Securities Regulation Daily Wrap Up, TOP STORY—D.C. Cir.: ALJs not final; SEC wins in-house court case, (Aug. 9, 2016)

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By Mark S. Nelson, J.D.

A panel of the D.C. Circuit has, for now, ended the constitutional battle between Raymond J. Lucia and the Commission over whether the agency's administrative law judges could properly hear his case under the SEC's administrative enforcement regime. After deciding the Article II issue in the Commission's favor, the court went on to deny Lucia's petition for review and instead upheld the sanctions imposed by the Commission on Lucia for violating federal securities laws while promoting his "Buckets of Money" retirement strategy (*Raymond J. Lucia Companies, Inc. v. SEC*, August 9, 2016, Rogers, J.).

Attention will now turn to whether Lucia may try to persuade the Supreme Court to take his case, one of the few to present a virtually clean Article II issue without the jurisdictional hurdles that have beset other challenges to the SEC's in-house courts. The question of whether federal agencies' ALJs are "Officers of the United States" was left open by a footnote in the Supreme Court's *Free Enterprise* opinion.

But the high court has recently declined certiorari twice in cases involving the SEC's ALJs (April 2016 in *Pierce*; March 2016 in *Bebo*). Several federal appeals courts also have shied away from opening the court house doors to the SEC's challengers because the facts in those cases were not extreme enough under the Supreme Court's precedents to justify district court jurisdiction (*e.g.*, Second Circuit; Seventh Circuit; Eleventh Circuit).

Finality is touchstone. The D.C. Circuit focused almost exclusively on the question of just how final are the SEC's ALJs? Lawyers for Lucia and his eponymous advisory firm argued that Exchange Act Section 4A allows for some matters in which the Commission has declined review to become final and that this degree of finality sets Lucia's case apart from the D.C. Circuit's *Landry* opinion (the panel reiterated that *Landry* is the law of the circuit) in which the court concluded the Federal Deposit Insurance Corporation's ALJs were not officers because their decisions lacked finality.

By contrast, the government urged the court to read the subparts of Section 4A in context rather than in the disaggregated manner pressed by Lucia. The statute provides the Commission with authority to delegate some functions, including to ALJs, while retaining discretion to review the resulting delegated action, but also providing for delegated actions that are not reviewed (*e.g.*, the Commission declined review or no review was sought) to become the action of the Commission. The Commission's rules of practice further specify the time for review and the requirements for a Commission order declining review, something it must do in each case. (The Commission recently finalized amendments to its rules of practice, but none of them touch the specific subsections cited by the court).

The D.C. Circuit found that the Commission's ALJ regime is similar to the FDIC regime the court upheld in *Landry*. In both instances, the Commission or the FDIC is final, despite a few "illusory" differences in the language of their respective laws and regulations (*e.g.*, the Commission's rules refer to "initial decisions" whereas the FDIC's rules refer to "recommended decisions"), differences in whether review is mandatory (FDIC) or discretionary (Commission), and the possibility that some legal or factual issues can still escape Commission or FDIC review.

Overall, the court said the Commission has reasonably interpreted its own in-house regime as denying independent finality to its ALJs' initial decisions. This conclusion was buttressed by the court's decision last year in *Jarkesy* where a different panel concluded that the Commission has the sole power to issue a final order. The court then rejected Lucia's arguments about the SEC's ALJs' discretion because the Commission still controls the record, including seeking more evidence via remand (it did this in Lucia's case) and not always deferring to ALJ credibility findings (but compare a case like *Freytag* where the Tax Court had to defer on credibility).

The court also found no basis for Lucia's claim that Congress would have intended for the SEC's ALJs to be inferior officers due to references in the securities laws to "officers of the Commission" (Securities Act

Section 21) because this phraseology is not necessarily equivalent to Article II's "Officers of the United States." Moreover, the court credited the Attorney General's *Manual on the Administrative Procedure Act*, a "contemporaneous" guide to the development of that law, which states that an agency has full decision making power regardless of an ALJ's initial decision. The manual was the subject of several skirmishes between the government and Lucia at the briefing stage.

Citing the Supreme Court's opinions in *Edmund* and *Freytag* (Tax Court Special Trial Judges are officers), the panel noted that policy underlying the Article II appointments clause is one of ensuring that persons who hold the appointment power are constitutionally accountable. The Supreme Court's *Buckley v. Valeo* opinion generally fixes a dividing line between officers and those not subject to the appointments clause based on whether they exercise "significant authority."

Commission sanctions upheld. Last year, the Commission upheld an ALJ's findings that Lucia and his firm violated the antifraud provisions of the Investment Advisers Act by making material misrepresentations about the backtesting of a model portfolio supposedly demonstrating the efficacy of Lucia's "Buckets of Money" investment strategy. Specifically, the Commission said Lucia misled investors about his use of a mix of historical results and other assumptions, not just historical results, in performing the backtests, and by not "rebucketizing" assets from riskier assets to safer ones.

The Commission imposed civil penalties of $50,000 on Lucia and $250,000 on Lucia's firm. The Commission also barred Lucia from associating with any investment adviser or broker-dealer because his conduct was "egregious," "recurrent," and he showed no remorse. In imposing the associational bar, the Commission rejected Lucia's suggestion that he instead be censured and required to comply with certain undertakings (OIP; Initial Decision; Corrective Order; Remand ALJ Decision; Commission Opinion).

The Commission's opinion was 3-2 against Lucia, with Chair Mary Jo White and Commissioners Luis Aguilar and Kara Stein forming the majority. Commissioners Daniel Gallagher and Michael Piwowar dissented because they believed the majority had engaged in "rulemaking by opinion" by adopting a standard for the advertising of backtests (an undefined term at the time) that was not grounded in the Commission's statutes or regulations, and had gone too far in its discussion of materiality. The dissenters also said Article III courts should decide the constitutionality of the agency's ALJs, even if the Commission can opine on the subject. Commissioners Aguilar and Gallagher have since left the Commission.

The D.C. Circuit found the Commission's opinion was backed by substantial evidence, including on the issue of materiality. As for Investment Advisers Act Section 206(1), which requires a showing of scienter, the court said Lucia's argument that "backtest" was poorly defined failed to grasp the Commission's message that it did not matter how Lucia described the backtests because Lucia's various descriptions were misleading.

Lastly, the court upheld the Commission's imposition of a lifetime associational bar on Lucia. The court explained that the Commission adequately backed up its choice of sanctions and that the court's review is "especially deferential" anyhow. The associational bar was the only sanction Lucia challenged.

The case is No. 15-1345.

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Companies: Raymond J. Lucia Companies, Inc.

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