UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15255

In the Matter of

JOHN THOMAS CAPITAL MANAGEMENT GROUP LLC d/b/a/ PATRIOT28 LLC, and

GEORGE R. JARKESY, JR.,

Respondents.

DIVISION OF ENFORCEMENT'S RESPONSE TO BRIEFING ORDER ON APPOINTMENTS CLAUSE CLAIM

The Division files this response to the Commission's August 3, 2015 order granting Respondents' request to adduce additional evidence and permitting the filing of supplemental briefing on "whether the Commission's ALJs are inferior officers within the meaning of the Appointments Clause; whether their manner of appointment violates the Appointments Clause; and the appropriate remedy if such a violation is found." Respondents have asserted that ALJ Foelak, who presided over the administrative proceeding in this matter, was unconstitutionally appointed to her position. *See* Respondents' Motion to Adduce Additional Evidence (June 30, 2015). That argument is without merit because ALJ Foelak—like each of the other ALJs at the Commission—is not an "inferior Officer" who was required to be appointed consistent with the requirements of the Appointments Clause of the Constitution.

Congress created and placed the ALJ position within the competitive service and granted the SEC discretion over whether and how to utilize ALJs. These facts, as well as the Commission's plenary authority over the administrative process, demonstrate that—consistent

with the only court of appeals decision on the constitutional status of ALJs, *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000)—ALJ Foelak is an agency employee, not a constitutional officer, and her appointment thus does not violate the Appointments Clause.

Since there is no constitutional defect, the Commission need not decide the potential effects of a hypothetical Appointments Clause violation. Nor should the Commission attempt to fashion a fix where there is no constitutional violation. Rather, and for the reasons explained below, the Commission should find that ALJ Foelak was hired in a manner consistent with Article II, Section 2, Clause 2 of the Constitution because she is an employee, and not a constitutional officer, and that there is therefore no Appointments Clause defect to remedy.

I.

The Appointments Clause mentions two categories of officers: principal officers and inferior officers. U.S. Const. art. II, § 2, cl. 2. Principal officers are selected by the President with the advice and consent of the Senate, while Congress may "by law vest the appointment" of "inferior Officers" in "the President alone, in the Courts of Law, or in the Heads of Departments." *Id.*; *see Buckley v. Valeo*, 424 U.S. 1, 132 (1976). The Clause does not speak to the power to appoint employees who are not officers, and the requirements of the Clause are therefore not applicable to these individuals. *See Buckley*, 424 U.S. at 126 n.162; *Tucker v. Comm'r of Internal Revenue*, 676 F.3d 1129, 1132 (D.C. Cir. 2012).

The Supreme Court has said that whether government personnel are officers or employees is determined by "the manner in which Congress has specifically provided for the creation of the . . . positions, their duties and appointment thereto." *Burnap v. United States*, 252 U.S. 512, 516 (1920); *see also Freytag v. Comm'r of Internal Revenue*, 501 U.S. 868, 881 (1991). "Inferior officers," like principal officers, are persons who "exercis[e] significant

authority pursuant to the laws of the United States," *Buckley*, 424 U.S. at 125-26, a category that excludes "lesser functionaries subordinate to officers of the United States," *id.* at 126 & n.162; *see Free Enterprise Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 506 n.9 (2010); *United States v. Germaine*, 99 U.S. 508, 509 (1878). All relevant considerations demonstrate that the Commission's ALJs are "lesser functionaries subordinate to officers of the United States."

Government agencies employ a total of approximately 1,600 ALJs, *see Free Enterprise,* 561 U.S. at 586 (appendix to dissent of Breyer, J.), and the Commission currently employs five. The Commission has made use of employees as hearing examiners throughout its existence. *See Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943) (reviewing Commission order following proceedings before hearing examiner). Hearing examiners were originally subject to the Classification Act of 1923 and dependent on their agency's ratings for compensation and promotion. *Ramspeck v. Federal Trial Exam'rs Conference*, 345 U.S. 128, 130 (1953). In order to address complaints about hearing examiners' partiality toward their employing agencies, when Congress enacted the Administrative Procedure Act in 1946, it "separat[ed] adjudicatory functions and personnel from investigative and prosecution personnel in the agencies," by placing hearing examiners under the jurisdiction of the Civil Service Commission in a merit-based civil service system for federal employees, and by vesting the Civil Service Commission with control of the ALJs' compensation, promotion, and tenure. *See id.* at 131-32. Congress, however, gave no indication that it meant to elevate ALJs' status above that of the investigative and prosecution personnel of the agency.

Indeed, in enacting the APA, Congress envisioned that an ALJ's "initial decision" would be "advisory in nature," and preserved for the agency "complete freedom of decision—as though [the agency] had heard the evidence itself." U.S. Dep't of Justice, *Attorney General's Manual*

on the Administrative Procedure Act 83-84 (1947) (Manual).[1] Thus, as the Second Circuit has recognized, in reviewing an ALJ's initial decision, the agency "retains 'all the powers which it would have in making the initial decision[.]'" *Nash v. Bowen*, 869 F.2d 675, 680 (2d Cir. 1989) (quoting 5 U.S.C. § 557(b)).

At the SEC, as throughout the federal government, ALJs are civil service employees in the "competitive service." 5 C.F.R. § 930.201(b). As such, they are subject to the provisions of the Civil Service Reform Act of 1978, 5 U.S.C. § 1101 *et seq.*, which, among other things, establishes merit systems principles to guide agency personnel management, *id.* § 2301, and specifies the administrative and judicial remedies available in response to prohibited personnel practices described in the statute, *id.* §§ 1204, 1212, 1214, 1215, 1221.

The Office of Personnel Management (OPM), which oversees federal employment for ALJs and other civil servants, administers a detailed civil service system for selecting ALJs that includes examinations for ALJ candidates, *see id.* §§ 1104, 1302; 5 C.F.R. §§ 930.201(d)-(e), 930.203; ranking ALJ applicants for placement on a register of eligible candidates according to their qualifications and numerical ratings, 5 U.S.C. § 3313; 5 C.F.R. § 332.401; and issuing "certificate[s] of eligibles" from which federal agencies—including the SEC—may select individuals to fill ALJ vacancies, 5 U.S.C. §§ 3317, 3318; 5 C.F.R. §§ 332.402, 332.404. OPM oversees each agency's "decisions concerning the appointment, pay, and tenure" of ALJs, 5 C.F.R. § 930.201(e)(2), and establishes classification and qualification standards for the ALJ positions, *id.* § 930.201(e)(3).

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[1] The Manual, as "a contemporaneous interpretation [of the APA]," *Vt. Yankee Nuclear Power Corp. v. Nat. Res. Def. Council, Inc.*, 435 U.S. 519, 546 (1978), is "give[n] 'considerable weight,'" *Brock v. Cathedral Bluffs Shale Oil Co.*, 796 F.2d 533, 537 (D.C. Cir. 1986) (citation omitted); *see also Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 218 (1988) (Scalia, J., concurring) (noting that the Manual "repeatedly" has been given "great weight").

II.

The Commission's regulations and governing statutes make clear that ALJs are simply employees of the Commission, which has retained its decision-making authority in every respect. The Commission employs ALJs in its discretion, and all final agency determinations are those of the Commission, not of its ALJs. Congress has not required the SEC to use its ALJs to conduct its administrative proceedings, and Commission regulations provide that a "[h]earing officer" can be an ALJ, a panel of Commissioners, an individual Commissioner, or any other person duly authorized to preside at a hearing. 17 C.F.R. § 201.101(a)(5). The Commission may at any time during the administrative process "direct that any matter be submitted to it for review." *Id.* § 201.400(a). An ALJ serving as a hearing officer prepares only an "initial decision." *Id.* § 201.360(a)(1). If no further review is sought or otherwise ordered by the Commission, then the Commission issues an order of finality, specifying "the date on which sanctions, if any, take effect." *Id.* § 201.360(d)(2).[2]

Commission review of the ALJ's initial decision is *de novo*. The Commission "may affirm, reverse, modify, [or] set aside" the initial decision, "in whole or in part," and it "may make any findings or conclusions that in its judgment are proper and on the basis of the record." *Id.* § 201.411(a). The Commission may also "remand for further proceedings," *id.*, "remand . . .

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[2] It is of no consequence that the federal securities laws and Commission regulations refer to ALJs as "officers" or "hearing officers." There is no indication that Congress or the Commission intended "officers" or "hearing officers" to be synonymous with "Officers of the United States," U.S. Const. art. II, § 2, cl. 2; *cf. Free Enterprise*, 561 U.S. at 484, 510 (members of the Public Company Accounting Oversight Board are inferior officers even though they were "not considered Government 'officer[s] or employee[s]' for statutory purposes" (brackets in original)). Indeed, the APA "consistently uses the term 'officer' or the term 'officer, employee, or agent'" to "refer to [agency] staff members." Kenneth Culp Davis, *Separation of Functions in Administrative Agencies*, 61 Harv. L. Rev. 612, 615 & n.11 (1948). *See also, e.g.*, 5 U.S.C. §§ 556, 557 (referring to official who presides over evidentiary hearing as the "presiding employee").

for the taking of additional evidence," or "hear additional evidence" itself, *id.* § 201.452. And if "a majority of participating Commissioners do not agree to a disposition on the merits," the ALJ's "initial decision shall be of no effect." *Id.* § 201.411(f).

For these reasons, the D.C. Circuit's conclusion in *Landry*, with respect to ALJs of the Federal Deposit Insurance Corporation, applies equally here: the Commission's ALJs are not constitutional officers but employees, whose appointments do not implicate Article II, because they "can never render the decision of the [agency]." 204 F.3d at 1133; *see also Tucker*, 676 F.3d at 1134 (explaining that *Landry* "found the absence of any authority to render final decisions fatal to the claim that the administrative law judges at issue there were Officers rather than employees"). In *Landry*, the D.C. Circuit held that the FDIC's ALJs are not constitutional officers because they issue only recommended decisions and proposed orders and "can never render the decision of the FDIC"; "final decisions are issued only by the FDIC Board of Directors." 204 F.3d at 1133. Similarly here, the Commission has plenary authority over all administrative proceedings and only the Commission can issue a final decision.

Freytag does not compel a different conclusion. There, the Supreme Court held that special trial judges of the Tax Court are inferior officers. *Freytag*, 501 U.S. at 880. But, as *Landry* expressly found, special trial judges are distinguishable from FDIC ALJs—and, by extension, SEC ALJs—because special trial judges are able to issue final decisions in certain categories of cases. 204 F.3d at 1134. In *Freytag*, it was undisputed that the special trial judges acted as inferior officers in a variety of cases. 501 U.S. at 882 (noting that IRS Commissioner had conceded that special trial judges "act as inferior officers" and that "the Chief Judge may assign special trial judges to render the decisions of the Tax Court" in certain cases); *see also* Respondent's Br. at 5, 10, *Freytag*, *supra*, No. 90-762, 1991 WL 11007941 (Apr. 3, 1991). The

government's argument was that the judges did not act as inferior officers in the specific category of cases at issue in *Freytag*. The Supreme Court found this reasoning unpersuasive, concluding that "[s]pecial trial judges are not inferior officers for purposes of some of their duties under [the statute], but mere employees with respect to other responsibilities." *Freytag*, 501 U.S. at 882.

In contrast, an ALJ can never render a final decision of the Commission in a case. The Commission need not involve ALJs in its administrative proceedings at all, and, if it determines that proceedings should take place before an ALJ, it is not bound by anything an ALJ decides. As the Commission has stated, it "retains plenary authority over the course of its administrative proceedings and the rulings of its law judges—both before and after the issuance of the initial decision and irrespective of whether any party has sought relief." *In re Michael Lee Mendenhall*, Exchange Act Release No. 74532, 2015 WL 1247374, at *1 (Mar. 19, 2015). Indeed, the Commission may review initial ALJ decisions on its own initiative, even where no review is sought. *See., e.g., In re Dian Min Ma*, Exchange Act Release No. 74887, 2015 WL 2088438, at *1 (May 6, 2015); *In re Michael Lee Mendenhall*, 2015 WL 1247374, at *1; *In re Raymond J. Lucia Cos.*, Exchange Act Release No. 540, 2013 WL 6384274, at *2 (Dec. 6, 2013).

Although the Supreme Court in *Freytag* did cite to the significant discretion exercised by special trial judges in cases over which they do not have final decision-making authority, as the D.C. Circuit observed in *Landry,* the Supreme Court's discussion "would have been quite unnecessary if the purely recommendatory powers were fatal in themselves." 204 F.3d at 1134. And, in any event, Commission ALJs' powers differ significantly from those of the Tax Court's special trial judges. As the D.C. Circuit noted, "even for the non-final decisions of the type made by the [special trial judges] in *Freytag,* the Tax Court was required to defer to the [special trial

judges'] factual and credibility findings unless they were clearly erroneous." *Landry*, 204 F.3d at 1133 (citing Tax Court Rule 183(c), 26 U.S.C. App. (1994)); *see also Tucker*, 676 F.3d at 1134 (holding that employees of the Internal Revenue Service's Office of Appeals were not inferior officers, even though their decisions were "effective[ly] final," on the ground that their "discretion is highly constrained"). By contrast, neither the Commission nor the FDIC Board that reviewed the ALJ decisions at issue in *Landry* defers to ALJs' factual findings. 204 F.3d at 1133; 17 C.F.R. 201.411(a); *see also JCC, Inc. v. Commodity Futures Trading Comm'n*, 63 F.3d 1557, 1566 (11th Cir. 1995) (noting that "agencies" are generally not bound by their ALJ's fact finding and instead "have the authority to make independent credibility determinations without the admitted advantage presented by the opportunity to view witnesses firsthand").[3] And whereas special trial judges have the power, for example, to issue subpoenas, 26 U.S.C. § 7456(a); Tax Court Rule 181, and "to enforce compliance with discovery orders," *Freytag*, 501 U.S. at 881-82, the Commission's ALJs may issue subpoenas, but an order would need to be obtained from a federal district court to compel compliance, *see* 15 U.S.C. § 78u(e). As Commission ALJs wield no more power than FDIC ALJs, *Landry*'s reasoning is fully applicable here.[4]

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[3] The Commission could make a factual finding partially based on an ALJ's credibility determination, but the Commission does not accept an ALJ's credibility determinations "blindly," *Kenneth R. Ward*, Exchange Act Release No. 47535, 2003 WL 1447865, at *10 (Mar. 19, 2003), and is not bound by such determinations, *see id.* The Commission can also choose to hear the witnesses' testimony itself. 17 C.F.R. § 201.452.

[4] That approximately 1,600 ALJs hold positions in the competitive civil service pursuant to statute does not make them officers in the various agencies which may employ them. And the authority given to the Commission to use ALJs at its discretion likewise does not render each of them an officer. The special trial judge, in contrast, operates within an Article I tribunal where Congress has "knowingly expanded the authority of special trial judges." *Samuels, Kramer & Co. v. Comm'r of Internal Revenue*, 930 F.2d 975, 982 (2d Cir. 1991).

Finally, if doubt existed as to the ALJs' status, the Commission should defer to Congress's own assessment of its statutory creations. *See Weiss v. United States*, 510 U.S. 163, 194 (1994) (Souter, J., concurring) (explaining that "in the presence of doubt" regarding constitutional officer status, "deference to the political branches' judgment is appropriate"). Congress has long treated ALJs as employees within the civil service system. Congress also specified that it is the "agency"—not the President, the department head, or the Judiciary—that appoints ALJs. Administrative Procedure Act, ch. 324, § 11, 60 Stat. 237, 244 (1946); *see* 5 U.S.C. § 3105; *Ramspeck*, 345 U.S. at 133 (in the APA, Congress "retained the [hearing] examiners as classified Civil Service employees"). Congress knew how to comply with the Appointments Clause, and indeed, at the time, the Supreme Court had long characterized appointments pursuant to the methods prescribed in the Appointments Clause as a "well established definition of what it is that constitutes [an officer of the United States]." *United States v. Mouat*, 124 U.S. 303, 307 (1888). In other words, Congress intended ALJs to be employees. With rare exceptions for particular agencies, in the seven decades since creating the position of ALJ, Congress has not changed the method of ALJ appointment.

III.

As is evident from this discussion, the SEC's ALJs are not appointed in a manner consistent with the Appointments Clause's requirement for the appointment of constitutional officers. That is not a bureaucratic oversight; nor does it demonstrate constitutional infirmity. Rather, it is a product of the statutory and regulatory scheme that Congress designed to protect ALJ impartiality. This process was established to ensure that ALJs "were not to be paid, promoted, or discharged at the whim or caprice of the agency or for political reasons." *Ramspeck*, 345 U.S. at 142. This process treats ALJs as employees, not officers, and their hiring

is consistent with that status. Because there is no constitutional violation under the Appointments Clause, there is no basis for a remedy.

If, however, the Commission determines that Commission ALJs are inferior officers and that their hiring violated the Appointments Clause because they were not hired with the approval of the Commissioners, the Division requests that it be permitted to submit additional briefing about the components of any appropriate remedy, such as ratifying Commission ALJs' prior hiring. To be clear, the Division does not seek any remedy, including as an alternative measure, at this juncture. Because of the potential ramifications of such a remedy[5] and because Congress has set out a scheme, implemented by OPM, for the hiring of these employees, the Division believes that any Commission efforts to superimpose on this scheme a remedy to rectify a problem that does not exist is inadvisable at this time.

CONCLUSION

For the foregoing reasons, the Commission should hold that its ALJs are employees, not inferior officers, and should not undertake to appoint these ALJs as inferior officers.

[5] Such a remedy is not only unnecessary but would fail to resolve the ongoing litigation before the Commission and in district courts around the country given the other constitutional claims raised that would not be addressed by such action. Further, it seems likely to prompt new issues in litigation, whether in this case or others.

Dated: August 28, 2015
New York, New York

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CERTIFICATE OF SERVICE

I certify that on August 28, 2015, I caused to be served the Division of Enforcement's Response to Briefing Order on Appointments Clause Claim by overnight mail and/or e-mail on the following:

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