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Administrative Law Judge Hiring and Constitutional Challenges

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The Bottom Line

The case of *Lucia v. Securities and Exchange Commission* started one of many administrative law enforcement actions at the Securities and Exchange Commission ("SEC"), but went all the way to the United States Supreme Court.

As a defense to the enforcement action, the respondent challenged the constitutionality of the SEC's use of administrative law judges ("ALJs"), under the "Appointments Clause" of the U.S. Constitution.[1] That provision requires that all "officers" of the United States be appointed by the president, by the "courts of law," or by the "heads of departments." The SEC ALJs were not appointed by the SEC, much less the president or the judicial branch, but hired instead by other employees within the SEC (under what used to be called the civil service system). If those ALJs are "officers" of the United States, then their appointments have been unconstitutional.

Along the way, the D.C. Appeals Court Circuit ruled against that challenge, but the 10th Circuit Appeals Court ruled in as separate case in favor of that type of challenge, creating a split in the circuits which made likely a Supreme Court review of this administrative law question.

Then a funny thing happened on the way to the Supreme Court. The United States Solicitor General, which had defended the SEC decision before the D.C. Circuit, did a 180 degree change of position, and in front of the Supreme Court sided with the enforcement respondent, claiming that the SEC's use of ALJs was indeed unconstitutional. The Solicitor General also tried to get the Supreme Court to address the question of the President's "removal power" regarding ALJs.

[1] U.S. Const., art. II, § 2, c. 2.

Because of the Solicitor General's 180 degree position change, the Supreme Court appointed an amicus curiae to defend the decision of the SEC before the Court. Many other amici were involved, including ALJ professional organizations, law professors, think tanks, and very wealthy investors who can also be subject to SEC enforcement actions.

There was a lively oral argument at the Supreme Court, with active questioning by a number of the Justices. But in the end, the Court in a 7-2 decision held that the case fell squarely within prior precedent (*Freytag v. Commissioner*). As a result, there was no jurisprudentially significant decision by the Supreme Court, though the decision did leave open some questions.

Less than three weeks after the Supreme Court ruling, an Executive Order was issued, in light of the *Lucia* decision, eliminating the examination and competitive hiring process for ALJs, and giving agency chiefs the power to hire ALJs according to their own standards. This Executive Order appears to be more significant than the *Lucia* decision itself.

While *Lucia* was a federal case, and concerned solely the "Appointments Clause" of the United States Constitution, it does tee up an opportunity look at what we have in Texas that is similar.

The Controversy

The underlying dispute began when the Securities and Exchange Commission ("SEC" or the "Commission") instituted an administrative enforcement action against Mr. Raymond J. Lucia and Raymond J. Lucia Companies (collectively referred to as "Lucia") for alleged violations of anti-fraud provisions of the Investment Advisers Act.

The charges were based on how Lucia presented its retirement wealth-management strategy – referred to as "Buckets of Money" – to prospective clients. Essentially, Lucia would make presentations at free retirement-planning seminars in which Lucia would advocate an investment strategy that called for spreading investments among several types of assets (i.e., in different "buckets") that varied in degrees of risk and liquidity. During the seminars, Lucia used a slideshow to illustrate how this strategy would have performed during historic economic downturns relative to other common investment strategies (referred to as "backtesting"). Each example showed how the "Buckets-of-Money" strategy would have increased the value of investments despite market downturns and would have done much better than utilizing the other common investment strategies.

Lucia's "Buckets-of-Money" presentation was allegedly misleading for at least three reasons:

1) Lucia stated that they were "backtesting" the "Buckets-of-Money" investment strategy, when the actual testing had not used only historical data, but instead relied on a mix of historical data and assumptions about the inflation rate and the rate of return on one type of asset on which the strategy relied. Lucia allegedly presented its investment strategy as so effective that it would have weathered historical periods of market volatility, and they never suggested that they were presenting "mere abstract hypotheticals." Additionally,

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