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# Federal Court Injunction Against SEC Prosecution

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A federal judge in Manhattan recently granted a preliminary injunction against the Securities and Exchange Commission in the latest of a series of rulings raising issues with the SEC's use of in-house proceedings before its administrative law judges ("ALJs") rather than proceed with its charges in federal court. The SEC has prevailed more frequently in its administrative proceedings than it has in federal court, where defendants have more robust procedural rights. This ruling by a judge in the Southern District of New York indicates the federal courts' ongoing concerns with the SEC's increased preference for administrative proceedings before its own ALJs. But the SEC has the ability to correct the constitutional flaw that the court found to exist with its appointments of ALJs, suggesting that this and similar rulings will likely only raise a short-term disruption of the SEC's use of its in-house courts.

The SEC initiated the administrative proceeding at issue against Barbara Duka, a former managing director at Standard & Poor's, charging that she played a role in the firm's issuance of misleading ratings of mortgage-backed securities.[1] Duka then sued the SEC in federal court, challenging as unconstitutional the agency's use of ALJs on the grounds that the SEC's appointment process violates the Appointments Clause of the United States Constitution. She argued that they are "inferior officers" within the meaning of Article II of the Constitution, and under the Appointments Clause, may exercise this "significant authority" only if appointed "by the President, courts of law, or department heads."[2]

In a ruling on August 12, 2015, Judge Richard Berman agreed and preliminarily enjoined the SEC from proceeding against Duka. He held that since ALJs are not appointed directly by the SEC Commissioners themselves but rather through a combination of the U.S. Office of Personnel Management and the Commission's Office of Human Resources, "they were not appropriately appointed pursuant to Article II, [and] their appointment is likely unconstitutional in violation of the

[1] Decision & Order, *Duka v. U.S. Sec. & Exchange Comm.*, 15 Civ. 357 (RMB) (SN) (S.D.N.Y. Apr. 15, 2015), at *5-6 (ECF 33).

[2] Decision & Order Granting Preliminary Injunction, *Duka v. U.S. Sec. & Exchange Comm.*, 15 Civ. 357 (RMB) (SN) (S.D.N.Y. Aug. 12, 2015), at *3-4 (ECF 60) (citing *Freytag v. Comm'r of Internal Revenue*, 501 U.S. 868, 880-81 (1991) and U.S. Const., Art. II, § 2, cl. 2).

Appointments Clause."[3] He enjoined the SEC "from in any way further pursuing the pending administrative proceeding" against Duka.[4]

Judge Berman's ruling follows the lead of a pair of rulings in recent months by a federal court in Atlanta, in which Judge Leigh Martin May ruled that the SEC followed a constitutionally flawed process for appointing its ALJs. In *Gray Financial Group, Inc. v. SEC* and *Hill v. SEC*, Judge May preliminarily enjoined the SEC from proceeding administratively on the same rationale that Judge Berman adopted in *Duka*. Judge May also noted that "the ALJ[s'] appointment[s] could easily be cured by having SEC Commissioners issue an appointment or preside over the matter[s] themselves."[5]

The SEC has thus far only indicated that it believes the constitutional issue is currently before the SEC itself and should be adjudicated there, and has not indicated whether it will appeal Judge Berman's ruling. It seems likely that the added weight of the ruling from the federal court for the Southern District of New York will spur a number of defendants in administrative proceedings to file similar attacks in federal court.

While the SEC has an obvious quick fix to this issue, namely having the Commission itself make the ALJ appointments, the SEC might not want to be seen as even tacitly acknowledging that administrative proceedings already in the pipeline are being tried before a constitutionally defectively appointed judge. A fairly recent Supreme Court case, *Nguyen v. United States*, 123 S. Ct. 2130 (2003), suggests there may be some risk for the SEC in acknowledging a defective process. In *Nguyen*, the Court invalidated a Ninth Circuit decision affirming the defendants' criminal convictions, on grounds that the three judge panel included a single non-Article III judge (namely the Chief Judge of the District Court of the Northern Mariana Islands). The Court sent the case back to the Ninth Circuit for "fresh consideration by a properly constituted panel" even though defendants did not object to the panel's composition before or after the hearing, and raised the issue for the first time in their petition to the Supreme Court for a writ of certiorari. In light of *Nguyen*, the potentially retroactive effects of an acknowledgement of unconstitutional appointments by the SEC could be far-reaching.

While the Appointments Clause constitutional issue is obviously important, it is not what lies at the heart of defendants' dispute with the SEC. Instead, what is driving this issue are serious concerns over the fairness of the SEC's increased use of its in-house courts. The SEC has long used its in-house courts to bring actions against regulated entities and persons (brokerage firms, investment advisers and companies, and other regulated entities), over which it had power to impose financial penalties as well as other remedies. The 2010 Dodd-Frank Act, however, extended the range of remedies the SEC can obtain administratively against non-regulated persons and entities as well, enabling it for the first time to obtain financial penalties in addition to disgorgement and cease and desist orders in all cases.

Armed with these additional powers, the SEC Enforcement Division stepped up its use of administrative proceedings in the wake of Dodd-Frank. During the next four years, the SEC's use of administrative proceedings increased markedly, from 63% of its filed cases in fiscal 2010 to

[3] Decision and Order, *Duka v. U.S. Sec. & Exchange Comm.*, 15 Civ. 357 (RMB) (SN) (S.D.N.Y. Aug. 3, 2015), at *5 (ECF 57).

[4] Decision & Order Granting Preliminary Injunction, *Duka*, 15 Civ. 357 (RMB) (SN) (S.D.N.Y. Aug. 12, 2015), at *4-5 (ECF 60).

[5] *Hill*, 2015 WL 4307088, at *43 (N.D. Ga. June 8, 2015).

82% in fiscal 2014. In June 2014, it announced that it would be bringing more insider trading cases administratively.

Administrative proceedings offer the SEC a serious home-court edge, while sharply curtailing the procedural rights of those charged. A person or entity charged by the SEC administratively does not have the right to take depositions or use subpoenas to obtain written discovery, as would any civil litigant in federal court, but rather must examine witnesses for the first time at trial. Defendants have no right to move to dismiss charges pretrial. The pre-hearing period is truncated—defendants can have as little as one month and typically no more than four to six months to prepare for trial following referral to an ALJ—even though the SEC will often have developed its investigative record, including extensive witness testimony, over a period of years. Rulings and final decisions are made by ALJs appointed and paid by the SEC, rather than federal judges and juries. At trial, the Federal Rules of Evidence, whose purpose is to exclude unreliable evidence, do not apply. Hearsay testimony, for example, may be freely admitted if it could "conceivably throw any light upon the controversy."[6] And if the SEC prevails, the defendant must appeal the decision to the SEC itself before he or she can obtain judicial review for the first time before a federal Court of Appeals. And even at the Court of Appeals, there is substantial deference given to the SEC's credibility determinations and fact finding.

Not surprisingly, the SEC has a much higher success rate when it proceeds administratively: between October 2010 and March 2015, the SEC won 90% of cases brought before ALJs, and only 69% of cases heard by federal district court judges.[7] In short, defendants have complained that in its in-house courts, the SEC acts as prosecutor, judge, jury, and the first line of appellate review. The constitutional challenge is intended to derail what is increasingly viewed as an inherently unfair process. And while Judge Berman's ruling in *Duka* and others like it may temporarily disrupt the SEC's ability to litigate before its ALJs, those rulings if upheld are likely only to slow, not stop, the trend that began with Dodd-Frank.

[6] *Jesse Rosenblum*, 47 S.E.C. 1065, 1072 (1984).
[7] Jean Eagleshem, *In-House Judges Help SEC Rack Up Wins*, Wall Street Journal, May 7, 2015.