors of the Appointments Clause. Moreover, the Article II proviso was further confounded by the two levels of insulation the PCAOB members enjoyed. This tenure protection made the PCAOB fundamentally untethered to the President’s will, given the clear lack of a presidential prerogative of recall. The resultant lack of accountability to the President only exacerbated the constitutional infirmity.

While the high Court left the vast bulk of Sarb-Ox undisturbed, this assertion of the Appointments Clause’s requirements vis-à-vis the PCAOB set in place a vital imperative for the constitutional delegation of administrative authority, cutting across a wide swath of regulatory agencies, not just the ones tasked to administer the securities laws. Indeed, *Free Enterprise* continues to emerge as a touchstone in cases questioning the apportionment of governmental power within the Executive and other Branches.<sup>2</sup>

We will soon see that the former parameters for appointments to the PCAOB at issue in *Free Enterprise* bore a striking similarity to the appointive process for the Commission’s ALJs. That justifies our care in expositing *Free Enterprise* as a linchpin in

the current imbroglio challenging the authority of the SEC's adjudicators, for those similarities have been exploited to no end by those opposing the agency's jurisdiction. That said, we have yet another Supreme Court landmark that guides the deliberations to follow.

Our second Supreme Court landmark goes to a subset of administrative law and the power of administrative agencies, precisely, the circumstances in which a federal court may preempt an agency's power to adjudicate matters arising under the administrative scheme created by Congress. Lest it be forgotten, one of the most fundamental maxims of administrative law is that once Congress creates an agency, and gives it the task of interpreting, administering, and enforcing a particular regulatory scheme, the actions and decisions of that agency are generally deferred to.<sup>3</sup> Of course, the *quid pro quo* for that deference is that agency action is not final until it is either validated or corrected by judicial review, typically had at the level of one of the circuit courts of appeal.

Leaving agencies undisturbed until it is time for appellate court review of their actions may be the norm, but it is not without exception. That brings us to *Thunder Basin Coal Co. v. Reich*,<sup>4</sup> wherein the high Court devised a well thought out mode of analysis for justifying interposing *district* court jurisdiction, well before circuit court review.

*Thunder Basin* promulgated a sophisticated three-pronged test, whereby a district court can effectively oust the agency from proceeding, and then assert its own jurisdiction over the controversy, when: a) the continuation of the agency action "as is" would foreclose the opportunity for meaningful judicial review before a higher court (typically the aforementioned circuit tribunal); b) the party seeking to block agency action raises claims "wholly collateral" to the general scope of the agency's administrative bailiwick; and c) the claims so made fall outside the agency's expertise. Note the above test is conjunctive in nature, emplacing a fairly steep hurdle to obtaining judicial intervention.

Please take heed of *Thunder Basin's* clear delineations of when it is appropriate for a district court to assert jurisdiction, and thereby derogate agency authority. Note well that in the first instance *Thunder Basin* does not upset the norm of reserving the power of judicial review to the courts of appeal, to be exercised only upon the finalization of agency action. *Thunder Basin* does not condone premature intervention by a lower district court, and provides but a narrow opportunity for such intervention, provided that the stringent requirements of the high Court's carefully crafted test are met. Knowing this, we can now witness how *Thunder Basin* has been pivotal in the cases that follow, albeit

applied in markedly divergent ways. And speaking of those conflicting lower court decisions, let us turn to those very cases that have firmly put us in the current dilemma.

### **Gupta—Jurisdiction Asserted**

Our first case for explication is *S.E.C. v. Gupta*,<sup>5</sup> a notable case indeed. Mr. Gupta was a true titan of the business world, a former director of several major American corporations, including Goldman Sachs at the height of the financial meltdown. Unfortunately for him, Gupta became entwined in the insider trading prosecution of his friend, hedge fund impresario Raj Rajaratman. Gupta was himself found guilty of securities fraud for tipping off Rajaratnam with insider information. But if that were not enough, Gupta was also the subject of a parallel SEC administrative case. And that is where our story lies.

Gupta's central complaint was this; the SEC's investigation of Rajaratnam and his cohorts implicated over two dozen Wall Street types, yet only Gupta was subjected to Commission administrative action before the agency's own ALJs, as opposed to the SEC suing the other individuals in the district court. Gupta characterized this strange turn of events as an intentional, irrational, and illegal attempt to single him out, a selective prosecution that violated his rights to equal protection under the law.

The controversy came before the eminent Judge Jed Rakoff, acknowledged to be the federal bench's leading authority on federal securities law, but nearly equally well known for carving his own path, sometimes in ways unexpected and unwelcome by government agencies, most especially the SEC.<sup>6</sup> Be that as it may, Judge Rakoff quickly cut to the heart of his power to hear the case at bar.

Rejecting the Commission's contrary view, Judge Rakoff affirmed that federal courts unquestionably have jurisdiction over all actions implicating the Constitution and laws of the United States.<sup>7</sup> The court concurred with Gupta's allegation that his right to equal protection would be violated were he compelled to defend himself before an SEC ALJ, given that the agency's own rules would deny him full discovery, the right to assert third party or counterclaims, and, most of all, a jury trial. Absent some explicit bar to asserting jurisdiction in this instance, the *Gupta* court readily concluded that the Judicial Code empowered it to intervene in this matter.

The Commission's next argument was that the defendant here was seeking to do an "end around" the agency, and that he should be kept to the statutorily prescribed path of seeking judicial review before a circuit court, after agency action became final. Judge Rakoff rebuffed that argument as well. Looking to *Free*

*Enterprise*, the *Gupta* court found that this defendant was raising precisely the allegations of equal protection violations that fall easily within nominal district court jurisdiction. Agencies, including the SEC, have no corner on hearing challenges to their own authority. Moreover, Judge Rakoff acknowledged that forcing Gupta to first exhaust all his administrative remedies before the Commission would subject him to the very proceeding which he sought to enjoin.<sup>8</sup>

The SEC cited to bedrock provisions of the securities code for its final argument. It is beyond refute, noted the agency, that Congress bestowed upon Gupta and all others similarly situated a right to appear before a circuit tribunal and obtain judicial review of Commission action.<sup>9</sup> Yet the logical converse of that privilege, claimed the agency, is that it quite naturally ousts the lower courts of jurisdiction to hear a respondent's claims before that time.

Incorrect, declared *Gupta*, ruling instead that district courts are empowered to intervene in administrative proceedings when subsequent appellate review thereof would be inadequate. The instant matter lands on all fours with *Free Enterprise*, said Judge Rakoff, contending that the high Court's ruling there made clear that an agency does not enjoy some exclusive bailiwick in matters that fall well within the nominal cognizance of the district judges.

That said, it was now time for Judge Rakoff to invoke the holding of *Thunder Basin*, as relevant to the case at bar. First, *Gupta* found that judicial intervention by a district court is not cabined unless the statutes exhibit a fairly discernible intent by Congress to delimit court jurisdiction. That said, the district judge looked to apply *Thunder Basin*'s tripartite test; interestingly, it made use of its three prongs in reverse order.

Commencing with *Thunder Basin*'s inquiry as to whether the issues at hand fell peculiarly within the agency's expertise, Judge Rakoff handily found that here they did not. Constitutional questions, such as the equal protection claim raised here, are best decided by federal jurists who deal with such matters each and every day. Moreover, opined the court, would it not be "inherently difficult" for the SEC to decide if it was, in fact, violating Gupta's constitutional rights?

The middle question of whether the respondent's challenge to the SEC was "wholly collateral" to the subject of the SEC's administrative proceeding was next. Judge Rakoff admitted the resolution of *Thunder Basin*'s second inquiry was a bit more problematical. To that end, the court had to distinguish *Free Enterprise*, where that plaintiff sought to deny the very constitutionality of the entire PCAOB. Even Gupta did not venture so far, conceded the court.

Yet Gupta still prevailed, ruled the court, for reason that his claim of the violation of his right to equal protection was entirely freestanding from the core of the SEC's administrative action. In simple terms, the defendant's constitutional claims were genuinely distinct, and therefore "wholly collateral," to the insider trading charges the SEC had leveled against him in the former's administrative proceeding. "These allegations . . . would state a claim even if Gupta were entirely guilty of the charges made against him." Accordingly, Gupta met the second part of the *Thunder Basin* test.

Now saving the first of the *Thunder Basin* rubric for last, Judge Rakoff inquired: would all meaningful review of agency action be precluded here if I do not intervene? *Gupta* completed the arc in favor of the defendant, indeed positing two grounds for a finding in his favor. First, Gupta has the right of it because "the SEC's administrative machinery does not provide a reasonable mechanism for raising or pursuing such a [constitutional] claim." SEC procedures lack fulsome discovery, the opportunity to assert counterclaims, and do not countenance a number of other items imperative to mounting an equal protection claim. And in the final estimation, Gupta would first have to endure the very alleged violation of his constitutional rights that he wanted a judicial authority to review. Such a set of circumstances easily met the parameter that meaningful judicial review was not to be had unless the district court took jurisdiction.

Second, Judge Rakoff reiterated the disconnect between "Gupta's equal protection claim [and] whether or not Gupta committed the acts of insider trading alleged [by the SEC]."<sup>10</sup> The first prong of the Supreme Court's test now indubitably met, the entirety of the *Thunder Basin* test was undeniably satisfied, and so Gupta prevailed.

Yet, in giving our due to *Gupta*, we would be remiss if we failed to point out the precautionary chord struck by Judge Rakoff towards the end of his holding. Implicating the uniqueness of the Commission's pursuit of Gupta, the court was constrained to point out that "it would not be prudent" to enjoin the SEC every time an aggrieved respondent wanted to derail a Commission administrative proceeding. Such expectations should be tempered by the warning that purely "diversionary tactics can be quickly dismissed by the usual route of proper pleading under the Federal Rules."<sup>11</sup> Implicitly, this thoughtful jurist signaled his intention that, while he might be opening the door a crack to this defendant, by no means should today's holding be regarded as open season to enjoin the SEC.

To summarize, *Gupta* represents a seminal notion as to the propriety of district court intervention in SEC affairs, predicated

upon Judge Rakoff's mantra that those "who can make a substantial showing that they have indeed been denied their rights" should never be turned away from the courthouse door. To be sure, *Gupta* was but the first volley of this controversy; most recently, much more has followed, and to those cases we now turn.

### Hill—The Appointments Clause Challenge

While *Gupta* may have been prescient in forging a path to enjoining SEC administrative action, its preferred mode of thinking is by no means the only one. There are other stars in this constellation of legal thought. Paramount among them is *Hill v. S.E.C.*,<sup>12</sup> which has already proven to be the building block for likeminded courts, and a lightning rod of controversy for jurists with a contrarian point of view. While *Hill* resonates because of its exposition of the interplay of administrative law and judicial authority, it is truly noteworthy for being among the first federal courts in modern times to grapple with the solemn constitutional issues that are now well on their way to dominating the instant controversy.

The plaintiff here took a different tack from the defendant in *Gupta*. He launched an all out attack on the Commission's ALJs by declaring their appointments to be violative of the Appointments Clause of Article II.<sup>13</sup> This accusation compelled District Judge Leigh Martin May to first marshal the pertinent linchpins of constitutional law.

The first bone of contention was an accurate characterization of the ALJs themselves. Here, the parties were in full opposition. The SEC called the ALJs mere employees. Hill posited a quite contrary view; he explicated how ALJs exercise "significant authority," the touchstone elucidated in *Free Enterprise*, as indicative of status as "inferior officers." Holding such rank, therefore, the ALJs should have been appointed by the President, held accountable by the President, and be terminable at will by the President. But they are not, and so their holding of office failed to comport with the Appointments Clause, a clear constitutional violation.

Judge May agreed with the plaintiff. Indisputably, the Commission's ALJs exercised the significant authority long recognized by the Supreme Court as imbuing the appointee with "inferior officer" status.<sup>14</sup> Yet both the agency process by which the ALJs attained office, and the two layers of tenure protection that kept them there, were wholly inconsistent with the rigors of the Appointments Clause. Finding this constitutional defect irreconcilable at present, Judge May asserted jurisdiction over the matter, and foreclosed the ALJ from taking action.<sup>15</sup>

To be sure, in her thoughtful writing District Judge May offered a less provocative way to end the nascent controversy. Rather than dismantle the entire SEC adjudicative structure, *Hill* respectfully suggests that the five SEC Commissioners themselves nominate and appoint each and every agency ALJ. It is generally accepted that the Commissioners, when acting as a body, constitute a “department head,” as that term is recognized in the lexicon of Appointments Clause jurisprudence. It is a given that heads of departments, much like Presidents and courts, may appoint “inferior officers.” So, without disturbing what most accept as the obvious exercise of significant authority by these adjudicators, the answer to satisfying the Appointments Clause lies in having them appointed by the proper entity.<sup>16</sup>

*Hill* is worthwhile for its own sake, as a well reasoned and rational decision. But if recent developments are any indication, the Georgia court’s decision may yet be destined to be deemed the landmark adhered to—or derided—by its brethren in the federal district that encompasses Wall Street itself—the Southern District of New York.

### **Duka—Building Upon Hill**

Herein we commenced with *Gupta*, a case emanating from the heart of America’s financial world, and an ignominious proceeding at that. We shifted to the Northern District of Georgia with *Hill*, but indicated above that the holding of that more southerly bench may yet be the cornerstone for the federal jurists that work within walking distance of Wall Street itself. Case in point—*Duka v. S.E.C.*,<sup>17</sup> in truth a very recent interconnected set of rulings, but which undeniably take firm hold of the Appointments Clause rationale of *Hill* and add its own backing to that emerging judicial school of thought.<sup>18</sup>

Decided by Judge Richard Berman (he of recent *Brady v. NFL* “Deflategate” notoriety), *Duka* presents yet another financial industry professional being charged by the SEC with alleged violations of the securities laws, with said respondent seeking to enjoin the agency from further pursuit. *Duka*’s claim—just like the plaintiff did *Hill*—was an Appointments Clause violation in the empowerment of the SEC’s ALJs. And the end result was markedly the same.

Most significant in his set of interlocked opinions, Judge Berman grappled with the significant Article II question, at the end of the day finding it the pivot upon which the just resolution of this matter turned. Much like his colleague Judge May, Judge Berman had no difficulty whatsoever in recognizing that SEC ALJs do in fact exercise significant authority, as that term is defined for Appointments Clause purposes, in the conduct of their

office. Key to this finding was the recognition that ALJs do much of what ordinary judges do on an everyday basis. *Duka* easily resolved the question by finding the Commission's adjudicators to be "inferior officers" pursuant to Article II.

Once again in full accord with *Hill*, the New York court likewise found that these inferior officers did not take nor maintain their offices in compliance with the Appointments Clause. This was a constitutional impediment that could not be reconciled, and so Judge Berman stepped in to deprive the agency of jurisdiction, and retained it for the district court instead.

It should be noted that, while the above was sufficient for the plaintiff to win the day in *Duka*, the court nevertheless deflected the second leg of her challenge to SEC authority, that being to question the two tiered tenure protection the appointive scheme presently bestows upon the ALJs. Judge Berman drew the line at this juncture, unpersuaded that this twice removed immunity from Executive accountability constituted yet another constitutional violation.

Indeed, Judge Berman moved virtually in lockstep with Judge May in additional ways. Like his peer from Georgia's Northern District, he declared the Appointments Clause violated, thereby justifying the enjoining of further Commission proceedings. Yet *Duka* also took up *Hill's* suggestion that the SEC take remedial action, most suitably by having the "head of department," that being the Commissioners themselves, appoint the SEC ALJs anew, and thus correct the Article II violation. While it appears Judge Berman did in fact allocate his sequential rulings in such a manner as to afford the agency time to duly consider the suggestions now made by two Article III judges, by all reports the SEC has decided it cannot or will not act. It is widely believed that the Commission will now plead its case to the Second Circuit Court of Appeals, and possibly beyond to the Supreme Court.

In sum, *Duka* joins its voice to the position emoted in *Hill*. Yet does this mode of judicial thinking stand unopposed? Certainly not, for Judge Berman finds one of his own peers on the Southern District taking a starkly opposite point of view. Let the conflict begin.

### **Tilton—The Loyal Opposition**

As a matter of law, federal trial judges are not bound by the decisions of their peers, even within the same judicial district.<sup>19</sup> That fundamental truth is no better exemplified than in the instant controversy. Notwithstanding *Duka's* finding of a constitutional deficiency in the appointment of SEC ALJs, Southern District Judge Ronnie Abrams resoundingly disagreed with her brethren, and indeed halted any judicial intervention at

the threshold.

The gravamen of Judge Abrams' ruling in *Tilton v. S.E.C.*<sup>20</sup> is easily grasped. Unlike her fellows, this jurist declared from the outset that the district courts are without jurisdiction in these matters. Judge Abrams grounded her contrary view on the statutory scheme that bestowed a right of appellate court review upon any final action by the SEC.<sup>21</sup> With laser like focus, *Tilton* expositis the undisputed fact that "federal appellate court review is expressly available" to respondents in a Commission action. Judge Abrams had no difficulty in finding that avenue of judicial oversight to be meaningful and substantial.

Given such, the court was thus compelled to rule that *Thunder Basin's* first prerequisite could not be met. The unquestioned availability of an appeal to a circuit court soundly defeated any claim that meaningful judicial review could not be had. With that threshold issue so resolved as against district court intervention, Judge Abrams essentially never reached the Appointments Clause issue to which her peers had devoted substantial effort.

To be sure, Judge Abrams was not unmindful of the plaintiff's pleas of constitutional defects. At a later point in the opinion, *Tilton* carefully parses out the means by which such claims are preserved for subsequent adjudication. The plaintiff can (and, in fact, did here) allege these Article II violations as affirmative defenses, compelling both the agency, the ALJ, and the Commission to take heed before such claims even reach a circuit panel. Crucially, Judge Abrams viewed the assertion of these constitutional arguments as not foreign to the SEC's proceedings, "but rather intertwined" with the main case. In that light, the further inquiries required by *Thunder Basin* would likewise lead to a finding that there was no district court jurisdiction to be had.

To be certain, Judge Abrams gave her due to three important facets of this controversy. First, she upheld the sacrosanct principle that federal courts have but limited jurisdiction, and therefore should not so easily breach the bounds of their authority. An additional consequence of the foregoing is that it evinces respect for the equally vital precept of separation of powers.

That leads to the second keypoint of *Tilton*, in that Judge Abrams' circumspection recognizes the Legislative Branch's power to create a scheme of administrative law, an agency to administer that law, and thereafter channel controversies over the law's administration to that agency's sound discretion. Third, and probably most significant, *Tilton* vigorously defends, not merely the existence, but the propriety of the route of judicial review chosen by Congress. With the utmost clarity, Judge Abrams refused to upend a key component of regulating the secu-

rities market that has worked uninterrupted for some eight decades.

Germane to that last point, *Tilton* also exhibits pragmatism. Keenly aware of the dangers of presumptuous judicial intervention, Judge Abrams cautioned that carving out exceptions to the statutory review provisos here and elsewhere “could swallow the schemes themselves.” And acknowledging sound public policy, *Tilton* further declared that liberal judicial intercession would not only “defeat Congressional intent” for the regulatory scheme the lawmakers created, it would constitute an invitation to targets of SEC action “to escape agency adjudication by fashioning an incidental constitutional challenge.”

In sum, proponents of the *Gupta/Hill/Duka* trilogy might criticize *Tilton* as evading the Appointments Clause question and/or improperly interpreting the *Thunder Basin/Free Enterprise* regimen. But we are not so quick to dismiss Judge Abrams’ reasoning. Rather, we accord it the proper respect, because its thoughtful analysis takes full cognizance of the statutory scheme, legislative intent, and, most of all, the stringent recognition that the Nation’s appellate courts stand ready, as they have for years, to afford full and proper review of SEC determinations.

At this juncture, we face quite a *mélange* of judicial thought. *Gupta* focuses upon its unique facts and the paramount issue of meaningful judicial review. *Hill* provides the foundation, which *Duka* builds upon, for combining the above with the constitutional dilemma found under an Appointments Clause analysis. *Tilton*, in the main, rejects all of them, and firmly grounds itself upon the explicit statutory right to circuit court review as the basis for refusing to assert jurisdiction. Which mode of analysis is superior? Better still, is there yet another option?

### **Chau—A Different Approach**

Above we have mapped out the sometimes vigorous positions staked out by district court judges as grounds to enjoin proceedings before SEC ALJs. It is beyond peradventure that these jurists, especially recently, have begun to raise constitutional issues of great portent, not merely with regard to SEC action, but with vast implications for the future of *all* administrative adjudicatory schemes.

Yet we must be mindful of the following: first, the decisions of one or more federal trial judges are by no means controlling; second, the handful of opinions before us do not reveal a clear consensus of judicial thought; and third, with regard to the *Hill/Duka* camp, do those holdings go too far in asserting Article III power over matters Congress, the Article I Branch, committed to the Executive Branch for administration? The last of that trio is one we find particularly worrisome.

So, we must ask: is there another way to resolve this controversy, one equally efficacious at restraining the SEC from exceeding the bounds of its lawful authority, while preserving fulsome judicial review and other important rights, yet at the same time leaving largely intact the righteous agency structure that has (more or less) done a fine job in enforcing the Nation's securities laws for the last eighty years?

We believe there is, and that this more rational and just approach can be found in the erudite reasoning of Judge Lewis Kaplan in *Chau v. S.E.C.*<sup>22</sup> That case continued the common thread we have seen thus far, *i.e.*, a party tasked to respond to agency charges before a Commission ALJ raises constitutional grounds in seeking to enjoin the Commission from proceeding. A significant distinction here is that the administrative hearing had already concluded, and the parties were merely awaiting the ALJ's decision. For this reason, Judge Kaplan reminded all that review before a circuit court was still in the offing, should the respondents be displeased by the adjudicator's decision.

Acknowledging the now familiar touchstones of *Thunder Basin* and *Free Enterprise*, Judge Kaplan summarized these high Court guideposts as permitting pre-enforcement challenges to administrative proceedings, notwithstanding the nominal deference to agency discretion clearly intended by Congress. Against that backdrop, *Chau* then canvassed a number of predecessor cases, noting in particular the differing views expressed by trial judges in its own district. To be sure, observed Judge Kaplan, these conflicting opinions "resist easy distillation into a black and white rule—and for good reason . . . [A]dequate review of administrative actions involves case-specific determinations." In other words, even with the constructs of *Thunder Basin* and *Free Enterprise*, a *sui generis* analysis was nevertheless appropriate and desirable.

Having stated the proper mode of analysis, Judge Kaplan turned to employ it. In doing so, *Chau* found it significant that the plaintiff had not, in truth, suggested that the entire agency proceeding was unconstitutional. A careful review of the allegations revealed that it was the plaintiff's perception of how the Commission was applying its rules to him that gave rise to his claim of constitutional violations. Indeed, it is notable that *Chau* himself, by drawing the court's attention to the highly individualized facts of this situation, validated Judge Kaplan's insistence that this controversy, and others like it, be decided on a case-by-case basis.

This inexorably led to the newer and more nuanced approach we referred to above. While still acknowledging the gravity of the plaintiff's constitutional claims, Judge Kaplan decreed that such allegations must be segregated into one of two categories: the

claim is a facial challenge to agency action, *i.e.*, the entire administrative process in play is unconstitutional; in contradistinction, the other classification is that the allegations constitute an as-applied challenge, meaning that, in view of the specific circumstances alleged, the respondent's rights are being violated by an otherwise constitutional process. To be sure, *Chau* struck a precautionary note, mindful that the border between these two species of challenges "is not so well defined" as to engender a bright-line rule. This, in turn, brings a federal jurist back to concentrate upon the precise facts undergirding a plaintiff's challenge to agency action.

To resolve this threshold issue of classification, *Chau* found that *Free Enterprise* provides the litmus test for determining if a claim is the more sweeping facial challenge to the entire statutory scheme. If so, Judge Kaplan agreed that district court jurisdiction would prevail.

In the instant case, Judge Kaplan cited the plaintiff's own positions to demonstrate why his was not a facial objection, but instead an as-applied challenge. First, *Chau's* allegation of a defective record in the already concluded administrative hearing was readily susceptible to circuit court review, if the traditional mode of appeal were followed. Indeed, the district court could not provide more review than the tribunal above it. Thus, with meaningful judicial review unquestionably still available, *Chau* failed to satisfy the first criteria of the *Thunder Basin/Free Enterprise* duality.

Second, and with regard to the "wholly collateral" prong of the Supreme Court's test, Judge Kaplan duly noted that this plaintiff had a singular focus upon the agency's precise actions in the administrative proceeding as providing the grounds for his constitutional challenge. Put another way, *Chau* found little or less collateral about the allegations made herein, let alone "wholly" disconnected from the SEC's actions.

The plaintiff in *Chau* had thus failed two of the three prongs of the *Thunder Basin/Free Enterprise* test; he fared no better on the third. Characteristically, Judge Kaplan did not mince words; the *Chau* court declared it was wholly unconvinced that *Chau's* constitutional claims, particularly that he has been denied his due process rights in the proceeding before the ALJ, were outside the agency's competency. Moreover, the full Commission is "well equipped to evaluate claims of unfairness in proceedings before its ALJs" were the plaintiff to adhere to the traditional mode of review. And, in the final analysis, if the plaintiff was right, and his constitutional rights had been wholly violated by the agency, then subsequent review by a court of appeals would afford him all the due process to which he was entitled.

As is evident from the foregoing, the court gave most of its attention to rebuffing the due process claims asserted in *Chau*. Therefore, it was almost parenthetical for the court to finally turn to this plaintiff's *Gupta*-like equal protection claim. Judge Kaplan made short shrift of it, noting that *Chau* was essentially a class of one, and thus he stood in sharp contrast with *Gupta*'s recital of his own travails at the hands of the SEC as compared to the treatment accorded the other twenty-eight similarly situated persons in the underlying insider trading investigation. It is worth noting that Judge Kaplan homed in on the peculiar facts germane to this aspect of the case, consistent with his insistence that these matters be subjected to a *sui generis* analysis.

Predicated upon the factual distinctions so made, *Chau* essentially repeated the mode of analysis already employed, once again finding that, with regard to the plaintiff's equal protection allegations, meaningful judicial review was still available from the circuit court, the claim was not wholly collateral, and it was not beyond the agency's capabilities to consider the allegation of a constitutional violation. Indeed, while nonetheless still agreeing that only the judicial branch can be the final arbiter of constitutional claims, *Chau* did not venture so far as to find the SEC "powerless" to consider such allegations, especially given the circuit court review which always lies at the end of the path.

Of significance, and therefore worthy of note, are the following additional declarations made in *Chau*. First, Judge Kaplan urged that care be taken in adjudging these types of challenges to agency action, such as those made here, as these claims might "upend all manner of administrative enforcement schemes," in addition to denigrating the Executive Branch's conscious choices of enforcement strategies.

Second, *Chau* takes pains to point out that there may be some harboring the belief that "they can procure a one-way ticket out of an agency proceeding" merely by alleging the deprivation of a constitutional right. *Chau* vigorously disabuses that notion. District court jurisdiction over a species of constitutional claims is not an "escape hatch . . . to delay or derail" SEC proceedings, declared Judge Kaplan. The Supreme Court had the "good sense" not to condone such gamesmanship when it crafted *Thunder Basin* and *Free Enterprise* as the cornerstones on this issue. Implicitly, lower courts should likewise strongly discourage such obfuscations, and conserve the mighty judicial power for controversies truly worthy of their attention.

The final words of Judge Kaplan that may well yet resonate as court opinions continue to coalesce around this issue. In its *coda*, *Chau* admits that some find troubling the growth of the Administrative State in the Twenty First Century, as compared to the

norm of judicial adjudication. Surely, some of that concern is grounded in the selfish desires of those called to task before agencies like the SEC. Nonetheless, any such self-interest does not delegitimize the genuine apprehension held by others that, if not kept in check and balance by the Judicial Branch, agencies may succumb to the self-aggrandizement of power. While ruling for the agency in this instance, Judge Kaplan wisely refused to diminish one iota concerns for the future, implicitly urging the legislative and executive branches of government to take heed of these weighty matters.

### **Conclusion—Constitutional Crisis or Compromise?**

In seeking to reach a just and sensible conclusion here, we freely admit to being conflicted. There are powerful arguments, to be sure, that support the unequivocal declarations already made by some district judges that the current regime of selecting and maintaining SEC ALJs in office is irreconcilable in view of the Appointments Clause. We have long advocated (and still do) for the straightforward application of the text of the Constitution, and respect for unequivocal precedent in interpreting the Founding Document. We hold steadfast to those beliefs.

Given fidelity to those principles, we gladly concur with courts such as *Hill* and *Duka* that the current scheme does not withstand scrutiny under the Appointments Clause. It is beyond cavil that ALJs exercise, not merely significant, but substantial, authority in the normal course of their duties. Therefore, it cannot be denied that they are truly “inferior officers” of the United States, as that term has been long defined and understood in well established Supreme Court jurisprudence.

In turn, we are compelled to this inescapable conclusion; since SEC ALJs are “inferior officers,” but were not appointed congruent with the Appointments Clause, and, worse yet, lack the accountability to the Chief Executive that the Article II proviso similarly demands, as of today they appear, for all intents and purposes, to hold office in contravention of constitutional norms.

Indeed, we are deeply concerned by this, not merely for purposes of the future well being of the SEC and lawful securities regulation, but for reason that this controversy goes far beyond oversight of the stock market, as important as that arena may be. The current impasse has vast implications for administrative agencies as a whole, including the regulation of such equally vital fields as labor, the environment, and the energy sector, just to name a few. Indeed, compliance with the Appointments Clause persists in being controversial with regard to other adjudicators, such as federal magistrate judges and bankruptcy judges. The final outcome here has the potential to reach into domains far beyond our musings of today.

And, as overwhelming as the foregoing may be, let us not abandon the equal imperative that the jurisdictional implications of this controversy must also be properly resolved. Not every court looked first to the constitutional infirmities found under an Appointments Clause analysis. *Gupta* proves that. It reminds us of the duality of *Thunder Basin* and *Free Enterprise* as a vital barrier to the encroachment of the “Administrative State” upon our daily activities, tempered by such imperatives as meaningful judicial review, the liberty to raise wholly collateral matters before an Article III judge, and not an agency, and freedom from blurred lines as to what is rightly subject to agency cognizance and what is better decided in a court of law.

Indeed, as to the last, it would be antithetical to our entire system of ordered liberty to “defer” to agency discretion on these matters, even in the best of circumstances. After all, what would the Founders think if they saw us relegating the adjudication of our hard won freedoms to mere bureaucrats?

Thus far, we appear to come out strongly on the side of those courts declaring the present day SEC ALJ appointment system to be constitutionally defective, as well as those courts asserting jurisdiction in such matters. That much is true, but there is a great deal more to be said.

We do not deny that constitutional issues can and should overwhelm all other imperatives. But we must ask—does every scenario need automatically arise to the level of a constitutional infraction? We think not, and that is why we place great stock in *Chau* as representing a better reasoned view, and as suggesting a more reliable methodology for resolving these weighty matters.

The primary reason for our advocacy of *Chau* is its adoption of the more subtle approach, emphasizing a rigorous, fact specific analysis in the first instance. And it does so with no sacrifice of the federal courts’ rights to intercede *in the right circumstances*, those very conditions as succinctly set forth in the *Thunder Basin/Free Enterprise* rationale.

What we find enlightened about *Chau* is its call for an initial and careful parsing of the individual facts in such controversies, so as to first determine if the challenge offered is facial or as-applied. If the former, then we cautiously proceed to a weighty constitutional analysis, quite appropriate since a claim of that timber calls an entire statutory scheme into question. But if the latter, we can forego the *gravitas* of the alleged constitutional violations, and confine ourselves to a comparatively prosaic review of specific agency behavior as aimed at specific persons.<sup>23</sup> Above all, in the realm of the as-applied challenge, objective and rational examination of the pertinent facts rules the day.

To be sure, *Chau* is truly not inapposite to *Hill*, *Duka*, and

*Gupta*. Rather than oppose that trio head on, it instead points to an alternative pathway to a just resolution. Traveling that road enjoys these singular benefits: it permits a more strenuous analysis of constitutional prerequisites, if and when such is necessitated by a facial challenge to the entire administrative construct itself. Yet it need not go so far, when the challenge is of the much narrower as-applied variety, since such a claim is fundamentally one that asks precisely what did the agency do to this individual in these specific circumstances. A constitutional battle over the very agency infrastructure thus at a remove, a less cataclysmic and more focused, case-by-case resolution can be had.

In closing, we can say only this. This controversy will not go away soon, nor shall it depart neatly. Given the emergence of subtle and some not so subtle distinctions between the thinking of district court judges (even some in the same vicinage), only further decisions by one or more appellate courts will bring clarity to a currently murky situation. Indeed, we are very much of the view that it shall take the intervention of our highest tribunal, the Supreme Court, to truly bring this internecine conflict to an end. On the way to that ending, while we respect the Appointments Clause jurisprudence of the cases at hand, we still hope that even greater credence will be given to the more nuanced approach proffered in *Chau*.

## NOTES:

<sup>1</sup>*Free Enterprise Fund v. Public Co. Accounting Oversight Bd.*, 561 U.S. 477, 130 S. Ct. 3138, 177 L. Ed. 2d 706 (2010).

<sup>2</sup>*See Morrison v. Olson*, 487 U.S. 654, 108 S. Ct. 2597, 101 L. Ed. 2d 569 (1988), as one of the seminal cases in the never ending tug of war over empowering “inferior officers” within the three competing branches, including ongoing divisiveness over the role of magistrate and bankruptcy judges within the Article III branch.

<sup>3</sup>*Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 104 S. Ct. 2778, 81 L. Ed. 2d 694, 21 Env’t. Rep. Cas. (BNA) 1049, 14 Env’t. L. Rep. 20507 (1984).

<sup>4</sup>*Thunder Basin Coal Co. v. Reich*, 510 U.S. 200, 114 S. Ct. 771, 127 L. Ed. 2d 29, 16 O.S.H. Cas. (BNA) 1553, 127 Lab. Cas. (CCH) P 10969, 1994 O.S.H. Dec. (CCH) P 30312 (1994).

<sup>5</sup>796 F.Supp.3d 503 (S.D.N.Y. 2011).

<sup>6</sup>*See* Story, “Judge Accepts S.E.C.’s Deal With Bank of America,” *New York Times* (February 23, 2010) (cataloguing Judge Rakoff’s reluctant approval, after an earlier rejection, of the settlement reached between the SEC and Bank of America over the latter’s ordeal in taking over the venerable but distressed Merrill Lynch at the height of the financial crisis).

<sup>7</sup>*See* 28 U.S.C.A. § 1331 (district courts have original jurisdiction over all civil actions arising under the Constitution, laws, and treaties of the United States).

<sup>8</sup>See also *Touche Ross & Co. v. S.E.C.*, 609 F.2d 570, 577, Fed. Sec. L. Rep. (CCH) P 96854 (2d Cir. 1979).

<sup>9</sup>See 15 U.S.C.A. § 78(y)(1) (a person aggrieved by a decision of the SEC may seek judicial review before the circuit court of appeals where he resides or does business or before the D.C. Circuit, where the Commission resides).

<sup>10</sup>Parenthetically, Judge Rakoff pointed out that Gupta's constitutional claims would turn upon evidence entirely different from that pertinent to the securities fraud charges.

<sup>11</sup>See also *Ashcroft v. Iqbal*, 556 U.S. 662, 129 S. Ct. 1937, 173 L. Ed. 2d 868, 2009-2 Trade Cas. (CCH) ¶ 76785, 73 Fed. R. Serv. 3d 837 (2009) (landmark holding establishing federal standards of pleading).

<sup>12</sup>*Hill v. S.E.C.*, \_\_\_ F.Supp.3d \_\_\_, 2015 WL 4307088 (N.D. Ga. June 8, 2015) (15-cv-1801).

<sup>13</sup>Art. II, § 2, cl. 2.

<sup>14</sup>See *Freytag v. C.I.R.*, 501 U.S. 868, 881-82, 111 S. Ct. 2631, 115 L. Ed. 2d 764, 91-2 U.S. Tax Cas. (CCH) P 50321, 68 A.F.T.R.2d 91-5025 (1991) ("Special Trial Judges" hearing tax controversies hold power very typical of judges, and so their holding of office violated the Appointments Clause).

<sup>15</sup>More recently, Judge May substantially reiterated *Hill* with a similar holding in *Gray Financial Group, et al. v. S.E.C.*, \_\_\_ F.Supp.3d \_\_\_ (N.D. Ga.) (August 4, 2015) (15-cv-492), once again asserting jurisdiction for reason of the Appointments Clause defect in ALJs currently holding office.

<sup>16</sup>As of this writing, we are unaware of any movement by the SEC or the Executive Branch towards acting on that suggestion.

<sup>17</sup>*Duka v. S.E.C.*, \_\_\_ F.Supp.3d. \_\_\_ (S.D.N.Y. August 13, 2015) (15-cv-00357).

<sup>18</sup>To fully appreciate *Duka*, the reader must evaluate what are, in actuality, at least three sequential opinions and orders, respectively dated April 15, August 3, and the aforementioned August 13, 2015, that tell the entire tale.

<sup>19</sup>See *American Electric Power Co. v. Connecticut*, 564 U.S. \_\_\_ (2011).

<sup>20</sup>*Tilton v. S.E.C.*, \_\_\_ F.Supp.3d. \_\_\_ (S.D.N.Y. June 30, 2015) (15-cv-2472).

<sup>21</sup>See 15 U.S.C.A. § 78(y)(1).

<sup>22</sup>*Chau v. U.S. S.E.C.*, 72 F. Supp. 3d 417, Fed. Sec. L. Rep. (CCH) P 98317 (S.D. N.Y. 2014).

<sup>23</sup>See generally *Zobrest v. Catalina Foothills School Dist.*, 509 U.S. 1, 113 S. Ct. 2462, 125 L. Ed. 2d 1, 2 A.D.D. 176, 83 Ed. Law Rep. 930 (1993), wherein the dissenters, led by Justice Sandra Day O'Connor, reached back to the days of Justice Brandeis for the proposition that it is unnecessary and unwise to decide on constitutional grounds if a statutory or other basis for decision is available.