LOS ANGELES
Daily Journal
www.dailyjournal.com
THURSDAY, AUGUST 13, 2015
PERSPECTIVE

Is SEC's home court advantage legal?

By Thomas Zaccaro, Nicolas Morgan and Peter T. Brejcha

When the Securities and Exchange Commission brought an enforcement action against Atlanta-based investment adviser Timbervest LLC, in 2013, it accused the firm and its principals of improperly concealing brokerage fees relating to timberland property transactions with clients. No doubt Timbervest and its principals noted with concern the SEC's choice of venue: The SEC initiated an administrative proceeding in front of an administrative law judge rather than filing a complaint in federal court in front of an Article III judge.

As highlighted by numerous court challenges, articles and comments since Dodd-Frank was signed into law five years ago expanding the SEC's ability to use administrative proceedings, the differences between administrative proceedings and federal court are stark. SEC administrative proceedings generally must be completed in 300 days, discovery is very limited, there are no juries, and the SEC's factual findings are "conclusive" and cannot be overturned on appeal as long as they are supported by "substantial evidence."

But perhaps the difference that has drawn the most attention is the perceived home court advantage the SEC appears to enjoy in its administrative proceedings. As reported in the Wall Street Journal in May, the SEC prevailed in 95 percent of its administrative proceedings brought between January 2010 and March 2015 (with an 88 percent success rate on appeals of ALJ decisions to the full SEC).

As U.S. District Court Judge Rakoff commented at the time, "The SEC appoints the judges, the SEC pays the judges, they are subject to appeal to the SEC. That can create an appearance issue, even if the judges are excellent, as I have every reason to believe they are." More alarmingly, however, one former ALJ said in an interview that she retired as a result of criticism from the SEC's chief administrative law judge for finding too often in favor of defendants, questioning her "loyalty to the SEC."

Recent federal court challenges to SEC administrative proceedings have had mixed results. In June, Timbervest filed a complaint in federal district court in Atlanta seeking a temporary restraining order halting the SEC's administrative proceeding as unconstitutional. Timbervest's strategy follows in the footsteps of several other similar lawsuits. In *Tilton v. SEC, 2015 U.S. Dist. LEXIS* 85015 (S.D.N.Y. June 30, 2015), and *Bebo v. SEC*, 2015 U.S. Dist. LEXIS 25660 (E.D. Wisc. March 3, 2015), federal judges ruled that they did not have subject matter jurisdiction to decide the constitutionality of administrative proceedings. In *Duka v. SEC*, 2015 U.S. Dist. LEXIS 49474 (S.D.N.Y. Apr. 15, 2015), the court found that it had subject matter jurisdiction but denied a request for preliminary relief.

But in June, the federal judge presiding over one such challenge granted a temporary restraining order halting an SEC administrative proceeding in *Hill v. SEC*, 2015 U.S. Dist. LEXIS 74822 (N.D. Ga. June 8, 2015). Several other constitutional challenges, including Timbervest's, have landed with the same federal judge in Atlanta as "related cases" to *Hill*. The SEC challenged Timbervest's description of its matter as a "related case" to *Hill* — somewhat ironically accusing Timbervest of "judge-shopping."

Two other constitutional claims have found their way to the same judge, who stayed another SEC administrative proceeding last week relying on the same rationale as in *Hill*. See *Gray Financial Group Inc. v. SEC*, 15-00492 (N.D. Ga. Aug. 4, 2015). The SEC has appealed the original adverse ruling in *Hill*, and likely will appeal the *Gray Financial* decision as well.

The constitutional challenges make similar arguments. The administrative proceedings violate Article I of the Constitution by delegating decision-making authority to the SEC to choose a forum. Administrative proceedings violate the Seventh Amendment jury trial rights. And, finally, administrative proceedings violate the Article II Appointments Clause because of the way ALJs are appointed.

Courtesy of Zaccaro Morgan

Thomas Zaccaro, left, and Nicolas Morgan, founders of LA-based boutique Zaccaro Morgan LLP.

It is the Appointments Clause theory that appears to be gaining traction and was embraced by the judge in *Hill*. The clause provides that the president shall nominate officers of the United States, "but the Congress may by Law vest the Appointment of such inferior officers as they think proper... in the Heads of Departments." The theory can be traced to an earlier, successful challenge to the Public Company Accounting Oversight Board in which the U.S. Supreme Court held that the SEC commissioners collectively hold the power to appoint "inferior Officers" within the meaning of the Clause. *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 512-13 (2010).

SEC ALJs, who have their offices on the second floor of the SEC's Washington D.C. headquarters, it turns out, are not appointed by the president, a court of law, or the SEC commissioners and have two layers of good cause tenure protection. The judge in *Hill* determined that the ALJs were "inferior officers," and, consequently, their appointment violated the Appointments Clause.

While the SEC continues to fight against the Appointments Clause issue in district court and on appeal to the 11th U.S. Circuit Court of Appeals, any victory on this basis by opponents of the SEC's use of administrative proceedings would be Pyrrhic at best. As the judge in *Hill* observed, the obvious cure to the Appointments Clause defect is for the SEC to directly appoint ALJs. That may tidy up the constitutional issue, but it certainly won't put a dent in the SEC's home court advantage.

Recent developments suggest that the perceived administrative proceeding bias issues are not going away. On Aug. 7, the SEC's inspector general released an interim report describing his ongoing investigation into ALJ bias, which was initiated partly as a result of SEC Chair Mary Jo White's reaction to the Wall Street Journal article and the Timbervest proceedings. In an unprecedented response to Timbervest's allegations of ALJ bias, the SEC commissioners "invited" the ALJ presiding over that proceeding to submit an affidavit to the commission indicating whether he felt pressured to rule in the SEC's favor. The ALJ declined to submit an affidavit, and the inspector general has thus far not discovered any ALJ willing to admit to feeling pressured.

Thomas Zaccaro *and* **Nicolas Morgan**, *the cofounders of Zaccaro Morgan LLP, are former SEC trial counsel. Zaccaro Morgan LLP is a boutique trial firm specializing in complex civil litigation, government and corporate investigations, and white collar defense.* **Peter T. Brejcha** *is an associate in the firm.*