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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of: **JAMES A. WINKELMANN, SR. AND BLUE OCEAN PORTFOLIOS, LLC,** **Respondents.**	ADMINISTRATIVE PROCEEDING File No. 3-17253

RESPONDENTS' BRIEF IN SUPPORT OF PETITION FOR REVIEW

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I. PRELIMINARY STATEMENT

Respondents James Winkelmann and Blue Ocean Portfolios ("Blue Ocean" or the "Firm") seek the Commission's review of the Initial Decision's conclusions that (1) a conflict of interest existed between Blue Ocean and its clients; (2) Blue Ocean failed to disclose the alleged conflict; and (3) Respondents failed to show that they reasonably relied upon the advice of their counsel with regard to the same.

The proceeding below involved a multitude of alleged misrepresentations and omissions, yet none was ultimately supported by the evidence. Ultimately, the Division succeeded on only one of the contested allegations in the OIP: the alleged undisclosed conflict of interest.

For the reasons stated herein, the Initial Decision erred not only in concluding that the conflict existed, but that Respondents' "failure" to disclose it was "willful" or "reckless." In concluding as it did, the Initial Decision ignored the evidence in the record – the documents and testimony presented – and instead accepted as true (but without evidentiary support) the extrapolations, interpretations, and assumptions advocated by the Division.

The Commission, which reviews the record *de novo*, should quickly separate the wheat from the chaff, look beyond the Division's unsupported theories and assumptions, and examine the actual evidence presented. When the Commission does that, it will find that, contrary to the Initial Decision's findings, the record is replete with evidence that undermines the Division's position that Respondents failed to disclose a material conflict of interest and did so "recklessly." In fact, not only does the evidence contradict the Division's position, it wholly supports Respondents' defense. In ignoring that evidence, the Initial Decision made a serious error, one that can only be remedied by reversal of the findings or, in the alternative, remand to the ALJ assigned to this proceeding for additional review.

II. STANDARD OF REVIEW

Rule 411(a) of the Commission's Rules of Practice authorizes the Commission to "affirm, reverse, modify set aside or remand for further proceedings, in whole or in party, an initial decision by a hearing officer and may make any findings or conclusions that in its judgment are proper on the basis of the record."[1] The Commission's review of an initial decision is *de novo*.[2]

III. FACTS

The Respondents in this matter are James Winkelmann and Blue Ocean Portfolios. Blue Ocean is an investment advisory firm that Mr. Winkelmann formed in 2009.[3] Blue Ocean provides its advisory clients - a mix of individuals and small-to-midsize institutional clients - with portfolio allocation services on a fee-only basis.[4] At all relevant times, Mr. Winkelmann was Blue Ocean's CEO and CCO.[5]

A. The Royalty Unit Offerings

Blue Ocean's mission as an investment advisory firm was to provide its clients with an alternative to the commission-driven client/advisor relationship.[6] Instead of focusing on individual stocks and bonds, and speculating on their future performance, Blue Ocean focused on portfolio allocation. It chose investments in low-cost index funds, establishing the allocation

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[1] 17 C.F.R. § 201.411(a).

[2] *In Re Flanagan*, S.E.C. Release No. 48255; 2003 WL 21755920 (July 30, 2003)).

[3] Tr. 412:17-23; 413: 6-14 (Winkelmann).

[4] RX-001, pp. 7-9; Stip. No. 3. The Parties' Factual Stipulations were filed November 14, 2016 and are referred to herein as "Stip. No.___").

[5] Stip No. 5.

[6]RX-001 pp. 6-7.

based on client-specific factors. It did not chase individual investment performance.[7] It advertised its approach in print and radio ads throughout the St. Louis area.

In 2010, Blue Ocean began experimenting with targeted advertising, that is, using a combination of radio, online, direct mail, and print advertising to spread awareness of its investment approach and attract new customers to the Firm.[8] While advertising in the industry is common, Blue Ocean did not merely flood the airwaves with advertisements and hope for the best. Instead, each advertisement and advertising vendor was closely monitored. The cost of the advertisement was measured against its success in actually bringing in new clients.[9] Only those advertising venues which were successful were pursued.[10] Those with poor performance were discontinued.[11]

In 2011, the Firm decided to expand the scope of its campaign to attempt to attract more clients and grow its assets under management ("AUM").[12] To fund the campaign, the Firm contemplated a capital raise. Mr. Winkelmann met with Michael Morgan, an attorney at the law firm of Greensfelder Hemker & Gale, P.C. ("Greensfelder") in St. Louis, to discuss the possibility.[13] Mr. Morgan specialized in advising clients in all aspects of securities law and regulatory compliance.[14] Together, Mr. Morgan and Mr. Winkelmann settled on the royalty unit

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[7] *Id.*

[8] RX-003, pp. 7-8.

[9] Tr. 1252:10-19; Tr. 1298:13-1299:9; (Winkelmann); Tr. 861: 12-23 (Juris).

[10] *Id;* Tr. 463: 23-464:12; Tr. 1292: 5-19 (Winkelmann).

[11] Tr. 1252:10-19; Tr. 1298:13-1299:9; Tr. 1317: 4-22 (Winkelmann); Tr. 861: 12-23 (Juris).

[12] Tr. 439: 16-440:4.

[13] Stip. No. 51; Tr. 1318:24-1319: 15 (Winkelmann).

[14] *Id;* Tr. 1326: 17-23 (Winkelmann).

structure for each of the four offerings at issue here (the "Offerings").[15] While each Offering varies in its specific terms, the structure of each is the same.[16]

1. Royalty Unit Structure: Mandatory Percentage Payments

Under the terms of the Offerings, purchasers of royalty units would contribute capital to Blue Ocean in exchange for the right to receive a certain minimum percentage of the Firm's cash gross receipts on a monthly or quarterly basis, regardless of whether the Firm managed to achieve a profit during the same time period ("mandatory percentage payment").[17] There was no obligation for Mr. Winkelmann or the Firm to pay anything above the mandatory percentage payment, but the Firm could, in its sole discretion, make additional payments once the Firm "achieved profitability."[18]

Until profitability was reached, investors were explicitly cautioned to expect to receive only the mandatory percentage payments,[19] which would continue in perpetuity until the investor was paid back his or her principal investment plus some stated multiple of the investment.[20] These payments were always made from the Firm's cash receipts – i.e., revenue – and not

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[15] Tr. 1246:10-1248:8; Tr. 1249:11-1250:16. At all times relevant, Mr. Morgan was an attorney at Greensfelder.

[16] There were four Royalty Unit Offerings at issue here: Round 1(March 2011), Round 2 (February 2012), Round 3 (September 2012) and Round 4 (February 2013). Each is discussed further herein. Together, they are referred to as the "Offerings."

[17] Tr. 1274:19-25-1275:1-4 (Winkelmann); Tr. 277:2-7 (Laby).

[18] Except for Round 1 which projected $150 million each offering projected "profitability" would occur at $124 million. RX-001 p. 13; RX-002, p. 6; RX-003 p. 4, 16; RX-004 p. 14. Mr. Winkelmann testified to the same at hearing. Tr. 1515:24-1516:24. The investors called to testify likewise understood that the repayment was dependent on the Company achieving stability. Tr. 1056:8-19 (Mr. Swift).

[19] RX-002 p. 16 (emphasis added). Similar disclosures appear in Rounds 3 and 4. The language of Round 1 projects a different threshold. (RX-001 pp. 11-12).

[20] The multiple changed slightly from offering to offering. In Round 1, it was 3; in Round 2, it was 2.5; in Round 3, it was 2.25; and, in Round 4, it was 2.5 . FOF 7,9,11,13, respectively.

profits, meaning investors were paid first, before any expenses were factored in and regardless of whether the Firm was profitable for the period.[21]

Further, the explicit terms of each Offering Memorandum stated that there was no established timeframe within, or deadline by, which investors would be repaid.[22] Rather, the Offerings stated that the percentage payments would simply continue for as long as necessary for investors to receive their promised returns:[23]

> The Subscriber acknowledges that the Royalty...may never be paid in full by the Company and the Royalty is not required to be paid in full before any scheduled date.

2. The Source of the Mandatory Percentage Payments

It is important to note when considering the mandatory percentage payments that they were to be paid from gross cash receipts and gross revenue, not profits. Thus, regardless of the Firm's expenses, as long as it generated revenue, the royalty unit holders received a stated percentage of that amount.[24] The structure ensured that even if the Firm's expenses greatly exceeded revenue, royalty unit holders nevertheless received their mandatory percentage payment.[25] It was only after royalty unit holders were paid that remaining revenue could be used to cover the Firm's expenses, including salaries.[26] The risk that expenses would rise – and dwarf

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[21] Tr.45:3-10 (Swardson); Tr.188: 1-9 (Collins); Tr.189:17-190:1 (Collins); Tr. 1273: 5-9 (Winkelmann); Tr. 1273:15-25 (Winkelmann); Tr. 277:2-7 (Laby).

[22] RX-001 p. 98 (paragraph (r)); CX-124 (paragraph (p)); RX-003 p. 132 (paragraph (p); RX-004 p. 146 (paragraph (p)).

[23] RX-001 p. 98, paragraph (r). Similar language for Offerings 2-4 appears at CX-124 (paragraph (p)); RX-003 p. 132 (paragraph (p); RX-004 p. 146 (paragraph (p)).

[24] Tr. 277:2-7; Tr. 300:3-17 (Division's Expert Witness); Tr. 188: 25-25, 189:1-4 (SEC Examiner Collins). Tr. 1274:19-25 -1275:1-4 (Winkelmann); Tr. 1402:25- 1403:1-8 (Winkelmann).

[25] *Id.*

[26] This includes Mr. Winkelmann's salary, which the Division contends gives rise to a conflict.

the Firm's revenue – was borne only by Blue Ocean and Mr. Winkelmann; the royalty unit holders carried no expense risk at all.[27]

3. Royalty Unit Structure: Discretionary Additional Payments

The Offering Memoranda allowed the Firm to make additional payments to investors at its "sole and absolute discretion".[28] Those additional payments, if made, would mean an investor would be repaid his principal-plus-multiple more quickly.[29] The Offering Memoranda made clear, however, that there was no promise that investors would be repaid in any particular time frame.[30] Nor was there any promise that the additional payments would occur *at all*.[31] Investors specifically warranted, in the Subscription Agreement, that they understood these facets of the Offering and accepted them.[32]

To the contrary, the offering documents expressly disclosed that the Firm's ability to make additional payments was entirely conditioned on its ability to reach and maintain lower advertising factors and sustained profitability.[33]

4. The Interest of Investors and the Firm are Aligned: Both Want to Increase the Firm's Revenue

A primary feature of the Offerings, and the reason the royalty unit structure was selected, was that it "aligned" the financial interest of the Company and the royalty unit holders.[34] That is,

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[27] Tr. 1273:15-25 (Winkelmann).

[28] RX-001 p. 82; Tr. 558:13-23 (Winkelmann); Tr. 272:20-23 (Laby); CX-124; RX-003 p. 132; RX-004 p. 146. Profitability is a defined term under the offering documents.

[29] It is worth reflecting upon the purpose of the additional payments. Mr. Winkelmann hoped to pay investors more than he was obligated to. He wanted the Firm to be successful.

[30] *Id.*

[31] RX-001 p. 82; Tr. 558:13-23 (Winkelmann); Tr. 272:20-23 (Laby); CX-124; RX-003 p. 132; RX-004 p. 146.

[32] *Id.*

[33] Except for Round 1 which projected $150 million. Mr. Winkelmann testified to the same at hearing. Tr. 1515:24-1516:24. The investors called to testify likewise understood that the repayment was dependent on the Company achieving this level of stability. Tr. 1056:8-19 (Mr. Swift).

because the investors were entitled to a percentage of cash receipts, both investors and Blue Ocean were interested in increased revenues.[35] Higher revenues for the Firm meant the Firm was growing (its stated objective). Higher revenues for the Firm also meant the investors received higher royalty payments, even if only the minimum percentage was applied. The higher their payments, the more quickly they would be repaid their principal plus the promised multiple (which varied by offering).[36]

This "alignment" was one of the primary reasons that Mr. Winkelmann and Mr. Morgan chose the royalty unit structure. The success of growing the Firm's recurring revenue depended on its ability to successfully convert advertising spends into new advisory clients, and, thus, higher AUM, and higher recurring advisory fee revenues.[37] Since investors in the Offerings were entitled to be paid purely out of gross revenue, the higher the Firm's AUM grew, the higher the Firm's revenue grew, and the more quickly investors would be repaid.[38]

5. Greensfelder Retained to Prepare Offering Documents

As stated above, Michael Morgan, an attorney at Greensfelder, was retained to (and did) assist Respondents with each of the four Offerings.[39] Each offering was made pursuant to a written Offering Memorandum, which Mr. Morgan reviewed.[40] Further, Mr. Morgan was intimately involved with the offerings from their inception. Not only did Mr. Morgan participate

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[34] RX-001 p. 11 ("The overall objective is keep the interest of the investors, employees, customers, and owners of Blue Ocean Portfolios aligned at all times.") RX-002 p. 15 ("The interests of the owners, employees and royalty holders are aligned to create the fastest growth."); RX-003 p. 13 (same language as RX-002); RX-004 p. 13 (same language as RX-002).

[35] *Id.* Tr. 1248:20 1249:10; Tr. 1248:20-25; 1249: 1-10 (Winkelmann).

[36] RX-001 p. 11; RX-002 p. 15; RX-003 p. 13; RX-004 p. 13.

[37] RX-001 p. 9; Tr. 45:20-23 (Swardson); Tr. 1248:20-25; 1249: 1-10 (Winkelmann).

[38] *Id.*

[39] Stip. Nos. 51-55.

[40] *Id.*

in the preparation and review of the Offering Memoranda, Mr. Morgan and Mr. Winkelmann, together, came up with the royalty unit structure.[41]

IV. ARGUMENT

The record evidence, including unrebutted testimony by Mr. Winkelmann, undercuts the Division's assertions of liability and supports Respondents' affirmative defense that they reasonably relied upon the advice and counsel of their attorney when he advised them that the disclosures in the offering documents, with regard to conflicts of interest, were accurate and in compliance with applicable legal standards. In holding otherwise, the Initial Decision reached several conclusions lacking in both legal and factual support.

A. The Administrative Proceeding before the ALJ was Unconstitutional and its Finding Void.

Turning, momentarily, from the specific facts of this case, in light of recent developments in the Federal Courts and by the Commission itself, the Commission should reconsider its position that the administrative law judges ("ALJ") who oversee SEC administrative proceedings (including the ALJ who oversaw this proceeding) are "employees" as opposed to "inferior officers," in light of the recent rulings of two federal district courts and the Commission itself.

The Commission has long taken the position that its ALJs are not inferior officers and therefore are not governed by the Appointments Clause.[42] Its position is based entirely on the theory that the D.C. Circuit holding in *Landry v. FDIC*[43] (FDIC ALJs who preside over FDIC proceedings are not inferior officers) governs and the U.S. Supreme Court's ruling in *Freytag v.*

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[41] Tr. 439:16-24 (Winkelmann).

[42] *In re Lucia*, 2015 WL 5172953 (SEC Sept. 3, 2015); *In re Timbervest*, 2015 WL 5472520 (SEC Sept. 17, 2015); *In re Bandimere*, 2015 WL 6575665 (SEC Oct. 29, 2015); *In re Pierce*, 2016 WL 1566396 (SEC Feb. 29, 2016); *In re Page*, 2016 WL 3030845 (SEC May 27, 2016) (holding that the ALJ who administered Respondents' case, ALJ Patil, did not have to be constitutionally appointed).

[43] *Landry v. FDIC*, 204 F.3d 1125, 1134 (D.C. Cir. 2000).

Commissioner, 501 U.S. 868 (1991)[44] (special trial judges are interior officers subject to the Appointments Clause) is distinguishable.[45] The Commission's position was initially upheld by the D.C. Circuit in *Lucia* wherein the Court held, based upon the finding in *Landry,* that SEC ALJs, like FDIC ALJs, are not "inferior officers."[46] Since the *Lucia* decision, however, the authority upon which the Commission's position (and court opinions) are based, has been vacated, distinguished, and rejected by the federal courts.

The hearing in this matter occurred in October 2016. The post-hearing briefing was completed on December 22, 2016. On December 27, 2016, the 10th Circuit issued its ruling in *Bandimere v. Securities and Exchange Commission* wherein it ruled that SEC ALJs were inferior officers under the Appointments Clause of the United States Constitution[47] and that the SEC ALJs held their office unconstitutionally.[48] Further, *Bandimere* expressly denounced the reasoning employed by *Lucia* and *Landry,* as well as the Commission's attempt to distinguish SEC ALJs from the Supreme Court's reasoning in *Freytag* (finding ALJs to be interior officers)[49]:

> The SEC makes similar arguments here. It contends the *Freytag* Court relied on the [special trial judge's "STJs"] final decision-making power when it held they were inferior officers. The agency draws on *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000), in

[44] 501 U.S. 868 (1991).

[45] *In the Matter of Edgar R. Page & Pageone Fin. Inc.*, Release No. 4400 (S.E.C. Release No. May 27, 2016), *reconsideration denied,* Release No. 4454 (S.E.C. Release No. July 14, 2016) ("As we have previously explained, the D.C. Circuit's decision in *Landry v. FDIC* guides our resolution of this question."); *Raymond J. Lucia Companies, Inc. v. Sec. & Exch. Comm'n*, 832 F.3d 277, 283 (D.C. Cir. 2016), *reh'g en banc granted, judgment vacated* (Feb. 16, 2017) ("Relying on *Landry*... the Commission concluded its ALJs are employees, not Officers, and their appointment is not covered by the [Appointments] Clause").

[46] *Lucia*, 832 F.3d 277, 285 (D.C. Cir. 2016) ("But to the extent petitioners contend that the approach required by *Landry* is inconsistent with *Freytag* or other Supreme Court precedent, this court has rejected that argument and *Landry* is the law of the circuit.)

[47] U.S. Const. art. II, § 2, cl. 2;

[48] *Bandimere v. Sec. & Exch. Comm'n*, 844 F.3d 1168, 1179, 1188 (10th Cir. 2016).

[49] *Bandimere v. Sec. & Exch. Comm'n, 844 F.3d 1168, 1182* (10th Cir. 2016) (some internal citations omitted).

> which the D.C. Circuit attempted to distinguish *Freytag* and held that FDIC ALJs were employees. In *Landry*, the D.C. Circuit stated *Freytag* "laid exceptional stress on the STJs' final decision making power." *Id.* The court therefore considered dispositive the FDIC ALJs' inability to render final decisions. *Id.*
>
> This past August, the D.C. Circuit addressed the same question we face here. *Raymond J. Lucia Cos., Inc. v. SEC*, 832 F.3d 277, 283 (D.C. Cir. 2016). The D.C. Circuit followed *Landry* and concluded that SEC ALJs are employees and not inferior officers. *Id.* at 283–89. The holding was based on the court's conclusion that SEC ALJs cannot render final decisions. *Id.* at 285 ("[T]he parties principally disagree about whether [SEC] ALJs issue final decisions of the [SEC]. Our analysis begins, and ends, there.").
>
> We disagree with the SEC's reading of *Freytag* and its argument that final decision-making power is dispositive to the question at hand.

Following the *Bandimere* ruling, finding SEC ALJs to be inferior officers under *Freytag,* the SEC petitioned the 10th Circuit for *en banc* review. That request was denied.[50] Following denial, the Commission entered an order staying all pending administrative proceedings where the respondent had a right to appeal an adverse decision to the 10th Circuit.[51]

Shortly after the 10th Circuit's holding in *Bandimere* – which called the reasoning behind *Lucia* into question – the D.C. Circuit vacated its ruling in *Lucia* and granted a petition for *en banc* review.[52] The D.C. Circuit heard oral argument *en banc* on May 24, 2017. A ruling on that decision is pending. All respondents who appeal decisions of the Commission may appeal to the D.C. Circuit.

[50] *Bandimere v. Sec. & Exch. Comm'n,* 855 F.3d 1128 (10th Cir. 2017).

[51] *In re: Administrative Proceedings,* Exchange Act Release No. 80741 (May 22, 2017).

[52] *Raymond J. Lucia Companies, Inc. v. Sec. & Exch. Comm'n* 832 F.3d 277 (D.C. Cir. 2016), *reh'g en banc granted, judgment vacated (Feb. 16, 2017).*

With *Lucia* vacated, the Commission should apply the law as set forth in *Bandimere* and dismiss as void the instant proceeding and all sanctions and decisions rendered therein.[53] Even after the finding in *Bandimere,* the Commission "declined" to follow it and turned instead to *Lucia,* which was (then) applicable D.C. Circuit precedent.[54] That is no longer the case, as with *Lucia* vacated, there is no D.C. Circuit to which to cite.

Further, not only has the Commission's precedent been erased with *Lucia's* vacatur, its arguments set forth in support of the *Lucia* decision have been rejected as well. The Commission has historically refused to recognize its ALJs as inferior officers (and thus denied challenges based on the Appointments Clause) for the same reasons it set forth in its Petition for *en banc* review, filed with the 10th Circuit in *Bandimere.*[55] Namely, its arguments that (1) the ALJs were not inferior offices because the Commission and not the ALJs have the final authority to bind the agency; (2) that *Freytag* was distinguishable because SEC ALJs carried less authority than the special trial judges of the tax courts who were found to be interior officers).[56] Those arguments were rejected by the 10th Circuit when it denied the SEC's *en banc* request for rehearing.[57]

[53] As the U.S. Supreme Court wrote, "an opinion announcing a rule of federal law 'is properly understood to have followed the normal rule of retroactive application.'" *Harper v. Virginia Dept. of Taxation,* 509 U.S. 86, 97 (1993), *quoting James B. Bean Distilling Co. v. Georgia,* 501 U.S. 529, 539 (1991) (opinion of Souter, J.). When a federal court "applies a rule of federal law to the parties before it, that rule is the controlling interpretation of federal law and must be given full retroactive effect in all cases still open on direct review ...." *Id.*

[54] *In re Haring Advisory LLC,* 2017 WL 66592, at *15 n. 90 (SEC Jan. 6, 2017) (After citing *Bandimere,* the Commission stated "we adhere to the D.C. Circuit's decision in *Lucia.*")

[55] *In the Matter of Bennett Group Fin. Services, LLC & Dawn J. Bennett,* Release No. 4676 (S.E.C. Release No. Mar. 30, 2017) (refusing to consider constitutional challenge for reasons incorporated by reference from its petition for *en banc* hearing in *Bandimere*); *Bandimere v. SEC* Petition for ReHearing or Rehearing *En Banc,* No. 15-9586 (filed March 13, 2017). (Attached hereto as Exhibit A).

[56] *Id.*

[57] *Bandimere v. United States Sec. & Exch. Comm'n,* 855 F.3d 1128 (10th Cir. 2017).

The Courts' decisions in *Bandimere* and *Lucia*, as well as the Commission's decision to stay all administrative proceedings ultimately appealable to the 10th Circuit, constitute intervening changes in controlling law that were issued after the hearing in this matter was completed and the post-hearing briefings filed.[58] The ALJ who oversaw this proceeding is one of five working for the SEC. Under *Bandimere*, he held his office unconstitutionally when he presided over Respondents' hearing. For this reason alone, notwithstanding the specific facts or allegations set forth in this dispute, the Commission should vacate the findings in the Initial Decision, including the findings of liability, as well as all resultant the sanctions and penalties assessed.

B. No Conflicts of Interest.

Reversal is also warranted as a result of the errors in the Initial Decision. After rejecting the lion's share of the Division's allegations, the Initial Decision erred in finding that an undisclosed conflict of interest existed between Mr. Winkelmann and any advisory clients who purchased royalty units.[59] The finding of liability was based, in part, on the Initial Decision's finding there was insufficient evidence the Firm relied upon the advice of its counsel. That issue is addressed fully, below.

As a threshold matter, however, the Initial Decision erred in concluding that an undisclosed conflict of interest existed between Blue Ocean and its advisory clients who purchased royalty units.

[58] Because the SEC has concluded – contrary to the position espoused by the Court in *Bandimere* – he did not need to be appointed consistent with the Appointments Clause of the U.S. Constitution. *In re Page*, 2016 WL 3030845, at*16 (SEC May 27, 2016).

[59] The Initial Decision properly held that there was no such conflict with regard to non-advisory clients.

1. No Conflict with Regard to Additional Payments.

The Initial Decision found that with regard to the mandatory percentage payments, no conflict of interest existed, since those amounts were promised to the royalty unit holders without exception. The Initial Decision improperly found a conflict to exist, however, with regard to the Additional Payments, based on the reasoning that those additional payments "competed directly with [Mr. Winkelmann's] own compensation."[60] That finding is erroneous for four separate reasons.

a. No Conflict Existed because There was No Fiduciary Obligation imposed by the Offering.

The Initial Decision set forth a new, bright-line rule that investment advisors, in discussing any investment with any person, are necessarily acting as fiduciaries.[61] This new standard, which is unsupported by statute, regulatory guidance or case law, is a limitless extension of the fiduciary duty placed on investment advisors when they are acting as such.[62] Investment advisors have a fiduciary obligation *to their clients* when they are, in fact, acting as an invest advisor. As a result, disclosure of conflicts is required because they might induce an advisor to make an *investment recommendation* or provide *investment advice* that is not in the client's best interest.[63] The Initial Decision takes this obligation and improperly extends it beyond the advisor-client relationship. It states that an investment advisor acts in a fiduciary capacity when dealing with any individual regarding any investment[64]:

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[60] Initial Decision p. 32.

[61] Initial Decision p. 56.

[62] In support, the Initial Decision relies upon 15 U.S.C. § 80b-6, which prohibits fraud by investment advisors against clients or prospective clients. The cited section does not state that investment advisors perpetually function as fiduciaries, regardless of context.

[63] *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963).

[64] Initial Decision p. 56.

> While Winkelmann caveated his overtures with the assertion that he was not giving advice or making a recommendation, he nonetheless had a fiduciary obligation to each client in presenting them the investment opportunity...to disclose conflicts. To find otherwise would mean that all investment advisers, simply by telling a client it is not advice or a recommendation, can now present any other investment opportunity to them, fail to disclose conflicts of interest, and empty the advisory clients' accounts into such investments.

This expansion of the fiduciary relationship is both unsupported and not viable. First, it is important to understand the two capacities in which Mr. Winkelmann was acting. On the one hand, he was an investment advisor to his advisory clients. By virtue of that relationship, he recommended portfolio allocations that would reduce fees and promote long-term account growth. In making those recommendations, and allocating portfolios, Mr. Winkelmann carried fiduciary obligations, and honored them. On the other hand, Mr. Winkelmann was also the CEO of a company that was raising money to expand its presence. In offering royalty units to fund that expansion, and via the written offering materials, he offered (but expressly did not recommend) the investment.[65]

Second, neither the Initial Decision nor the Division in its briefing on this issue were able to cite to any authority holding that investments advisors remain fiduciaries outside of the *advisory relationship* with their *clients.* The Division cited a number of cases for the proposition that the fiduciary obligation should be considered "broadly." Each of those cases, however, considered the fiduciary duty within the context of the advisory relationship.

Consider *Geman v. SEC,*[66] one of the few cases identified by the Division in its post-hearing submission. The case involved a firm whose business changed from agency only trading (executing its customer trades with third parties) to principal trading (executing the customers'

[65] Tr. 549:19-550:17; Tr. 1252:20-1255:10-24 (Winkelmann).

[66] *Geman v. S.E.C.*, 334 F.3d 1183, 1190 (10th Cir. 2003).

trades itself). The firm in *Geman* argued that it was not acting as an investment advisor when it placed trades for its clients but, instead, was simply brokering trades. Therefore, it reasoned, there was no breach of fiduciary obligation when it used the customer trades to achieve more favorable pricing on its own, proprietary trades, keeping the profits for itself.

Right off the bat, the differences between *Geman* and the instant proceeding are clear. *Geman* involved the investment advisory firm acting on its *clients'* behalf in directing and executing investments *within their advisory accounts.* And, it was based on that conduct occurring within the advisory relationship that Geman lost. *Geman* does not hold, however, that the fiduciary duty itself can be broadly applied outside the client-advisor relationship. Certainly, it does not support the Initial Decision's limitless extension of the fiduciary relationship.

Moreover, not only does *Geman* fail to support the Initial Decision's new expanded fiduciary duty, it undermines its very reasoning. The Initial Decision found that investment advisors cannot limit the universe of people with whom they may have a fiduciary relationship – even where they expressly inform the client that they not providing them with advice on the matter and cannot make a recommendation as to whether or not the client should purchase.[67] *Geman* suggests the opposite is true. While it did not consider the issue expressly, it did consider the written agreement and promotional materials exchanged between the firm and its clients, and held[68]:

> "Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." Here, the customers' response to the firm's promotional material, which included the statement quoted above to the effect that the firm would act as a fiduciary, established an agency with its attendant fiduciary duties. *Id.* ("An agent is a

[67] Initial Decision p. 56.

[68] *Geman v. S.E.C.*, 334 F.3d 1183, 1189 (10th Cir. 2003).

> fiduciary with respect to matters within the scope of his agency."). Accordingly, the firm must be held to fiduciary duties with respect to the wrap fee program.

No such agency or fiduciary relationship was extended via the Offering Memoranda at issue here. Furthermore, the uncontroverted evidence presented at hearing (including testimony from the Division's investor witnesses) was that Mr. Winkelmann, in informing his advisory clients of the Offerings, expressly informed then that he could not recommend and was not recommending the investment. Consider the following letter drafted by Mr. Winkelmann and Mr. Morgan to be sent to advisory clients, which closed[69]:

> Because of the fiduciary relationship we have with you, I cannot recommend that you or your family participating in this offering due to the potential conflict that such a recommendation will create, and this letter is not an offer. Nonetheless I wanted to make you aware of this situation and can provide you with offering material should your interest warrant.

This communication is the exact opposite of the representation made in the *Geman* decision. Instead of an offer of a fiduciary relationship, it is a disclaimer of one. And, when asked whether or not this type of disclaimer could be used to limit the scope of an advisory relationship, even the Division's expert agreed that it could[70]:

> JUDGE PATIL: I have a question ...and counsel will object as they deem appropriate. But what difference, if any, would it make if Mr. Winkelmann was careful to tell investment advisory clients that "I'm not advising you to buy the Royalty Unit. I'm just presenting this as an offer and an option and I'm not recommending you take it. You have to make the decision for yourself"?
>
> THE WITNESS: So it wouldn't make any difference at all with respect to misstatements and material omissions because those are illegal and those prohibitions apply to all persons. That's section

[69] RX-106 p. 401. This letter is discussed in greater detail in Section IV.C, below.

[70] Tr. 319:- 320:22 (Laby). Laby cited SEC Rel. No. IA-1092 in support of his position. Nothing in that release extends fiduciary obligations to entities issuing securities as part of a capital raise.

> 10B of the Exchange Act. So with respect to just outright lies, misrepresentations, or material omissions, wouldn't make any difference at all.
>
> The only possible way it could make a difference is if there were something that was simply a conflict of interest, then at least potentially that duty to disclose a conflict would be more robust in the context of advisory clients. And so to the extent that Mr. Winkelmann were to say, "Look, when it comes to this transaction, I am no longer acting as your investment advisor and I no longer owe you a fiduciary duty." And that's the key. Say "I'm taking off my fiduciary duty hat and I don't owe you that duty anymore." Then, at least potentially, a conflict of interest might not have to be disclose in the way that it would have to be disclosed if one were acting as an investment advisor.
>
> But I would add the caveat that based on SEC release 1092 and a lot of other guidance, in order to, quote, switch hats in the way that your question suggested, the investment advisor has to be crystal clear that they're not acting as an investment advisor, they no longer owe a fiduciary duty, and the investors are, for lack of a better word, on their own -- lack of a better phrase, on their own with respect to the investment.
>
> JUDGE PATIL: Thank you.

It is hard to imagine language that is clearer than that Mr. Winkelmann used when communicating with his advisory clients regarding the Royalty Unit Offerings.[71]

Given the lack of authority supporting the Division's position, which was adopted by the Initial Decision, and in light of the authority suggesting the new limitless-fiduciary standard conflicts with existing law, the finding that Mr. Winkelmann was unable to limit with whom he entered into a fiduciary relationship should be reversed. The Commission should conclude that in light of this clear explanation of the scope of his conduct, when Mr. Winkelmann was offering royalty units in Blue Ocean, he was not acting in a fiduciary capacity. Because he did not act as a fiduciary, he had no fiduciary obligation to disclose conflicts of interest. Because he had no

[71] Even the investor witnesses called by the Division in its case-in-chief testified that Mr. Winkelmann had made the same representation to them orally. Tr. 27:12-25.

duty to disclose, the Initial Decision improperly found a violation of Advisers Act § 206, and that erroneous finding should be reversed.

b. Additional Payments were not to be Expected until the Firm reached Profitability.

Even assuming, *arguendo,* that additional payments were capable of creating a conflict of interest, investors were expressly cautioned that they should not expect those additional payments unless and until the Company "achieved profitability." Each Offering Memorandum clearly disclosed that investors should expect to receive only the mandatory percentage payments until the Company achieved sustained profitability.[72] The Firm projected that it would reach "profitability" once it achieved and AUM of $124 million, and those profits were "sustainable".[73]

The disclosures relating to the timing of when additional payments could be contemplated were express:

- ***Investors should expect the minimum*** of (0.25%) of total revenue per unit initially. Once Blue Ocean achieves profitability, the current plan (although not required) is to pay at least 50% of the profits, which we expect will exceed 0.25% of revenue, to the Royalty Unit holders until their 2.50x payback is achieved. [74]
- Blue Ocean Portfolios will have the ability to increase the investors' royalty per unit participation ***if*** lower advertising yield factors are ***achieved and maintained.***[75]
- Under the planned expenses and advertising assumptions, Blue Ocean Portfolios will produce ***a positive cash flow at approximately $124 million*** in AUM. [76].

[72] *See* Section III.A.3., above, providing the text of the relevant disclosures.

[73] Except, as noted, above, for Round 1 which projected $150 million.

[74] RX-002 p. 16 (emphasis added). Similar disclosures appear in Rounds 3 and 4. The language of Round 1 differs slightly. (RX-001 pp. 11-12).

[75] *Id.* (Emphasis added).

- Once *recurring sustainable profitability* is achieved, larger and larger portions of the cash receipts will be used to pay back the Royalty Unit holders.[77]

This language informed all investors and prospective investors that additional payments, if any, should not be expected unless and until the Firm achieved the stated profitability metric.

Therefore, even if Mr. Winkelmann's discretion to compensate himself for running Blue Ocean was able to cause a conflict of interest, that conflict was effectively theoretical unless and until the Firm generated sustained profitability. Thus, investors were aware that, under the terms of the Offering Memoranda, they "should expect the minimum of [percentage] of total revenue."

c. No Conflict Existed because the Offering Memoranda only Required the Payment of the Mandatory Percentage Payments.[78]

The Initial Division also erred in finding Mr. Winkelmann and Blue Ocean violated the Advisers Act because the underlying conflict he allegedly failed to disclose did not, in fact, exist. That is, even if Respondents had an obligation to disclose conflicts, there was nothing to disclose here.

The only obligation imposed on Blue Ocean by the terms of the Offerings was to make the mandatory percentage payments out of the revenue the Firm generated during the particular time period. Beyond that, Mr. Winkelmann and Blue Ocean had no further obligation to pay investors any particular amount at any particular time or at any particular pace.

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[76] RX-002 p. 18. Similar language for the other offerings at RX-001 p. 13 (Round 1); RX-003 p. 16 (Round 3); RX-004 p. 16 (Round 4). All of the offering memoranda use the $124 million threshold to profitability and higher payments, except for Round 1, which estimated $150 million.

[77] RX-002 p. 6 (Round 2); RX-003 p. 14 (Round 3); RX-004 p. 13 (Round 4).

[78] Taking a step back from the details momentarily, one can appreciate the absurdity of the Division's case. First, that Mr. Winkelmann's admirable reservation of the right, but not the obligation, to make additional payments to investors so he could repay them more quickly, is what made the offerings fraudulent. Second, the fact that had Mr. Winkelmann added one sentence to his offering memoranda disclosing the obvious fact that he would be compensated by Blue Ocean as its CEO in an amount he determined (as CEO) that this allegedly "fraudulent" set of offerings would have been fully cured.

Instead, Offering Memoranda gave the Firm the ability, but not the obligation, to repay investors more quickly out of the Firm's profits (once it had some profits):

> [T]he current plan (although not required) is to pay at least 50% of the profits, which we expect will exceed 0.25% of revenue, to the Royalty Unit holders until their 2.50x payback is achieved.

Other language in the offering documents made clear that this "goal" (as the Division called it) was not an obligation the Firm assumed, merely an aspiration it carried.[79]

Further, the finding that Mr. Winkelmann's compensation created a conflict of interest ignores the stated purpose of the offerings. The capital raises were to fund Blue Ocean's expansion. As discussed immediately above, additional payments made to investors were never contemplated unless and until the Firm made a profit (and could distribute that profit back to investors).[80] Making additional payments out of profits fits the stated purpose and goals of the offerings. The purpose of the Offerings was to raise money the Firm could use to expand the scope of its operations. That is, Blue Ocean needed the money to spend on various revenue-generating endeavors and to keep the lights on. It would not serve that purpose (or benefit the investors, who expected to be paid back their principal plus some multiple of the same) to use the hard-earned proceeds of the offerings to begin aggressively repaying. To make the profits necessary to pay the investors (two or three times their initial investment) faster than if they just received the mandatory minimum payments, the Firm had to put that money into its operations.

Thus, contrary to the finding in the Initial Decision, Mr. Winkelmann did not "fac[e] the recurring choice of whether to increase payments to investors or to increase his own compensation."[81] To the contrary, Mr. Winkelmann never faced that choice at all because (1) the

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[79] Tr. 558: 13-18 (Winkelmann); Tr. 272: 20-23 (Laby); DOE PHB at p. 7; Tr. 262:19-263:6 (Laby).

[80] *See* Section IV.B.1.b., above

[81] Initial Decision p. 55.

Firm was never profitable and (2) repaying investors out of funds raised, instead of profits enjoyed, would undercut the objective of the offering and stated use of the proceeds. Accordingly, no conflict existed as a result of Mr. Winkelman's compensation, no disclosure was required, and Mr. Winkelmann did not violate the Advisers Act § 206.

d. There was No Violation because the Fact Mr. Winkelmann would be compensated was disclosed.

Moreover, while the primary focus of the offerings was funding the Firm's advertising campaign, the Offering Memoranda expressly disclosed that the proceeds would also be used to retain and compensate the necessary team of professionals needed to run the Company:

- The proceeds of this Royalty Offering will be used exclusively for operations of Blue Ocean Portfolios, LLC.[82]
- Blue Ocean is planning to use the proceeds of the Royalty Offering to expand its advertising reach... and pay for general and administrative expenses. Proceeds can also be used to fund other revenue-producing activities that are directly or indirectly related to Blue Ocean Portfolios' business activities. [83]
- As with any small private business, there will always be management, personal, and execution risk. The key risk in this plan is running out of capital before cash flows turn positive."[84]
- The Chief Executive Officer is expected to have extensive experience in financial services sales, management, administration, compliance, and regulatory relations...all positions will be compensated with a base salary plus an objective bonus paid on profitability of the company. All employees will be focused on the top and bottom line. This focus is directly in line with the investor's payback and the owner's potential distributions.[85]

Even were Mr. Winkelmann found to be acting as an investment advisor in issuing the Royalty Units, the Initial Decision's finding should nonetheless be reversed because the specific

[82] RX-001 p. 12.

[83] RX-002 pp. 6-7. Nearly identical language appears in the other three offerings.

[84] RX-001 p. 13.

[85] RX-001 p. 14.

conflict – Mr. Winkelmann's ability to determine his compensation and pay himself – was disclosed.[86]

e. Mr. Winkelmann's Compensation was Modest.

In addition to the above disclosures, regarding the fact that the Offering proceeds may be used to fund general and administrative expenses, and the investors' awareness that Mr. Winkelmann was being compensated by the Firm, it is worth noting how modest his compensation was. The Division casts Mr. Winkelmann's salary as though it were an act of greed. Yet, while Mr. Winkelmann is punished for increasing his salary once the Offerings were successful, he gets no credit for the months where he drew no salary. Between January 2011 and September 2011, he was paid nothing at all.[87] Thereafter, he was paid $2,000 per month ($24,000 per year), and was working six to seven days a week.[88] These figures are hardly startling.[89]

f. Initial Decision misread the Offering Memoranda when it found a "reckless" failure to disclose a conflict of interest.

The Initial Decision's finding that Respondents failed to disclose a potential conflict – and that the non-disclosure was reckless – was based on a misreading of the statements in the Offering Memoranda. The Initial Decision found[90]:

> While Winkelmann appears to hold a sincere belief that the royalty unit offerings and associated representations post no conflicts of interest, that view is nonetheless extremely reckless...Mr. Winkelmann did not just fail to disclose the actual and potential conflicts, but instead affirmatively misrepresented that he "eliminated" them...The reckless misrepresentations by Winkelmann and BOP regarding the elimination of conflicts of

[86] Every investor witness called to testify admitted they understood Mr. Winkelmann was compensated.

[87] Tr. 186:5-9.

[88] Tr. 1485:16-25.

[89] Even when Mr. Winkelmann increased his salary, he earned just over $100,000 per year.

[90] Initial Decision p. 55. This conclusion appears in several other places in the Initial Decision, reflecting the emphasis the Court placed on the finding. pp. 55-56; pp. 31-32.

> interest represent violations of Exchange Act ...and Securities Act[.]

This finding is based entirely on a misreading of the Offering Memoranda as it confuses two different representations made therein. On pages 31-32 of the Initial Decision, the Court expressly states the language regarding conflicts of interest held to be problematic. One of those statements refers to the objective of the royalty unit Offerings, specifically, the statement that:[91]

> The expansion of capital in the form of Royalty Units is a way to fund growth, provide immediate cash flow stream to the royalty Unit holders, and align all interest for returns at a relatively low risk.

The Initial Decision contrasts this statement, regarding an "alignment of interests" in favor of increased revenues, with other statements in the Offering Memoranda regarding the "elimination of conflicts," including the following:

> BOP "attracts clients who are fed up with conflicts of interest prevalent at the broker/dealers where representatives/advisors make more money selling one security over another"[92]
>
> BOP "creates value for its clients by eliminating conflicts of interest."[93]
>
> "The plan is to...be the 'go to' solution when investors are fed up with the conflicts of interest from their advisor/broker. This message is currently being broadcasted through advertising."[94]

The Initial Decision also considered a PowerPoint slide deck attached to the Offering Memoranda that described Blue Ocean's business objective as providing "conflict free Wealth Management."[95] Juxtaposing these representations, the Initial Decision concluded that Mr.

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[91] Initial Decision p. 32, citing RX-001 p. 15, RX-002 p. 22, RX-003 pp. 21-21; and RX-004 at 21.

[92] Initial Decision p. 31, citing RX-001 p. 6; RX-002 p. 8; RX-003 p. 6; and RX-004 p. 6.

[93] Initial Decision p. 32, citing RX-001 p. 7, RX-002 p. 9, RX-003 pp. 6; and RX-004 at 7.

[94] Initial Decision p. 32, citing RX-001 p. 8.

[95] Initial Decision p. 32 citing RX-001 p. 115; RX-002 p. 124 and RX-003 p. 143. There is no similar attachment to the Offering Memoranda for Round 4.

Winkelmann had acted recklessly because he not only failed to disclose the alleged conflict, but he "affirmatively misrepresented" that conflicts had been eliminated.

The error in the Court's reasoning is that the sections cited, referencing the "elimination" of conflicts, do not relate to the royalty unit Offerings; rather, they describe Blue Ocean's advisory business strategy. Each representation discussing the "elimination" of conflicts of interest cites to a page discussing the advisory firm's approach to investing its client assets. It does *not* state that the royalty unit offering has "eliminated" conflicts.

To understand where the Court erred, the Commission must look at the structure of the Offering Memoranda themselves. While each differs slightly in terms and verbiage, all follow the same format. They begin with an Executive Summary, which informs the reader that Blue Ocean is looking to raise money to expand its investment advisory business model through a private offering of royalty units.[96] Following the Executive Summary, each Memoranda has a section describing the "Wealth Management Industry"[97] followed by a section titled "Why Blue Ocean Portfolios?"[98] These two sections discuss Blue Ocean's advisory business, its investment strategy, and how its advisory business sets itself apart from other broker/dealers or representatives/advisors that are compensated based on which product they sell, revenue sharing agreements, and other "soft dollar" agreements.[99] That is, these sections describe the advisory firm and its unique approach to investing.

The language cited by the Initial Decision, in support of the proposition that the Offering advertised the "elimination" of conflicts of interest, all cite to these two sections. Yet, nothing in

[96] E.g. RX-001 p. 5. Offerings 2-4 follow the same format. *See,* RX-002, RX-003, RX-004.

[97] RX-001 p. 6.

[98] RX-001 p. 7.

[99] RX-001 p. 6.

either section discusses conflicts of interest vis a vis royalty unit investors. Instead, these sections describe to potential investors how Blue Ocean has worked to eliminate conflicts of interest in managing client portfolios. That is, why Blue Ocean's advisory business was conflict free.

Contrast those representations regarding the "elimination" of conflicts in the advisory business with the "alignment" language, also cited in the Initial Decision. That language, which does relate to the royalty unit offering (as opposed to the underlying advisory business), appears in the second-to-last sentence in the Offering Memoranda – ten pages later.[100]

In finding an undisclosed conflict to exist and in finding Mr. Winkelmann to have acted recklessly, the Initial Decision based its reasoning by reading these entirely separate sections (discussing two entirely different relationships) together and erroneously conflating them.[101] Thus, the Court reached the unsupported and inaccurate conclusion that Mr. Winkelmann "[d]id not just fail to disclose actual and potential conflicts, but instead affirmatively misrepresented that he "eliminated" them" and that his "belief that he had somehow eliminated conflicts of interest was extremely reckless."[102] Because that finding is based on a misreading and/or misconstruction of the language of the Offering Memoranda, the finding should be reversed and the Commission should hold that the Division of Enforcement failed to prove the existence of a conflict and also failed to prove that Mr. Winkelmann or Blue Ocean's conduct was "reckless."[103]

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[100] Not including the attachments to the Offering Memoranda. RX-001 p. 15.

[101] Initial Decision pp. 31-32,54, 55-56.

[102] Initial Decision p. 55.

[103] A mental state of recklessness is the threshold required for a finding of *scienter*. Because the Initial Decision's finding of recklessness was in error, its conclusion that Mr. Winkelmann acted with scienter should be reversed. Without a finding of scienter, the Division's claims brought under the Exchange Act Section 10(b) and Rule 10b-5, Securities Act Section 17(a), and Advisors Act 206(1) fail as a matter of law.

C. **The Evidence Showed Mr. Winkelmann Relied on the Advice of his Counsel that he Could Sell Royalty Units to Clients and that the Disclosures in the Offering Memoranda were Proper for Those Sales.**[104]

Perhaps the most staggering fining in the Initial Decision is the finding that Mr. Winkelmann failed to present sufficient evidence that he reasonably relied upon the advice of his counsel in offering royalty units to advisory clients. Mr. Winkelmann's unrebutted testimony was that he asked Mr. Morgan, his counsel at Greensfelder, whether he could offer royalty units to advisory clients and that Mr. Morgan told him he could[105]:

> Q Tell us about conversations you had, if any, with Mr. Morgan about the propriety of offering the Royalty Units to advisory clients.
>
> A When I would bring this up with Mr. Morgan, he goes, "That's the beauty of the structure, Jim, because there is no conflict of interest."
>
> Q So did Mr. Morgan have an opinion on whether it was proper or not to offer Royalty Units to your advisory clients?
>
> A Yes.
>
> Q What was his opinion?
>
> A That under this structure, it would be appropriate. It would be no problem.

Yet, the Initial Decision did not only disregard this unrebutted testimony, it went on to find that:[106]

> There is nothing in the substantial documentary production from Greensfelder that reflects that Winkelmann ever asked them for advice on whether or not he could sell royalty [sic] to units to clients or that Greensfelder advised he could. There is no evidence that Winkelmann ever asked Greensfelder attorney whether he could successfully sidestep his fiduciary duties to advisory clients

[104] Respondents have filed a Motion for Leave to Admit Additional Evidence on this issue. Depending on the resolution of that Motion, additional briefings on the topic may be warranted.

[105] Tr. 1251:5-12 (Winkelmann).

[106] Initial Decision p. 63.

> by caveating his presentations of investment opportunities...simply by saying he was not advising or recommending that they invest. Had he done so, one would expect evidence that Greensfelder considered it before advising him.

The Initial Decision errs in its conclusion above. The "substantial documentary production" presented at hearing contains several examples documents that corroborate Mr. Winkelmann's testimony that Mr. Morgan knew he was selling royalty units to advisory clients and "blessed" the Offering documents knowing that to be true.[107]

The Round 1 Offering occurred on March 31, 2011.[108] This is undisputed. Also undisputed, on February 15, 2011, Mr. Winkelmann sent Mr. Morgan an email titled "Client notice of Capital Raise." Attached to the email was a letter to Mr. Jay Shield. In the body of the email, Mr. Winkelmann wrote:

> Mike – this is my idea for the ***letter to clients that are suspects for participation in Blue Ocean Portfolios royalty units***. Please let me know what you think.

This email expressly refers to Mr. Winkelmann's intent to provide "notice" to "clients" of the "capital raise."[109]

On March 28, 2011, three days before the first offering at issue, Mr. Winkelmann again emailed Mr. Morgan, asking "this is the letter I came up with...would like to send this out to a handful of accredited investors – Schnucks, Shields, Holland, etc."[110] Attached to that email is a letter clearly marked as a "DRAFT."[111]

[107] Tr. 549:19-550:17 (Winkelmann); DX-40;

[108] RX-001 p. 1.

[109] Nothing appears on the Firm's February 2011 invoice reflecting that Mr. Morgan researched or explored this issue at the time. RX-113 p. 1.

[110] RX-106 p. 399.

[111] As stated in Respondents' Motion to Add Evidence, Mr. Morgan had trouble sending this particular email and it took a few tries for the email and attachment to come through. *See* Respondents' Motion filed May 19, 2017. Attached to the Motion was an affidavit from Ms. Hennessy. Exhibit 1 to that affidavit was the full email chain

It reads[112]:

> Dear Jay,
>
> ***Thanks to clients like you*** we have been steadily growing our Blue Ocean business…
>
> My idea for the new capital is to privately place up to 40 Blue Ocean Royalty Units for $25,000 each. Each one of these Blue Ocean Royalty units would give the unit holder rights to at least 0.25% of the cash receipts of Blue Ocean, LLC until the unit holder would be re-paid $75,000. These payments would be made every quarter. Then the unit holder would have a warrant to purchase 0.25% of Blue Ocean Portfolios for $25,000. We already have several units spoken for from friends and family members.
>
> ***Because of the fiduciary relationship we have with you, I cannot recommend that you or your family participate in this offering due to the potential conflict that such a recommendation will create, and this letter is not an offer. Nonetheless I wanted to make you aware of this situation and can provide you with offering materials should your interest warrant.*** Please do not hesitate to call should you have any questions or comments.
>
> Sincerely yours,
>
> Jim Winkelmann

Additional correspondence, from later in the attorney-client relationship, confirms the above. In January 2013, shortly before the Fourth Round Offering, Mr. Winkelmann was revising the Firm's annual Form ADV and determining whether any disclosures needed to be updated. Specifically, Mr. Winkelmann was considering the import of the fact one of his former colleagues, Bryan Binkholder, was under federal investigation – a fact Mr. Winkelmann had learned just two months prior, in November 2012.[113]

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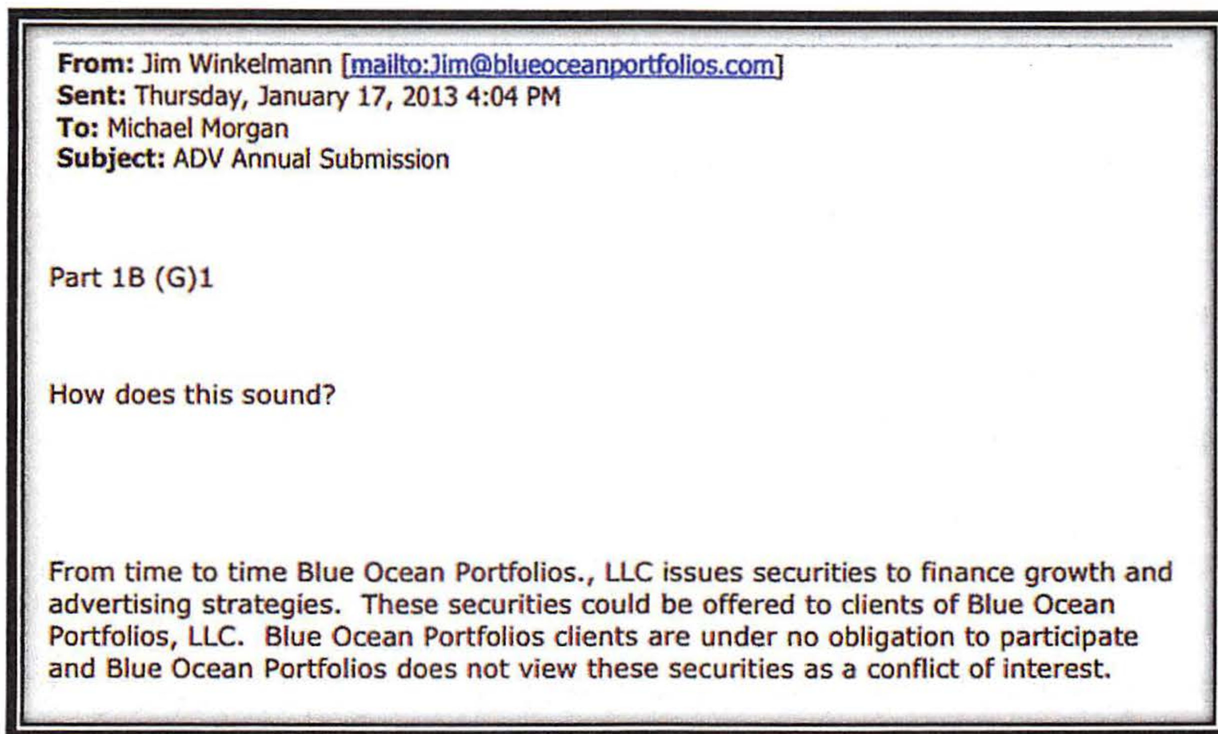
between Mr. Morgan and Mr. Winkelmann attempting to transmit the draft letter that appears at RX-106 p. 401. Exhibit A to the Motion includes the email that appears at RX-106 pp. 399-400 and the attached DRAFT letter. That copy shows the redlined changes input by Mr. Morgan, underscoring the fact that he was aware Mr. Winkelmann would be offering the royalty units to clients and that he failed to counsel him otherwise.

[112] RX-106 p. 401 (emphasis supplied).

[113] Stip No. 57; RX-106 pp. 1914—1916.

Mr. Winkelmann asked how the Firm should answer Item 6: Other Business Activity.[114] Mr. Winkelmann queried whether the following disclosure should be added[115]:



From: Jim Winkelmann [mailto:Jim@blueoceanportfolios.com]
Sent: Thursday, January 17, 2013 4:04 PM
To: Michael Morgan
Subject: ADV Annual Submission

Part 1B (G)1

How does this sound?

From time to time Blue Ocean Portfolios., LLC issues securities to finance growth and advertising strategies. These securities could be offered to clients of Blue Ocean Portfolios, LLC. Blue Ocean Portfolios clients are under no obligation to participate and Blue Ocean Portfolios does not view these securities as a conflict of interest.

The email specifically referenced the fact the Initial Decision held was absent from the record – Mr. Morgan's knowledge that royalty units "could be offered to clients."[116] Mr. Morgan responded that the disclosure was "better" but expressed his concern about making the disclosure, after years of not doing so.[117] He was concerned it could be interpreted as "a sneaky form of gun-jumping."[118] Mr. Morgan advised:

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[114] RX-106 p. 1906.

[115] RX-106 p. 1899.

[116] *Id.*

[117] RX-106 p. 1901.

[118] RX-106 p. 1901.

From: Michael Morgan [mailto:mm@greensfelder.com]
Sent: Thursday, January 17, 2013 5:13 PM
To: Jim Winkelmann
Cc: Giles M. Walsh
Subject: RE: ADV Annual Submission

Yeah that's better but now I'm wondering if it could be seen as a sneaky form of gun-jumping. Maybe just drop it and amend the ADV when there is a later offering.

MM

Michael Morgan

Greensfelder, Hemker & Gale, P.C.

314.516.2637

[redacted] (cell)

Despite this advice from Mr. Morgan, that the disclosure was unnecessary, Blue Ocean pushed the issue. The next day, one of Blue Ocean's employees (Ms. Hennessey) followed up with Greensfelder, asking[119]:

[119] RX-106 p. 1904.

From:	Kelly Hennessy <Kelly@blueoceanportfolios.com>
Sent:	1/18/2013 3:00:07 PM +0000
To:	Michael Morgan <mm@greensfelder.com>; Giles M. Walsh <gmw@greensfelder.com>
CC:	Jim Winkelmann <Jim@blueoceanportfolios.com>
Subject:	ADV Updates
Attachments:	Part 1A Item #6(B).PNG

Hi Mike/Giles,

I have a few questions regarding the ADV updates you discussed with Jim yesterday:

1) Where is this description supposed to be entered (it's not required for Part 1B Item G)? Should it be entered on ADV Part 2 Item #19(E)? Should it also be included under Part 2 Item #10 since Item 19 will no longer be included when we switch to SEC? Also, I assume it should read "In 2011 and 2012...."

"In 2011 and 2011 Blue Ocean Portfolios., LLC issued securities on a private placement basis to finance its growth and advertising strategies. Some of these securities were offered and sold to certain clients of Blue Ocean Portfolios. Blue Ocean Portfolios clients were under no obligation to participate. Future offerings are anticipated."

2) Regarding ADV Part 1A #6 Other Business Activities (see attached). Should Item B(1) be answered yes? Or should B(3), which is currently answered yes due to insurance products, also include the description above?

Again, the email specifically references the fact that the securities "were offered and sold to certain clients" although those clients "were under no obligation to participate" and that "future offerings [were] anticipated." This second communication also runs contrary to the Initial Decision's finding that "there is nothing at all in writing" reflecting Mr. Morgan's knowledge.[120]

[120] Initial Decision p. 61.

In response to Ms. Hennessy's email, Mr. Morgan, Mr. Winkelmann and Mr. Walsh traded emails on the topic which read, in order of transmission[121]:

From: Jim Winkelmann [Jim@blueoceanportfolios.com]
Sent: Monday, January 21, 2013 9:57 AM
To: Michael Morgan
Cc: Giles M. Walsh
Subject: ADV Filing

Mike/Giles

I think we should just check the box in Part 1B and not include the narrative in Part 2. I am concerned that if we include the narrative now it could be implied as an admission that we should have included it before. IARD is shut down due to the holiday.

Thoughts?

Thanks

Jim

From: Michael Morgan [mailto:mm@greensfelder.com]
Sent: Monday, January 21, 2013 10:15 AM
To: Jim Winkelmann
Cc: Giles M. Walsh
Subject: RE: ADV Filing

We talked about this on Friday. I can make arguments either way. I guess there is an argument that if you did not schedule this on Part II before, why are you doing so now. The answer is because they are now asking the question in Part I, and we believed it was necessary to amplify it so we can still take the position that we are not in the business of issuing securities - we only do so from time to time.

What if we add to the narrative: Although BOP does not consider itself to be in the business of issuing securities (or whatever the exact wording of the question is), in order to make a clear disclosure it so indicated on question ___ to part I of form adv because it does make securities offerings from time to time. and then carry on with the rest of the narrative. Or something like that.

MM

[121] RX-106 pp. 1914--1916.

From: Jim Winkelmann [mailto:Jim@blueoceanportfolios.com]
Sent: Monday, January 21, 2013 10:43 AM
To: Michael Morgan
Cc: Giles M. Walsh
Subject: RE: ADV Filing

The issue they may be concerned about is whether or not the issuance of the securities presents a conflict of interest. Of course our position has been that no - the OS satisfactorily addresses any potential conflicts and the economic model of the royalty units does more to align interest rather than create a conflict interest. Look at their consent order (enclosed) against Binkholder para 16-18 gives us a hint of what they may be gearing up for. I feel that at this point we are in catch 22.

What is the least of evils; argue that our ADV filings in June 2012 - are accurate and that the royalty units are not material to clients and prospective clients? OR now disclose on Part 2 and argue that we needed to do this because the new question on Part 1 would have triggered additional comments?

From: Michael Morgan
Sent: Monday, January 21, 2013 11:24 AM
To: Jim Winkelmann
CC: Giles M. Walsh
Subject: RE: ADV Filing

I go with no. 2 but I'm willing to put it to a vote among the three of us. There are no absolute right answers here. MM

Michael Morgan
Greensfelder, Hemker & Gale, P.C.
314.516.2637
[redacted] (cell)

From:	Jim Winkelmann <Jim@blueoceanportfolios.com>
Sent:	Tuesday, January 22, 2013 9:16 AM
To:	Michael Morgan
Cc:	Giles M. Walsh
Subject:	RE: ADV Filing

OK – Kelly is preparing draft of the revised filing. Under question 19 E. -

"Blue Ocean Portfolios has no relationship or arrangement with any outside issuer of securities. However to finance growth and advertising strategies Blue Ocean Portfolios has issued securities itself to clients and non-clients under Regulation D 506 exemption. It is contemplated that additional securities will be issued to finance additional growth and advertising strategies."

The same day Greensfelder and the Firm made the decision that they would make the disclosure in the Form ADV (despite Mr. Morgan's insistence that there were no "absolutes" on whether or not to do so), Ms. Hennessy sent revised language for Mr. Morgan's review, which read[122]:

> Blue Ocean Portfolios does not have any relationship or arrangement with any outside issuer of securities. However, Blue Ocean Portfolios has issued securities in the past to finance its advertising strategy and may issue additional securities in the future.

Mr. Walsh forwarded Ms. Hennessey's email to Mr. Morgan (not copying Mr. Winkelmann) and asked:[123]

> Mike [Morgan], My only comment is to change its' to its (no apostrophe in the second sentence) for the disclosure below. Jim had sent another disclosure about 3 minutes before this one that mentioned the purchasers of the securities were clients and non-clients. *Do you think we need to mention that some of the purchasers were clients*?

Mr. Morgan and Mr. Walsh discussed this issue over the phone and, shortly thereafter, Mr. Walsh emailed Ms. Hennessey and Mr. Winkelmann, stating[124]:

[122] RX-106 p. 1919.

[123] *Id.* Emphasis supplied.

[124] RX-106 p. 1921-22.

From: Giles M. Walsh [mailto:gmw@greensfelder.com]
Sent: Tuesday, January 22, 2013 10:20 AM
To: Kelly Hennessy
Cc: Jim Winkelmann; Michael Morgan
Subject: RE: ADV Disclosure

Kelly,

Here is my revised disclosure:

"Blue Ocean Portfolios does not have any relationship or arrangement with any outside issuer of securities. However, Blue Ocean Portfolios has issued securities in the past to clients and non-clients pursuant to private placements to finance its advertising strategy and may issue additional securities in the future."

Please note the deletion of the apostrophe from "its" in the second sentence as it may not be readily apparent.

Jim --

You sent a different disclosure right before this one and I have included some of the additional details from your disclosure in my revised disclosure above. Mike and I did discuss the above changes on the phone and are in agreement.

Please let me know if you have any questions or comments.

Thanks,

Mr. Walsh's email clearly included the disclosure that Blue Ocean Portfolios ***"has issued securities in the past to clients and non clients..."***[125]

Four things are apparent from the face of these emails. First, Mr. Morgan was well aware that the Firm was selling advisory units to clients, and intended to continue doing so. The emails wholly support Mr. Winkelmann's testimony on that same fact.[126] Second, the communications evidence that Mr. Morgan and Mr. Walsh did not, as the Initial Decision believed they should have, devote a tremendous amount of analysis or research to the issue. Thus, the "missing" time

[125] RX-106 p. 1921.

[126] In addition to these contemporaneous emails, which the Initial Decision ignored, subsequent emails between Mr. Winkelmann and Greensfelder sent after the SEC began its examination of the firm (and after Mr. Morgan passed away) reflect the same. RX-106 pp. 2400-2402.

records or research memoranda that the Court had *hoped* to see did not exist because Greensfelder determined they were not necessary. Their absence was not attributed to a lack of knowledge, as the Initial Decision surmised.

Third, the emails further evidence that Mr. Morgan was unconcerned with the fact that the Firm was selling royalty units to clients. Mr. Morgan passed away in 2015 and could not testify to corroborate Mr. Winkelmann's testimony.[127] Mr. Winkelmann's unrebutted testimony, however, was that Mr. Morgan was not only aware of, but unconcerned with the sales. The above email chain reflects the same.

Fourth, while the text of the emails, alone, corroborates Mr. Winkelmann's testimony (and refutes a finding of scienter), its *timing* leaves no room for error. The above email exchange occurred in late January 2013. In February 2013 – mere weeks later – the Round 4 Offering Memorandum was finalized and circulated to investors. Mr. Morgan, now *indisputably* aware that the Firm had offered royalty units to advisory clients and was intending to continue to do so, made no changes to the conflicts of interest language, to the disclosures in the offering documents or to the subscription agreement (discussed at length immediately below). According to the assumptions made in the Initial Decision, once Mr. Morgan learned of this fact, he should have immediately revised the offering documents to disclose this supposed "conflict." On this point, the Initial Decision was resolute[128]:

> All agree that Morgan was an experienced securities practitioner and ***it is not conceivable*** that he would have blessed this scheme in the absence of any documentation or correspondence to show how he arrived at the advice that Winkelmann recalls receiving. Yet there is nothing at all in writing.

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[127] And Mr. Walsh was a junior associate at the time who was unaware whether the sales to clients was possibly worth "mentioning" in a disclosure document.

[128] Initial Decision p. 61. Emphasis suppled.

In making the above assumptions about (1) Mr. Morgan's knowledge and (2) the inconceivable nature of his "blessing," the Initial Decision erred. The above communications show that Mr. Morgan was well aware of and did bless the Offerings, as inconceivable to the Court as that may be. Because these conclusions are erroneous and against the weight of the evidence, the Initial Decision's finding of "extreme recklessness" and its conclusion that Mr. Winkelmann failed to sustain his burden of establishing reliance on counsel should be reversed, and the sanctions imposed as a result of these findings – including the permanent bar – should be vacated.

D. The Initial Decision Erred in Accepting the Division's Reading of the Subscription Agreement.

This same reasoning – that the Court "expected" Mr. Morgan to have "engage[d] in thoughtful consideration" of the conflict issue and, in turn, expected to see documentary evidence on the topic – is relevant to another erroneous conclusion. One of the reasons the Initial Decision gave for its conclusion that Mr. Morgan was unaware the Firm was selling royalty units to advisory clients was paragraph 2(a) of the Subscription Agreement. While the subscription agreements varied across the four offerings, the paragraph relevant here did not change:[129]

> The Subscriber acknowledges that (i) the Company has not provided any investment advice to subscriber...

Considering this language, the Initial Decision held:

> The quoted language from the subscription agreement more reasonably suggests that the Greensfelder attorneys drafted it at the time with the view that Respondents would not be making these sales to advisory clients.

[129] RX—1 p. 95; CX-124; RX-003 p. 129; RX-004 p. 130.

This conclusion, based solely on hypothesis, contradicts with actual evidence presented to the contrary, discussed in Section IV.C., above, showing Mr. Morgan's knowledge that the Firm intended to (and did) sell royalty units to advisory clients.[130]

Moreover, this conclusion runs contrary to the ample evidence presented regarding the evolution of the subscription agreement language – or lack thereof. First, on March 15, 2011, Mr. Walsh, a junior associate working for Mr. Morgan, emailed Mr. Winkelmann a draft of the subscription agreement for the Round 1 offering. Mr. Walsh informed Mr. Winkelmann that "Mike [Mr. Morgan] is still in the process of reviewing it, but we wanted to get any feedback that you might have."[131] Attached to that email is the initial draft of the subscription agreement. Paragraph 2(a) of that draft is identical to the paragraph used in all four of the Royalty Unit Offerings at issue.

Over the course of the four offerings Mr. Morgan and Mr. Winkelmann exchanged several drafts of the subscription agreement, many of them redlined. No changes or comments were ever proposed, considered or accepted with regard to paragraph 2(a).[132] Nor is there any analysis of its purpose, implication, or importance.[133] Mr. Walsh prepared the initial draft, and the language remained unchanged over the course of four different offerings and three years.

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[130] Further to this point, the record contains an email sent from Mr. Morgan to Mr. Walsh shortly after Greensfelder took on the representation. Mr. Morgan provided a list of issue to consider in creating the offering documents – a process he referred to as a "white paper exercise." RX-106 p. 58. Mr. Morgan's issue list does not list the subscription agreement representation at issue amongst these queries.

[131] RX-106 p. 92-94.

[132] RX-106 pp. 224-235; 474; 497-500; 514; 1042-1053; 1056-1068; 1214 and 1250-1259; 1491-1499; 1512-1521;

[133] To the contrary, when Mr. Walsh asked Mr. Morgan whether he should include more specific language about risk factors in the subscription agreement, Mr. Morgan responded[133]:

> Generic is good, plus: something about no tax advice, they are on their own; there is no final date by which the $300K has to be paid; forward-looking statements BS; no reps except as provided in the Certificate, the warrant or the subs agmt.

There is no evidence anywhere in the record that Greensfelder drafted the first sentence of paragraph 2(a) with the objective or reasoning that the Division argued. Despite the fact that many different drafts exchanged between Greensfelder and Blue Ocean, there was no discussion on this paragraph or its supposed meaning. There is no analysis of its application or recitation of why it is important investors understand it.

Had Greensfelder attributed the import to that sentence that the Division argued, under the Initial Decision's own reasoning, one would have "expected" that Mr. Morgan, an experienced securities attorney, would have "engage[d] in thoughtful consideration of this issue" and reduced it to a communication with Mr. Winkelmann (or at least Mr. Walsh). There is no evidence that occurred.

Second, as discussed in Section IV.C., above, as of January 2013, Mr. Morgan was unquestionably aware that Mr. Winkelmann had been selling royalty units to advisory clients and intended to continue to do so. Nevertheless, Mr. Morgan reviewed the Round 4 offering documents without making any changes to any of the disclosures relating to conflicts of interest.[134] Importantly here, Mr. Morgan made no change to paragraph 2(a) of the subscription agreement. In light of this evidence, the interpretation of Paragraph 2(a) in the Initial Decision is clearly erroneous. Similarly, the Initial Decision's conclusion that the paragraph evidences Mr. Morgan's *ignorance* of the fact the Firm intended to offer royalty units to advisory clients is erroneous, as well.

Therefore, because the record affirmatively proves that Mr. Morgan was aware that Mr. Winkelmann was selling royalty units to clients, and advised Mr. Winkelmann that those sales did not create a conflict of interest, and because the record contains no evidence that paragraph

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[134] Stip. No. 52-55.

2(a) of the subscription agreement was drafted to carry the meaning attributed to it by the Division, the Initial Decision's reasoning to the contrary should be reversed. In turn, the Commission should hold that Respondents successfully demonstrated that they relied in good faith upon the advice of their experienced counsel in offering the royalty units to advisory clients and making the disclosures that they did.

Furthermore, because this good faith reliance is a defense to the allegation of scienter, the Initial Decision's finding of "extreme recklessness" should be reversed, and all sanctions and penalties assessed as a result thereof, vacated.

E. The Evidence does not Support the Permanent Bar Imposed on Mr. Winkelmann.

The Initial Decision found a permanent bar was warranted against Mr. Winkelmann because his conduct – selling royalty units to advisory clients – was "egregious" and "extremely reckless."[135]

First, for the reasons already set forth above in Section IV.C., however, Mr. Winkelmann's conduct was neither "egregious" nor "extremely reckless." The good faith reliance on the advice of his sophisticated securities counsel at Greensfelder negates any finding of scienter – including scienter based on recklessness. Further, his good faith reliance evidences that neither Mr. Winkelmann nor the Firm acted negligently because they reasonably relied upon their counsel's advice. Second, the Initial Decision, just before assessing the permanent bar, admitted that it was probably not necessary in the face of a cease-and-desist order.[136] That is, the cease-and-desist was sufficient to discourage Mr. Winkelmann from repeating his "mistakes." The imposition of a bar on top of the cease-and-desist was unnecessary, and wholly punitive.

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[135] Initial Decision p. 65.

[136] Initial Decision p. 65.

Third, the imposition of a bar is unsupported by *Steadman*, which requires that any sanction assessed be in the public interest.[137] Relevant factors include: (1) the egregiousness of the respondent's actions; (2) the isolated or recurrent nature of the infraction; (3) the degree of scienter involved;(4) the sincerity of the respondent's assurances against future violations; (5) respondent's recognition of the wrongful nature of his or her conduct; and (6) the likelihood that the respondent's occupation will present opportunities for future violations. Other factors that have been considered include: (7) the age of the violation;[138] (8) the degree of harm to investors and the marketplace resulting from the violation;[139] (9) the extent to which the sanction will have a deterrent effect;[140] and (10) whether there is a reasonable likelihood of violations in the future.[141]

Each of the above factors weighs heavily against the sanction imposed, but above all others, the fact that:

- Mr. Winkelmann's conduct was not "egregious" as set forth above;
- There is no evidence of scienter, as set forth above;[142]
- There is no harm to investors. The Initial Decision found investor harm to be the fact that they invested – not that they suffered any loss. In fact, the evidence showed the opposite. No customers had lost money; no customer has filed

[137] *Steadman v. SEC,* 603 F.2d 1126, 1140 (5th Cir. 1979) *aff'd on other grounds,* 450 U.S. 92 (1981) ("Steadman factors").

[138] *Marshall Melton,* 56 S.E.C. 695, 698 (2003).

[139] *Id.*

[140] *Schield Mgmt. Co.,* Exchange Act Release No 53201 (Jan 31, 2006), 87 SEC Docket 848, 862.

[141] *Id.*

[142] Indeed, even in cases where a "high level" of scienter is established (not this case), bar orders have been declined. *U.S. S.E.C. v. Boey,* 07-CV-39-SM, 2013 WL 3805127, at *3 (D.N.H. July 22, 2013) ("In addition, although he acted with a high level of scienter, the SEC has not shown that there is any plausible risk that he will commit future violations.")

complaints or instituted litigation; no customers had asked for their money back; and all customers still retain the right to be repaid the purchase price plus the promised multiple. Simply put, there is no harm.

- Finally, there is no deterrent effect to a bar. It is purely punitive. Mr. Winkelmann issued the offerings at issue with the advice of his counsel. The documents were prepared and reviewed by counsel. Counsel advised that Mr. Winkelmann's sales to clients were not an issue. Mr. Winkelmann heeded his counsel's advice. In sum, Mr. Winkelmann went to great lengths to do everything properly.

Fourth, the Initial Decision was clear that Blue Ocean should not be barred, nor should the Offerings be unwound. Either action would destroy the value of the royalty unit investments and deprive the investors of the benefit of their bargain.[143] The Initial Decision concluded it could bar Mr. Winkelmann, without impacting the Firm or its investors.[144] Yet, as Mr. Winkelman testified, while Mr. Winkelmann hoped that he could build a company that would withstand his absence (and, specifically, at the time of its inception, withstand his death), the Firm never made it there. Blue Ocean has lost the majority of the highly talented employees it had during the offerings. Currently, it employs only Mr. Winkelmann and his daughter, Claire, who helps with the administrative items, leaving the Company entirely dependent on Mr. Winkelmann.[145] With Mr. Winkelmann barred, there is simply no one left. Despite all this, Blue Ocean has still never missed a royalty payment.[146]

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[143] *Id.* at 65-66.

[144] *Id.*

[145] Tr. 1401:7-11.

[146] Tr. 1402:24-1403:3.

The investor harm the Division alleged (but never proved) and that the Initial Decision sought to avoid (unsuccessfully) will ultimately come to be[147]:

> I mean, Judge, it's a kiss of death to be charged -- as an investment advisor to be charged with fraud. And I mean, it's been remarkable that we've hanged on to 90 percent of the clients, but 10 percent of them gone... So the impact, if you look at our AUM growth that was heading a 45-degree angle up, you know, if you look back at it as of September 2014 when this enforcement action was instigated or we were notified, it flat-lined and then it dropped.
>
> It's very difficult to overcome these charges with the clients, even though the clients, 99 percent of the clients have nothing to do with these proceedings.

F. The Evidence Does Not Support the Disgorgement Awarded.

The same is true for the disgorgement. The Initial Decision concluded that the amount of money Mr. Winkelmann earned in compensation from Blue Ocean for the three-year period it issued the royalty unit Offerings should be disgorged. As a threshold matter, that finding should be set aside for the reasons set forth in Section IV.B., above. Namely, because there was no conflict, there can be no disgorgement for failure to disclose the same.

G. The Evidence Does Not Support Second-Tier Penalties.

Finally, because the Initial Decision erred in its finding of liability and, most important when considering sanctions, its finding of "extreme recklessness," its assessment of second-tier civil penalties must be reversed as well.

First, the Initial Decision found that second-tier penalties were justified because Mr. Winkelmann "held their royalty unit payments at near-minimal levels" and that "while they fared poorly, Winkelmann benefited" in the form of his salary.[148] As set forth herein, in

[147] Tr. 1399:21-1402:24.

[148] Initial Decision p. 69.

Sections III.A.3. and IV.B.1.(b)-(e), additional payments to investors (above and beyond the mandatory percentage payments) were not contemplated until the Firm reached profitability.

There can be no disclosure failure in the presence of a specifically disclosed precondition, as exists here. Not only was there never any obligation to make the additional payments – ever – but they were only contemplated "once Blue Ocean achieves profitability" and, even then, were paid at Blue Ocean's discretion.[149] Given this clear language, and in light of the fact that the Firm never reached its disclosed profitability threshold, the fact that investors continued to earn only the percentage payments was merely a disclosed facet of the offering – not a "reckless disregard" of some obligation to the contrary. Thus, civil penalties are unjustified.

Second, the penalties imposed should be reversed because they were based, in part, on the Initial Decision's belief that they would "deter" future breaches of fiduciary obligations by investment advisors. Since no such obligation existed here, as set forth in Section IV.B.1., above, and because the conduct at issue was not violative of either the terms of the offering or any applicable law, rule or statute, there is no deterrent value to the penalties imposed, and they should be reversed.

Third, the penalties are based largely on the Initial Decision's finding that Mr. Winkelmann acted recklessly. In addition to the reasons already set forth in this Section, the finding of recklessness is negated by the fact that Mr. Winkelmann acted in good faith reliance upon the advice of his securities counsel in preparing and issuing the offerings, including (1) legal advice that he could sell royalty units to advisory clients without issue; and (2) that the disclosures contained in the offering documents were proper.[150] In light of this evidence, there

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[149] *Id.*

[150] *See* Section IV.C. for a full discussion on reliance on counsel and lack of scienter.

can be no finding of reckless disregard of a regulatory requirement.[151] The penalties based on such a finding should be reversed.

H. No Willfulness.

The Initial Decision found that Respondents relied upon the advice of their counsel with regard to the custody disclosure in Form ADV and that the non-disclosure was neither negligent nor made with scienter. Despite this finding, and without identifying some other conduct that would constitute "willfulness", the Decision improperly found the violations of § 206(4) and § 207 to be willful. The Division carried the burden of proving the element of willfulness and, in the absence of any evidence that he acted with the "requisite mental state", his submission of the forms was not willful:[152]

> Whether [respondent] acted with the requisite mental state for his actions to constitute a violation of the Advisers Act is a question of fact. Here, the Court does not find that [respondent] intentionally or willfully omitted material facts from his SEC filings. As willfulness is an element of a Section 207 violation... the Court concludes that the Commission failed to meet its burden on this claim, and rules in favor of the Defendants[.]

The Initial Decision's holding to the contrary, should be reversed.

V. CONCLUSION

For the reasons stated herein, the Commission should: (1) vacate the findings and sanctions imposed in the Initial Decision in light of the 10th Circuit's holding in *Bandimere* that the ALJs assigned to oversee the administrative proceedings were not appointed in conformity with the Appointments Clause of the Constitution; (2) in the alternative, stay this proceeding pending ruling the D.C. Circuit's *en banc* review of *Lucia* and any subsequent review by the United States Supreme Court; (3) reverse the erroneous findings of fact and conclusions of law

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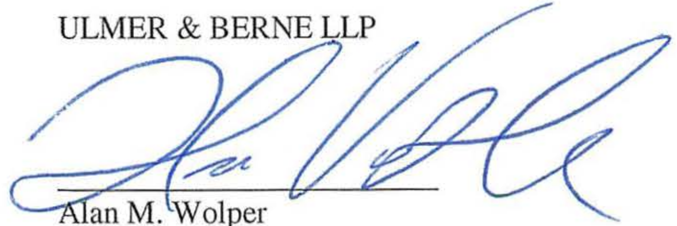
[151] Initial Decision p. 70.

[152] *SEC v. Slocum, Gordon & Co.*, 334 F. Supp. 2d 144, 181-82 (D.R.I. 2004).

contained in the Initial Decision as set forth herein; (4) in the alternative, remand this proceeding to the ALJ for further review of the issues raised herein; and (5) in the findings at issue be upheld, reduce the sanctions imposed on Respondents, including the permanent bar, in conformity with the applicable sanction parameters and authority.

Dated: June 7, 2017

ULMER & BERNE LLP



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CERTIFICATE OF COMPLIANCE

In accordance with Rule 450(d) of the Rules of Practice, I certify that this brief, exclusive of the cover page, table of contents, table of authorities, and signature block is in compliance with the 14,000-word limit. The brief contains 13,723 words, according to the word processing system used to prepare the brief. The word count includes the text of the emails that appear on pages 29-33, and 35.

Heidi VonderHeide

CERTIFICATE OF SERVICE

I hereby certify that on June 7, 2017, I served a copy of the foregoing **RESPONDENTS' BRIEF IN SUPPORT OF PETITION FOR REVIEW**, as follows:

Original and three copies to: Via facsimile transmission and overnight mail delivery	Brent J. Fields, Secretary Office of the Secretary Securities and Exchange Commission 100 F. Street, N.E. Washington, D.C. 20549 Fax: (202) 772-9324
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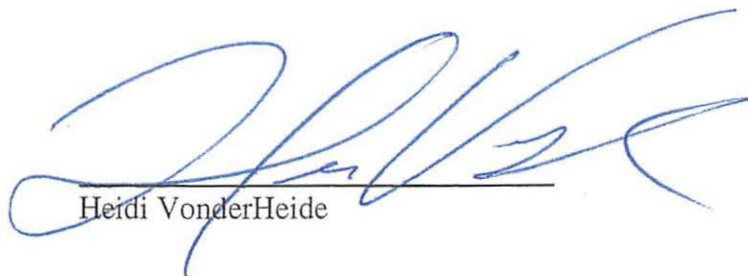

Heidi VonderHeide

EXHIBIT A

No. 15-9586

UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

David F. Bandimere,
Petitioner,

v.

Securities and Exchange Commission,
Respondent.

On Petition for Review of an Order of the
Securities and Exchange Commission

PETITION FOR REHEARING OR REHEARING EN BANC

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GLOSSARY

ALJ	Administrative Law Judge
APA	Administrative Procedure Act
Commission or SEC	Securities and Exchange Commission
JA	Joint Appendix
STJ	Special Trial Judge

INTRODUCTION AND RULE 35 STATEMENT

A divided panel of this Court declared that the administrative law judges employed by the Securities and Exchange Commission (SEC) are "inferior Officers" who must be appointed in the manner prescribed by the Appointments Clause. As Judge McKay's dissent observes, the panel's ruling "risks throwing much into disarray," Dissenting Op. 15, and reflects a fundamental misunderstanding of the role of ALJs and Supreme Court precedent. The decision calls into question essential features of agency adjudicative practice that predate the Administrative Procedure Act (APA) and were largely codified in that statute. As the Supreme Court explained in *Ramspeck v. Federal Trial Examiners Conference*, 345 U.S. 128 (1953), Congress retained examiners as "classified Civil Service employees," *id.* at 133, to provide non-political support for the administrative process, *see id.* at 142. Congress made clear that the APA left decision-making authority with politically accountable agency heads, not their ALJs, and the SEC has made absolutely clear that this is the Commission's practice. The panel's decision presents an issue of exceptional importance that warrants review by the full Court. *See* Fed. R. App. P. 35(a)(2), (b)(1)(B).

An "Officer" under the Constitution is a federal official who, in his own right, "exercis[es] significant authority pursuant to the laws of the United States." *Buckley v. Valeo*, 424 U.S. 1, 126 (1976). The requirements of the Appointments Clause do not apply to "lesser functionaries subordinate to officers of the United States." *Id.* at 126 n.162. As the Commission explained in the decision on review, its ALJs function

entirely as aides to the Commission's decision-making process and cannot bind the agency's discretion in any respect. JA466-68. The Commission's use of its ALJs in this manner reflects Congress's judgment in enacting the APA, which codified the longstanding practice in the SEC and other agencies of using hearing examiners and similar employees as aides to politically accountable agency heads.

Under both the securities laws and the APA, all adjudicative authority resides in the politically accountable agency heads. No separate authority is vested in the ALJ. *See, e.g.,* 5 U.S.C. § 557(b) (on review of an ALJ decision, "the agency has all the powers which it would have in making the initial decision"). Indeed, in enacting the APA, Congress contemplated that the "initial decision[s]" of hearing examiners, as ALJs were then known, would "in no way b[i]nd" an agency, and that the agency would retain "complete freedom of decision—as though it had heard the evidence itself." *Attorney General's Manual on the Administrative Procedure Act* 83 (1947) (*Attorney General's Manual*). That was a deliberate legislative choice.

The panel's ruling calls into doubt that basic congressional judgment. As Judge McKay's dissent observed, "[s]ince the Administrative Procedure Act created the position of administrative law judge in 1946, the federal government has employed thousands of ALJs to help with the day-to-day functioning of the administrative state." Dissenting Op. 15. And as the Supreme Court explained in *Ramspeck*, the practice of employing hearing examiners to assist politically accountable agency officials long predated the APA. 345 U.S. at 130-32. That practice has never been

thought to vest "significant authority" under federal law in the employees who provide that assistance. The Appointments Clause is concerned with political accountability. Here, as Judge McKay stressed, the Commission's regulations and practices leave the public in no doubt "where the buck stops": with the politically accountable Commissioners themselves. Dissenting Op. 9-10.

ALJs and their predecessors have assisted agency heads in their adjudicative functions for many decades under the APA without apparent infringement on executive branch authority. The Supreme Court has stressed that such a "'[l]ong settled and established practice is a consideration of great weight in a proper interpretation of constitutional provisions' regulating the relationship between Congress and the President." *NLRB v. Noel Canning*, 134 S. Ct. 2550, 2559-60 (2014) (alteration in original) (quoting *The Pocket Veto Case*, 279 U.S. 655, 689 (1929)).

Freytag v. Commissioner, 501 U.S. 868 (1991), which the panel majority believed to be dispositive, provides no basis for declaring this longstanding practice unconstitutional. *Freytag* held that special trial judges (STJs) of the Tax Court were properly appointed by the Chief Judge of the Tax Court, an Article I court whose orders are enforceable by fine and imprisonment. It was conceded that the STJs were officers for most purposes because they were empowered to enter final decisions and to enforce compliance with their orders. As Judge McKay's dissent explains, the majority's decision wrongly equates Article I judges, such as the special trial judges of the Tax Court, with civil-service employees who exercise no independent power in

their own right but simply assist politically accountable agency heads in performing their functions under law.

The Supreme Court has never held that the Appointments Clause applies to a position designed by Congress to be filled by federal employees. Only in *Buckley v. Valeo*, where a statute authorized appointment of executive officers by members of Congress, has the Supreme Court disturbed a congressionally chosen method of appointing government personnel. That is not to say that Congress's determinations are unreviewable. But nothing in the Commission's use of ALJs warrants setting aside the judgment of Congress, the understanding of the Commission, and many decades of administrative practice.[1]

ARGUMENT

THE COMMISSION'S ALJs ARE NOT OFFICERS UNDER THE APPOINTMENTS CLAUSE

A. Under the securities laws and consistent with the APA, the Commission's ALJs assist the politically accountable Commissioners, who retain sole authority to bind the agency.

1. The securities laws vest the adjudicative powers of the Securities and Exchange Commission exclusively in the five members of the Commission itself. No

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[1] A panel of the D.C. Circuit in *Lucia v. SEC*, 832 F.3d 277 (D.C. Cir. 2016), held that SEC ALJs are employees. *See also Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000) (same for FDIC ALJs). The D.C. Circuit granted en banc review in *Lucia*, and argument is scheduled for May 24, 2017.

statute or regulation vests the Commission's ALJs—employees whom the Commission may use, or not, in its discretion—with authority independent of the Commission. Judge McKay's dissenting opinion cogently summarizes the role of an ALJ, which is to serve as an aide to the final decisionmaker. Judge McKay explained that "[t]he Commission may review its ALJs' conclusions of law and findings of fact de novo"; that "[i]t employs ALJs in its discretion, and all final agency orders are those of the Commission, not of its ALJs"; that "[a]n ALJ serving as a hearing officer prepares only an 'initial decision'"; and that "at any time during the administrative process, the Commission may 'direct that any matter be submitted to it for review.'" Dissenting Op. 6-7 (quoting 17 C.F.R. §§ 201.360(a)(1), 201.400(a)). "The Commission thus 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." *Id.* at 7 (internal quotation marks and citation omitted).

The Commission's ALJs exemplify the model of administrative adjudication that Congress chose when enacting the APA. Under that model, civil-service employees, hired on the basis of merit and protected from retaliation for their decisions, assist agencies in performing their adjudicatory functions under law, but all decisionmaking authority on questions of both fact and law resides in the politically accountable agency head.

In this respect, the APA codified and preserved a longstanding feature of administrative practice in the United States. Federal agencies have long retained employees, comparable to today's ALJs, to assist agency heads in performing their adjudicative functions by formulating the administrative record and making initial findings. *See, e.g.*, Act of June 29, 1906, ch. 3591, sec. 7, 34 Stat. 584, 595 (authorizing the Interstate Commerce Commission to use "special agents or examiners" with the "power to administer oaths, examine witnesses, and receive evidence"). These employees, who often held positions as "examiners," were vital in carrying out the agency's day-to-day tasks, since it was a "reality that many persons in the agency other than the heads must do the bulk of this work." *Administrative Procedure in Government Agencies*, S. Doc. No. 77-8, at 21 (1941) (*Attorney General's Report*); *id.* at 314 (app. F). SEC examiners, for example, ruled on evidentiary motions, issued subpoenas, and "file[d] a report containing ... findings of fact." *Id.* 395-96 (app. H). The Commission regarded the hearing examiner's report "as advisory only." *Id.*

In enacting the APA, Congress considered several competing proposals to improve the quality of administrative adjudications, including a "proposal for the creation of an administrative court." H.R. Rep. No. 79-1980, at 8 (1946), *reprinted in Administrative Procedure Act: Legislative History*, S. Doc. No. 79-248, at 242 (1946). This proposal would have removed the adjudicatory function from agencies and established "a single administrative court which would hear cases for all agencies." *Ramspeck v. Federal Trial Exam'rs Conference*, 202 F.2d 312, 314 n.21 (D.C. Cir. 1952)

(Bazelon, J., dissenting), *rev'd*, 345 U.S. 128 (1953). That administrative court would have been a full Article I "court of record" akin to the Court of Federal Claims or the Tax Court, with the power to call on the U.S. Marshals to enforce its orders, and its judges would have been constitutional officers, appointed by the President and confirmed by the Senate.[2]

Congress rejected that proposal. It did not make hearing examiners into constitutional officers in a court of record. Instead, consistent with the views of the SEC and the ABA,[3] Congress provided in section 11 of the APA for hearing examiners who would be "appointed by and for each agency" in accordance with "the civil-service and other laws," and specified that these examiners could be removed "only for good cause established and determined by the Civil Service Commission." 60 Stat. 237, 244 (1946) (codified as amended at 5 U.S.C. § 3105). To address concerns about decisional independence, Congress transferred responsibility for rating and promoting examiners to the Civil Service Commission. Thus examiners were "given independence and tenure within the existing Civil Service system," but with "control of their compensation, promotion, and tenure [vested] in the Civil Service

[2] *See* S. 5154, 70th Cong. (1929); S. 1835, 73d Cong. (1933) (same); S. 3787, 74th Cong. (1936) (similar proposal); Special Committee on Administrative Law, American Bar Association, *1934 ABA Annual Report* 539 (1934).

[3] *Administrative Procedure: Hearings Before a Subcomm. of the S. Comm. on the Judiciary*, 77th Cong. 397, 1000 (1941).

Commission to a much greater extent than in the case of other federal employees." *Ramspeck*, 345 U.S. at 131-32.[4]

The APA structure makes clear that, as employees, ALJs function to assist—but not to bind—politically accountable agency heads in the exercise of their adjudicative powers. Indeed, the APA specifically provides that, on review of an initial decision rendered by an agency employee, the agency retains "all the powers which it would have in making the initial decision." 5 U.S.C. § 557(b). The 1947 *Attorney General's Manual* explained that Congress included this provision to make clear that examiners' "initial decision[s]" would "in no way b[i]nd" an agency, and that the agency would retain "complete freedom of decision—as though it had heard the evidence itself." *Attorney General's Manual* 83.[5] Then-professor Antonin Scalia thus described the APA's model of administrative adjudication in 1979: ALJs are "entirely subject to the agency on matters of law; they can be reversed by the agency on matters of fact, even where demeanor evidence is an important factor; and they can always be

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[4] In 1978, Congress changed the name "hearing examiner" to "administrative law judge," Pub. L. No. 95-251, 92 Stat. 183, and divided the duties of the former Civil Service Commission between the Office of Personnel Management and the Merits Systems Protection Board, *see* Civil Service Reform Act of 1978, Pub. L. No. 95-454, 92 Stat. 1111.

[5] As "a contemporaneous interpretation [of the APA]," *Vermont Yankee Nuclear Power Corp. v. Natural Res. Def. Council, Inc.*, 435 U.S. 519, 546 (1978), the *Attorney General's Manual* has consistently been afforded "great weight" in interpreting the APA's provisions, *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 218 (1988) (Scalia, J., concurring).

displaced, if the agency wishes, by providing for hearing before the agency itself or one of its members." Antonin Scalia, *The ALJ Fiasco—A Reprise*, 47 U. Chi. L. Rev. 57, 62 (1979).[6]

2. That Congress did not require examiners or ALJs to be appointed by department heads is entirely consistent with the fundamental purposes of the Appointments Clause, which, as the Supreme Court has emphasized, is "designed to preserve political accountability relative to important Government assignments." *Edmond v. United States*, 520 U.S. 651, 663 (1997); *see also Freytag*, 501 U.S. at 884 (stating that the Clause "limit[s] the appointment power," such that "those who wield[] it [a]re accountable to political force and the will of the people"). That is the case here: the politically accountable Commissioners, not their ALJs, have the power to bind the Commission, and it is the Commissioners alone who bear responsibility for the agency's determinations. As Judge McKay's dissent observed, "it is quite clear where the buck stops." Dissenting Op. 9.

The panel majority suggested that it was unclear whether Congress believed that ALJs were employees or officers and concluded that, in any event, Congress's judgment warrants no weight under *Freytag*. *See* Op. 32. The Supreme Court,

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[6] The article's title referred to an unsuccessful attempt in the 1940s to remove many hearing examiners, and a renewed attempt to reform ALJ selection and promotion. Professor Scalia advocated developing a multi-grade structure within the civil service for ALJ evaluation and promotion. *See generally* 47 U. Chi. L. Rev. at 57-58, 75-80.

however, has never suggested that Congress's judgment in creating a position is irrelevant under the Appointments Clause. The language of the Clause makes clear that it is Congress's prerogative to create an "office" in the first place. *Freytag*, which upheld the scheme established by the statute there at issue (while rejecting an argument made by the Executive Branch), does not suggest otherwise. The panel majority was of course correct in declaring that "'[n]either Congress nor the Executive can agree to waive [the Appointments Clause's] structural protection.'" Op. 32 (quoting *Freytag*, 501 U.S. at 880). The relevant question, however, is whether Congress established an office subject to the Clause's strictures. Nothing in the APA or the securities laws supports the panel's view that Congress did so in authorizing agency heads to retain "classified Civil Service employees" to assist in adjudications. *Ramspeck*, 345 U.S. at 133.

B. *Freytag* provides no basis for disturbing more than seventy years of administrative practice under the APA and the securities laws.

The panel majority placed principal reliance on *Freytag*, equating the powers vested in ALJs with those given to the special trial judges of the Tax Court. That analogy is fundamentally flawed. As *Freytag* made clear, the Tax Court and its special trial judges exercise "a portion of the judicial power of the United States." 501 U.S. at 891. They are thus vested with authority, including the power to enforce compliance

with their orders, that is different in degree and kind from the powers given to intra-agency adjudicators like the Commission's ALJs.[7]

1. Prior to *Freytag*, the Tax Court itself had already concluded that its special trial judges were "Officers" under the Constitution: "Because special trial judges may be assigned any case and may enter [final] decisions in certain cases, it follows that special trial judges exercise significant authority" and "are officers." *First W. Gov. Securities, Inc. v. Commissioner*, 94 T.C. 549, 557 (1990). The government in *Freytag* did not dispute the point and "concede[d] that ... special trial judges act as inferior officers" in many cases. *Freytag*, 501 U.S. at 882. The government argued, however, that the special trial judge in *Freytag* was not acting as an inferior officer in the specific case at issue because he could not enter a final decision in that particular category of case. U.S. Br. at 7-8, *Freytag v. Commissioner*, No. 90-762, 1991 WL 11007941 (Apr. 3, 1991). The Supreme Court disagreed, declaring that "[s]pecial trial judges are not inferior officers for purposes of some of their duties ... but mere employees with respect to other responsibilities." *Freytag*, 501 U.S. at 882.

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[7] Judge McKay correctly observed that "[t]he majority's reliance on Supreme Court decisions from the nineteenth century and early twentieth century" is misplaced, noting that "[t]he majority's casual citation to these cases might lead one to believe there is a body of caselaw to which we can analogize." Dissenting Op. 10. "But these decisions 'often employed circular logic, granting officer status to an official based in part upon his appointment by the head of a department.'" *Id.* (quoting *Landry*, 204 F.3d at 1132-33). Petitioner does not advocate that mode of analysis, under which the Court would accept Congress's determination that ALJs need not be appointed as constitutional officers.

Although the panel majority believed that the special trial judge's authority to enter final decisions was not critical to the Supreme Court's conclusion in *Freytag*, that authority was a predicate to the Court's holding that "[i]f a special trial judge is an inferior officer for" some purposes, then "he is an inferior officer." 501 U.S. at 882. That the special trial judges could not enter final decisions in the particular class of cases at issue was "beside the point" because "[t]he fact that an inferior officer on occasion performs duties that may be performed by an employee not subject to the Appointments Clause"—*i.e.*, proposing non-final decisions subject to a Tax Court judge's plenary review—"does not transform his status under the Constitution." *Id.* The Court had no reason in *Freytag* to address the status of personnel who do not bind the government in *any* class of cases.[8]

Moreover, as Judge McKay noted, even in the class of cases at issue in *Freytag*, the Tax Court was required to defer to a special trial judge's factual findings unless "clearly erroneous." Dissenting Op. 2-3; *see also Stone v. Commissioner*, 865 F.2d 342, 345 (D.C. Cir. 1989) (discussing rule requiring Tax Court judges to "presume[]" correct "findings of fact recommended by" a special trial judge). By contrast, as already discussed, the Securities and Exchange Commission decides all questions of

[8] The majority noted that *Freytag* "expressly approved" the Tax Court's decision that its special trial judges were inferior officers. Op. 11. But the Tax Court's conclusion, in turn, was based on the special trial judges' authority to "be assigned any case and [to] enter decisions in certain cases." *First W. Gov. Securities, Inc.*, 94 T.C. at 557.

fact and law de novo and may order submission of additional evidence directly before the Commission. That the Commission in some cases may *choose* to give weight to an ALJ's credibility determination has no bearing on the constitutional analysis. Dissenting Op. 2, 6-8 & n.3. As the SEC's decision explains, the Commission reviews the record itself and does not defer "blindly" to its ALJs' credibility determinations. *See* JA467 n.114.

The Commission exercises complete and final power, and the Commission—not its ALJs—is accountable for its decisions. Judge McKay's dissent explained: "[b]ecause the Commission is not bound in any way by its ALJ's decisions, unlike the Tax Court, the blame for its unpopular decisions will fall squarely on the commissioners and, in turn, the president who appointed them." Dissenting Op. 9-10. Congress did not unconstitutionally diminish the political accountability of the Commissioners by providing them the option to receive assistance from an apolitical employee.

2. The panel majority likewise erred in concluding that the other powers and attributes of "SEC ALJs closely resemble the STJs described in *Freytag*." Op. 22. The Supreme Court explained that special trial judges could "take testimony, conduct trials, rule on the admissibility of evidence, and have the power to enforce compliance with discovery orders," even in cases in which they did not enter final judgments. *Freytag*, 501 U.S. at 881-82. The Supreme Court noted, in other words, that even in cases in which they cannot render a final decision, the special trial judges preside over

proceedings in an Article I court. The Court's description does not suggest that any federal employee who presides over any form of hearing must be appointed in the manner prescribed by the Appointments Clause. In exercising a portion of the judicial power, special trial judges, as the Supreme Court stressed, have "the power to enforce compliance with discovery orders." *Id.* at 882; *see also id.* at 891 (noting that the Tax Court "has authority to punish contempts by fine or imprisonment" in holding that the Tax Court is a "Court of Law" under the Appointments Clause); *Ryan v. Commissioner*, 67 T.C. 212, 223 (1976) (punishing criminal contempt); *Aaronson v. Commissioner*, T.C. Mem. 1985-131 (1985) (special trial judge declining to impose contempt sanctions). Congress has further provided that, if a party refuses to comply with an order of the Tax Court, the Tax Court "shall have such assistance" from the U.S. Marshals in carrying out its orders "as is available to a court of the United States." 26 U.S.C. § 7456(c). And as a court "established by Act of Congress," the Tax Court may use its contempt power to enforce any order it may issue under the All Writs Act. 28 U.S.C. § 1651(a).

ALJs have no comparable authority. An SEC ALJ can issue a subpoena, but unlike a special trial judge of the Tax Court, an ALJ has no power to enforce a subpoena. An ALJ can only ask that the Commission, in its discretion, seek enforcement in a district court. ALJs also lack the contempt power that is a hallmark of a court. An ALJ can merely order a "contemptuous" person to leave a room—and

even that order that is subject to expedited Commission review. *See* 17 C.F.R. § 201.180.

In sum, the panel decision casts into doubt fundamental premises of the APA based on a mistaken equation of the powers vested in the special trial judges of the Tax Court and the "classified Civil Service employees," *Ramspeck*, 345 U.S. at 133, who provide initial decisions at the discretion of the Commission. In upending longstanding agency adjudicative practice, the decision gives little heed to the Supreme Court's admonition that "'long settled and established practice is a consideration of great weight in a proper interpretation of constitutional provisions' regulating the relationship between Congress and the President," and that, indeed, "'traditional ways of conducting government … give meaning to the Constitution[.]'" *NLRB v. Noel Canning*, 134 S. Ct. at 2559-60 (quoting *The Pocket Veto Case*, 279 U.S. at 689, and *Mistretta v. United States*, 488 U.S. 361, 401 (1989) (quotation marks omitted), respectively). The panel's decision presents a "question of exceptional importance," Fed. R. App. P. 35(a)(2), and should not be permitted to become the law of this Circuit without the benefit of review by the full Court.

CONCLUSION

The Court should order this case to be reheard en banc.

Respectfully submitted,

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ADDENDUM

FILED
United States Court of Appeals
Tenth Circuit

December 27, 2016

Elisabeth A. Shumaker
Clerk of Court

PUBLISH
UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

DAVID F. BANDIMERE, Petitioner, v. UNITED STATES SECURITIES AND EXCHANGE COMMISSION, Respondent. --- IRONRIDGE GLOBAL IV, LTD; IRONRIDGE GLOBAL PARTNERS, LLC, Amici Curiae.	No. 15-9586

PETITION FOR REVIEW OF AN ORDER OF THE SECURITIES AND EXCHANGE COMMISSION
(SEC No. 3-15124)

David A. Zisser, Jones & Keller P.C., Denver, Colorado, appearing for Petitioner.

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Paul D. Clement, Jeffrey M. Harris, and Christopher G. Michel, Bancroft PLLC, Washington, DC, filed an amicus curiae brief for Ironridge Global Partners, LLC.

Before **BRISCOE, MCKAY,** and **MATHESON,** Circuit Judges.

MATHESON, Circuit Judge.

When the Framers drafted the Appointments Clause of the United States Constitution in 1787, the notion of administrative law judges ("ALJs") presiding at securities law enforcement hearings could not have been contemplated. Nor could an executive branch made up of more than 4 million people,[1] most of them employees. Some of them are "Officers of the United States," including principal and inferior officers, who must be appointed under the Appointments Clause. U.S. Const. art. II, § 2, cl. 2. In this case we consider whether the five ALJs working for the Securities and Exchange Commission ("SEC") are employees or inferior officers.

Based on *Freytag v. Commissioner of Internal Revenue*, 501 U.S. 868 (1991), we conclude the SEC ALJ who presided over an administrative enforcement action against Petitioner David Bandimere was an inferior officer. Because the SEC ALJ was not constitutionally appointed, he held his office in violation of the Appointments Clause.

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[1] Office of Pers. Mgmt., Historical Federal Workforce Tables, https://perma.cc/LZ7P-EPAG. The first census in 1790 counted 3.9 million inhabitants in the United States. U.S. Census Bureau, 1790 Overview, https://perma.cc/EYF2-4K2L. The Perma.cc links throughout this opinion archive the referenced webpages.

Exercising jurisdiction under 15 U.S.C. §§ 77i(a) and 78y(a)(1), we grant Mr. Bandimere's petition for review.

I. BACKGROUND

The SEC is a federal agency with authority to bring enforcement actions for violations of federal securities laws. 15 U.S.C. §§ 77h-1, 78d, 78*o*, 78u-3. An enforcement action may be brought as a civil action in federal court or as an administrative action before an ALJ. In 2012, the SEC brought an administrative action against Mr. Bandimere, a Colorado businessman, alleging he violated various securities laws. An SEC ALJ presided over a trial-like hearing. The ALJ's initial decision concluded Mr. Bandimere was liable, barred him from the securities industry, ordered him to cease and desist from violating securities laws, imposed civil penalties, and ordered disgorgement. David F. Bandimere, SEC Release No. 507, 2013 WL 5553898, at *61-84 (ALJ Oct. 8, 2013).

The SEC reviewed the initial decision and reached a similar result in a separate opinion. David F. Bandimere, SEC Release No. 9972, 2015 WL 6575665 (Oct. 29, 2015). During the SEC's review, the agency addressed Mr. Bandimere's argument that the ALJ was an inferior officer who had not been appointed under the Appointments Clause. *Id.* at *19. The SEC conceded the ALJ had not been constitutionally appointed, but rejected Mr. Bandimere's argument because, in its view, the ALJ was not an inferior officer. *Id.* at *19-21.

Mr. Bandimere filed a petition for review with this court under 15 U.S.C. §§ 77i(a)

and 78y(a)(1), which allow an aggrieved party to obtain review of an SEC order in any circuit court where the party "resides or has his principal place of business." In his petition, Mr. Bandimere raised his Appointments Clause argument and challenged the SEC's conclusions regarding securities fraud liability and sanctions.[2]

II. DISCUSSION

The SEC rejected Mr. Bandimere's argument that the ALJ presided over his hearing in violation of the Appointments Clause. We review the agency's conclusion on this constitutional issue de novo. *Hill v. Nat'l Transp. Safety Bd.*, 886 F.2d 1275, 1278 (10th Cir. 1989). We first explain why we must address Mr. Bandimere's constitutional argument and then address its merits.

A. *Constitutional Avoidance*

Federal courts avoid unnecessary adjudication of constitutional issues. *City of Mesquite v. Aladdin's Castle, Inc.*, 455 U.S. 283, 294 (1982). Here, we must consider the Appointments Clause issue.

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[2] Other SEC respondents have attacked the validity of SEC ALJs by filing collateral lawsuits attempting to enjoin administrative enforcement actions. Circuit courts have rejected these attempts, holding that federal courts lacked jurisdiction because the respondents had failed to raise and exhaust the argument in the administrative proceedings. *See, e.g.*, *Hill v. SEC*, 825 F.3d 1236 (11th Cir. 2016); *Tilton v. SEC*, 824 F.3d 276 (2d Cir. 2016); *Jarkesy v. SEC*, 803 F.3d 9 (D.C. Cir. 2015); *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015). Here, Mr. Bandimere did not file a collateral lawsuit. He instead raised his constitutional argument before the SEC, which rejected it. We therefore have jurisdiction to address the Appointments Clause issue as properly presented in Mr. Bandimere's petition for review.

In its opinion, the SEC concluded Mr. Bandimere committed two securities fraud violations and two securities registration violations.[3] In his petition for review, Mr. Bandimere challenges the SEC's findings of securities fraud liability as arbitrary and capricious, but he does not challenge the registration violations on these non-constitutional grounds. He attacks the SEC's opinion as a whole, however, including both his securities fraud and registration liability, based on the Appointments Clause.[4] Because the sole argument attacking his registration liability is constitutional, we cannot avoid the Appointments Clause question. And because resolving this question relieves Mr. Bandimere of all liability, we need not address his remaining arguments on securities fraud liability.

B. *Appointments Clause Overview*

The Appointments Clause states:

> [The President] shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the supreme Court, and all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall

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[3] Specifically, the SEC held him liable for (1) securities fraud under Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Securities and Exchange Act of 1934 ("Exchange Act"), and 17 C.F.R. § 240.10b-5; (2) failure to register as a broker before selling securities under Exchange Act Section 15(a); and (3) failure to register the securities he was selling under Securities Act Sections 5(a) and (c). SEC Release No. 9972, 2015 WL 6575665, at *2, *4, *7, *17.

[4] Mr. Bandimere's petition states, "The [SEC's] Opinion must be vacated because it resulted from a process in which an improperly appointed inferior officer played an integral role." Aplt. Br. at 18; *see also id.* at 10, 13.

> be established by Law: but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.

U.S. Const. art. II, § 2, cl. 2.

The Appointments Clause embodies both separation of powers and checks and balances. *Ryder v. United States*, 515 U.S. 177, 182 (1995) ("The Clause is a bulwark against one branch aggrandizing its power at the expense of another branch . . . .").[5] By defining unique roles for each branch in appointing officers, the Clause separates power. It also checks and balances the appointment authority of each branch by providing (1) the President may appoint principal officers only with Senate approval and (2) Congress may confer appointment power over inferior officers to the President, courts, or department heads but may not itself make appointments.[6]

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[5] James Madison argued in Federalist Nos. 48 and 51 that checks and balances are needed to sustain a workable separation of powers. The Federalist Nos. 48 and 51, at 308, 318-19 (James Madison) (Clinton Rossiter ed., 1961); *see also* M.J.C. Vile, Constitutionalism and the Separation of Powers 153, 159-60 (1967).

[6] In Federalist No. 76, Alexander Hamilton explained the Senate-approval requirement "would be an excellent check upon a spirit of favoritism in the President, and would tend greatly to prevent the appointment of unfit characters from State prejudice, from family connection, from personal attachment, or from a view to popularity." The Federalist No. 76, at 456 (Alexander Hamilton) (Clinton Rossiter ed., 1961).

In *Weiss v. United States*, 510 U.S. 163 (1994), the Supreme Court stated the Framers structured "an alternative appointment method for inferior officers" to promote "accountability and check governmental power: any decision to dispense with Presidential appointment and Senate confirmation is Congress's to make, not the President's, but Congress's authority is limited to assigning the appointing power to the highly accountable President or the heads of federal departments, or, where appropriate, to the courts of law." 510 U.S. at 187.

The Appointments Clause also promotes public accountability by identifying the public officials who appoint officers. *Edmond v. United States*, 520 U.S. 651, 660 (1997). And it prevents the diffusion of that power by restricting it to specific public officials. *Ryder*, 515 U.S. at 182; *Freytag*, 501 U.S. at 878, 883. "The Framers understood . . . that by limiting the appointment power, they could ensure that those who wielded it were accountable to political force and the will of the people." *Freytag*, 501 U.S. at 884.

C. *Inferior Officers and* Freytag

1. Inferior Officers and the Supreme Court

The Supreme Court has defined an officer generally as "any appointee exercising significant authority pursuant to the laws of the United States." *Buckley v. Valeo*, 424 U.S. 1, 126 (1976) (per curiam). The term "inferior officer" "connotes a relationship with some higher ranking officer or officers below the President: Whether one is an 'inferior' officer depends on whether he has a superior." *Edmond*, 520 U.S. at 662.[7]

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[7] Other uses of "inferior" in the Constitution confirm the term speaks to a hierarchical, subordinate-superior relationship. The word appears once in Article I and twice in Article III, each time describing courts "inferior" to the Supreme Court. U.S. Const. art. I, § 8, cl. 9; *id.* art. III, § 1; *see also* Akhil Reed Amar, *Intratextualism*, 112 Harv. L. Rev. 747, 805-07 (1999) (discussing the use of "inferior" in Articles I, II, and III).

Statements from Alexander Hamilton and James Madison also indicate "inferior" means subordinate. In Federalist No. 81, Hamilton described inferior courts as those "subordinate to the Supreme." The Federalist No. 81, at 484 (Alexander Hamilton) (Clinton Rossiter ed., 1961). In the brief debate about the Excepting Clause at the Federal Constitutional Convention in 1787, Madison "mention[ed] (as in apparent

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This description of "inferior" may aid in understanding the distinction between principal and inferior officers. But we are concerned here with the distinction between inferior officers and employees. Like inferior officers, employees—or "lesser functionaries"—are subordinates. *Buckley*, 424 U.S. at 126 n.162.

Justice Breyer has provided this summary of the different ways the Supreme Court has described inferior officers:

> Consider the [Supreme] Court's definitions: Inferior officers are, *inter alia*, (1) those charged with "the administration and enforcement of the public law," *Buckley*, 424 U.S. at 139; (2) those granted "significant authority," *id.* at 126; (3) those with "responsibility for conducting civil litigation in the courts of the United States," *id.* at 140; and (4) those "who can be said to hold an office," *United States v. Germaine*, 99 U.S. 508, 510 (1879), that has been created either by "regulations" or by "statute," *United States v. Mouat*, 124 U.S. 303, 307-08 (1888).

Free Enter. Fund v. PCAOB, 561 U.S. 477, 539 (2010) (Breyer, J., dissenting) (citation style altered and some citations omitted).

The list below contains examples of inferior officers drawn from Supreme Court cases spanning more than 150 years:

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contrast to the 'inferior officers' covered by the provision) 'Superior Officers.'" *Morrison v. Olson*, 487 U.S. 654, 720 (1988) (Scalia, J., dissenting) (citing 2 The Records of the Federal Convention of 1787 627-28 (M. Farrand ed., rev. ed. 1966)). He also referred to "subordinate officers" in contradistinction to "principal officers" when explaining the appointment power during the Virginia ratification convention. 3 The Debates in the Several State Conventions on the Adoption of the Federal Constitution 409-10 (Jonathan Elliot ed., 2d ed. 1836); *see also* Tuan Samahon, *Are Bankruptcy Judges Unconstitutional? An Appointments Clause Challenge*, 60 Hastings L.J. 233, 251 (2008) (discussing Madison's remarks at the Virginia convention).

- a district court clerk, *In re Hennen*, 38 U.S. (13 Pet.) 230, 258 (1839);
- an "assistant-surgeon," *United States v. Moore*, 95 U.S. 760, 762 (1877);
- "thousands of clerks in the Departments of the Treasury, Interior, and the othe[r]" departments, *Germaine*, 99 U.S. at 511 (1878);
- an election supervisor, *Ex parte Siebold,* 100 U.S. 371, 397-98 (1879);
- a federal marshal, *id.* at 397;
- a "cadet engineer" appointed by the Secretary of the Navy, *United States v. Perkins*, 116 U.S. 483, 484-85 (1886);
- a "commissioner of the circuit court," *United States v. Allred*, 155 U.S. 591, 594-96 (1895);
- a vice consul temporarily exercising the duties of a consul, *United States v. Eaton*, 169 U.S. 331, 343 (1898);
- extradition commissioners, *Rice v. Ames*, 180 U.S. 371, 378 (1901);
- a United States commissioner in district court proceedings, *Go-Bart Importing Co. v. United States*, 282 U.S. 344, 352-54 (1931);
- a postmaster first class, *Buckley*, 424 U.S. at 126 (1976) (citing *Myers v. United States*, 272 U.S. 52 (1926));
- Federal Election Commission ("FEC") commissioners, *id.*;
- an independent counsel, *Morrison v. Olson*, 487 U.S. 654, 671 (1988);
- Tax Court special trial judges, *Freytag*, 501 U.S. at 881-82 (1991); and
- military judges, *Weiss v. United States*, 510 U.S. 163, 170 (1994); *Edmond*, 520 U.S. at 666 (1997).[8]

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[8] *See also Edmond*, 520 U.S. at 661 (listing examples of inferior officers); *Free Enter. Fund*, 561 U.S. at 540 (Breyer, J., dissenting) (listing examples of officers).

We think these examples are relevant and instructive. Although the Supreme Court has not stated a specific test for inferior officer status, "[e]fforts to define ['inferior Officers'] inevitably conclude that the term's sweep is unusually broad," *Free Enter. Fund*, 561 U.S. at 539 (Breyer, J., dissenting), and the *Freytag* opinion provides the guidance needed to decide this appeal.

2. ***Freytag***

The question in *Freytag* was whether the Tax Court had authority to appoint special trial judges ("STJs") under the Appointments Clause. 501 U.S. at 877-92. As a threshold matter, the Court addressed whether STJs were inferior officers or employees. *Id.* at 880-82. That question strongly resembles the one we face here. In our view, *Freytag* controls the result of this case.

Under the then-applicable 26 U.S.C. § 7443A(b), the Tax Court could assign four categories of cases to STJs. *Id.* at 873. For the first three categories, § 7443A(b)(1), (2), and (3), "the Chief Judge [could] assign the special trial judge not only to hear and report on a case but also to decide it." *Id.* In other words, STJs could make final decisions in those cases. But in the fourth category, § 7443A(b)(4), STJs lacked final decision-making power: "the chief judge [could] authorize the special trial judge only to hear the case and prepare proposed findings and an opinion. The actual decision then [was] rendered by a regular judge of the Tax Court." *Id.*

The Tax Court assigned the petitioners' case to the STJ under § 7443A(b)(4), the fourth category, which did not allow STJs to enter final decisions. *Id.* at 871-73. The

STJ issued a proposed opinion concluding the petitioners were liable, and the Tax Court adopted it. *Id.* at 871-72.[9] On appeal, the petitioners argued the STJs were inferior officers under the Appointments Clause and that the chief judge of the Tax Court could not appoint them because he was not the President, a court of law, or a department head. *Id.* at 878. The government contended STJs were not inferior officers because they did not have authority to enter a final decision in petitioners' case. *Id.* at 881.

The Court first expressly approved prior decisions from the Tax Court and the Second Circuit that held STJs were inferior officers. *Id.* "Both courts considered the degree of authority exercised by the special trial judges to be so 'significant' that it was inconsistent with the classifications of 'lesser functionaries' or employees." *Id.* (discussing *Samuels, Kramer & Co. v. Comm'r of Internal Revenue*, 930 F.2d 975 (2d Cir. 1991); *First W. Gov't Sec., Inc. v. Comm'r of Internal Revenue*, 94 T.C. 549 (1990)).[10]

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[9] As discussed below, *Ballard v. Commissioner of Internal Revenue*, 544 U.S. 40 (2005), spelled out the STJs' and Tax Court judges' collaborative decision-making process in which STJs and Tax Court judges jointly "worked over" STJs' preliminary "in-house drafts" to produce an opinion. 544 U.S. at 42.

[10] In *Samuels*, the Second Circuit concluded STJs are inferior officers. 930 F.2d at 985. It stated:

> Although the ultimate decisional authority in cases under section 7443A(b)(4) rests with the Tax Court judges, the special trial judges do exercise a great deal of authority in such cases. The special trial judges are more than mere aids to the judges of the Tax Court. They take testimony, conduct trials, rule on the admissibility of evidence, and have the power to

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The Court then turned to the government's argument that the STJs were employees because they "lack[ed] authority to enter a final decision" under § 7443A(b)(4). *Id.* The Court said the argument "ignore[d] the significance of the duties and discretion that special trial judges possess." *Id.* First, the STJ position was "established by Law." *Id.* (quoting U.S. Const. art. II, § 2, cl. 2). Second, "the duties, salary, and means of appointment for that office are specified by statute." *Id.* "These characteristics," the Court stated, "distinguish special trial judges from special masters, who are hired by Article III courts on a temporary, episodic basis, whose positions are not established by law, and whose duties and functions are not delineated in a statute." *Id.* Third, STJs "perform more than ministerial tasks. They take testimony, conduct trials, rule on the admissibility of evidence, and have the power to enforce compliance with discovery orders. In the course of carrying out these important functions, the [STJs]

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> enforce compliance with discovery orders. Contrary to the contentions of the Commissioner, the degree of authority exercised by special trial judges is "significant." They exercise a great deal of discretion and perform important functions, characteristics that we find to be inconsistent with the classifications of "lesser functionary" or mere employee.

Id. at 985-86 (quoting *Buckley*, 424 U.S. at 126).

In *First Western*, the Tax Court concluded STJs are inferior officers: "Because [they] may be assigned any case and may enter decisions in certain cases, it follows that special trial judges exercise significant authority." 94 T.C. at 557.

Although a factor, final decision-making power was not the linchpin of the Tax Court's analysis. *Id.* And in any event, the *Freytag* Court endorsed the Second Circuit's and Tax Court's analyses because they relied on "the degree of authority" STJs possessed. *Freytag*, 501 U.S. at 881.

exercise significant discretion." *Id.* at 881-82. Accordingly, the Court held STJs were inferior officers. *Id.*

Next, the Court addressed a standing argument from the government. *Id.* at 882. The government had conceded STJs act as inferior officers when hearing cases under § 7443A(b)(1), (2), and (3), but argued petitioners "lack[ed] standing to assert the rights of taxpayers whose cases [were] assigned to [STJs] under [those three categories]." *Id.*

The Court stated, "*Even if* the duties of [STJs] under [§ 7443A(b)(4)] were not as significant as we and the two courts have found them to be, our conclusion would be unchanged." *Id.* (emphasis added). The Court explained that an inferior officer does not become an employee because he or she "on occasion performs duties that may be performed by an employee not subject to the Appointments Clause." *Id.* "If a special trial judge is an inferior officer for purposes of subsections (b)(1), (2), and (3), he is an inferior officer within the meaning of the Appointments Clause and he must be properly appointed." *Id.* The Court thus rejected the government's standing argument as "beside the point." *Id.*

In the end, the *Freytag* majority held the Tax Court was a "Cour[t] of Law" with authority to appoint inferior officers like the STJs. *Id.* at 890, 892. Justice Scalia's partial concurrence, joined by three other justices, agreed with the majority's conclusion regarding the STJs' status: "I agree with the Court that a special trial judge is an 'inferior Office[r]' within the meaning of [the Appointments Clause]." *Id.* at 901 (Scalia, J., concurring) (first alteration in original). Thus, a unanimous Supreme Court concluded

STJs were inferior officers.

D. *SEC ALJs*

The SEC conceded in its opinion that its ALJs are not appointed by the President, a court of law, or the head of a department. SEC Release No. 9972, 2015 WL 6575665, at *19. The sole question is whether SEC ALJs are inferior officers under the Appointments Clause. Under *Freytag*, we must consider the creation and duties of SEC ALJs to determine whether they are inferior officers. 501 U.S. at 881-82.

The APA created the ALJ position. 5 U.S.C. § 556(b)(3); *see also Mullen v. Bowen*, 800 F.2d 535, 540 n.5 (6th Cir. 1986) ("[T]he ALJ's position is not a creature of administrative law; rather, it is a direct creation of Congress under the [APA]."). Section 556 of the APA describes the duties of the "presiding employe[e]" at an administrative adjudication. 5 U.S.C. § 556. It states, "There shall preside at the taking of evidence . . . (1) the agency; (2) one or more members of the body which comprises the agency; or (3) one or more administrative law judges appointed under section 3105 of this title." *Id.* § 556(b).

Under 5 U.S.C. § 3105, "Each agency shall appoint as many administrative law judges as are necessary for proceedings required to be conducted in accordance with [5 U.S.C. §§ 556, 557]." Agencies hire ALJs through a merit-selection process administered by the Office of Personnel Management ("OPM"), which places ALJs within the civil service (i.e., the "competitive service"). 5 U.S.C. § 1302; 5 C.F.R. § 930.201. ALJ applicants must be licensed attorneys with at least seven years of

litigation experience. 5 C.F.R. § 930.204; Office of Pers. Mgmt., Qualification Standard for Administrative Law Judge Positions, https://perma.cc/2G7J-X5BW. OPM administers an exam and uses the results to rank applicants. 5 C.F.R. § 337.101. Agencies may select an ALJ from the top three ranked candidates.[11] The SEC's Chief ALJ hires from the top three candidates subject to "approval and processing by the [SEC's] Office of Human Resources." Notice of Filing at 2, Timbervest, LLC, File No. 3-15519, https://perma.cc/G8M2-36P3 (SEC Division of Enforcement filing in administrative enforcement action). Once hired, ALJs receive career appointments, 5 C.F.R. § 930.204(a), and are removable only for good cause, 5 U.S.C. § 7521. Their pay is detailed in 5 U.S.C. § 5372. The SEC currently employs five ALJs. Office of Pers. Mgmt., ALJs by Agency, https://perma.cc/6RYA-VQFV.

The SEC has authority to delegate "any of its functions" except rulemaking to its ALJs. 15 U.S.C. § 78d-1(a). And SEC regulations task ALJs with "conduct[ing] hearings" and make them "responsible for the fair and orderly conduct of the proceedings." 17 C.F.R. § 200.14. SEC ALJs "have the authority to do all things

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[11] *See* Vanessa K. Burrows, Cong. Res. Serv., Administrative Law Judges: An Overview at 2 (2010), https://perma.cc/T8YY-EE7F; Robin J. Arzt et al., Fed. Admin. Law Judge Found., Advancing the Judicial Independence and Efficiency of the Administrative Judiciary: A Report to the President-Elect of the United States, 29 J. Nat'l Ass'n Admin. L. Judiciary 93, 101 (2009).

necessary and appropriate to discharge [their] duties." 17 C.F.R. § 201.111.[12] The table below lists examples of those duties.

Duty	Provision(s)
Administer oaths and affirmations	5 U.S.C. § 556(c)(1) 17 C.F.R. § 200.14(a)(1) 17 C.F.R. § 201.111(a)
Consolidate "proceedings involving a common question of law or fact"	17 C.F.R. § 201.201(a)
"Determin[e]" the "scope and form of evidence, rebuttal evidence, if any, and cross-examination, if any"	17 C.F.R. § 201.326
Enter default judgment	17 C.F.R. § 201.155
Examine witnesses	17 C.F.R. § 200.14(a)(4)
Grant extensions of time or stays	17 C.F.R. § 201.161
Hold prehearing conferences	17 C.F.R. § 200.14(a)(6)
Hold settlement conferences and require attendance of the parties	5 U.S.C. § 556(c)(6) 5 U.S.C. § 556(c)(8) 17 C.F.R. § 201.111(e)
Inform the parties about alternative means of dispute resolution	5 U.S.C. § 556(c)(7) 17 C.F.R. § 201.111(k)
Issue protective orders	17 C.F.R. § 201.322
Issue, revoke, quash, or modify subpoenas	5 U.S.C. § 556(c)(2) 17 C.F.R. § 200.14(a)(2) 17 C.F.R. § 201.111(b) 17 C.F.R. § 201.232(e)
Order and regulate depositions	17 C.F.R. § 201.233
Order and regulate document production	17 C.F.R. § 201.230
Prepare an initial decision containing factual findings and legal conclusions, along with an appropriate order	5 U.S.C. § 556(c)(10) 17 C.F.R. § 200.14(a)(8) 17 C.F.R. § 200.30-9(a) 17 C.F.R. § 201.111(i) 17 C.F.R. § 201.360

[12] Many of the SEC regulations refer to the duties of the "hearing officer." Under 17 C.F.R. § 201.101(a)(5), a "hearing officer" includes an ALJ. This opinion applies only to SEC ALJs specifically and not to hearing officers generally.

Punish contemptuous conduct by excluding a person from a deposition, hearing, or conference or by suspending a person from representing others in the proceeding	17 C.F.R. § 201.180(a)
Regulate the course of the hearing and the conduct of the parties and counsel	5 U.S.C. § 556(c)(5) 17 C.F.R. § 200.14(a)(5) 17 C.F.R. § 201.111(d)
Reject deficient filings, order a party to cure deficiencies, and enter default judgment for failure to cure deficiencies	17 C.F.R. § 201.180(b), (c)
Reopen any hearing prior to filing an initial decision or prior to the fixed time for the parties to file final briefs with the SEC	17 C.F.R. § 201.111(j)
Rule on all motions, including dispositive and procedural motions	5 U.S.C. § 556(c)(9) 17 C.F.R. § 200.14(a)(7) 17 C.F.R. § 201.111(h) 17 C.F.R. § 201.220 17 C.F.R. § 201.250
Rule on offers of proof and receive relevant evidence	5 U.S.C. § 556(c)(3) 17 C.F.R. § 200.14(a)(3) 17 C.F.R. § 201.111(c)
Set aside, make permanent, limit, or suspend temporary sanctions the SEC issues	17 C.F.R. § 200.30-9(b) 17 C.F.R. § 201.531
Take depositions or have depositions taken	5 U.S.C. § 556(c)(4)

E. ***SEC ALJs Are Inferior Officers Under* Freytag**

Following *Freytag*, we conclude SEC ALJs are inferior officers under the Appointments Clause. As the SEC acknowledges, the ALJ who presided over Mr. Bandimere's hearing was not appointed by the President, a court of law, or a department head. He therefore held his office in conflict with the Appointments Clause when he presided over Mr. Bandimere's hearing.

Freytag held that STJs were inferior officers based on three characteristics. Those

three characteristics exist here: (1) the position of the SEC ALJ was "established by Law," *Freytag*, 501 U.S. at 881 (quoting U.S. Const. art. II, § 2, cl. 2); (2) "the duties, salary, and means of appointment . . . are specified by statute," *id.*; and (3) SEC ALJs "exercise significant discretion" in "carrying out . . . important functions," *id.* at 882.

First, the office of the SEC ALJ was established by law. The APA established the ALJ position. 5 U.S.C. § 556(b)(3). In addition, the Securities and Exchange Act of 1934 authorizes the SEC to delegate "any of its functions" with the exception of rulemaking to ALJs,[13] and 17 C.F.R. § 200.14, a regulation promulgated under the Act, gives the agency's "Office of Administrative Law Judges" power to "conduct hearings" and "proceedings." *See* 15 U.S.C. § 78d-1(a) (authorizing SEC to delegate functions to ALJs); 17 C.F.R. § 200.1 (stating statutory basis for SEC regulations).

Second, statutes set forth SEC ALJs' duties, salaries, and means of appointment.

[13] The dissent's concern about how this opinion might affect the SEC ALJs' role in rulemaking is misplaced. Dissent at 14. SEC ALJs do not have a rulemaking role: the Exchange Act does not allow the SEC to delegate rulemaking authority to its ALJs. 15 U.S.C. § 78d-1(a) ("Nothing in this section shall be deemed . . . to authorize the delegation of the function of rule making . . . ."); *see also Raymond J. Lucia Cos., Inc. v. SEC*, 832 F.3d 277, 281 (D.C. Cir. 2016) (stating "the authority to delegate [does] not extend to the [SEC's] rulemaking authority"). Other agencies' ALJs rarely exercise rulemaking authority. *See, e.g., Perez v. Mortg. Brokers Ass'n*, 135 S. Ct. 1199, 1222 n.5 (2015) (Thomas, J., concurring) ("Today, . . . formal rulemaking is the Yeti of administrative law. There are isolated sightings of it in the ratemaking context, but elsewhere it proves elusive."); Kent Barnett, *Resolving the ALJ Quandary*, 66 Vand. L. Rev. 797 (2013) ("[F]ormal rulemaking is extremely rare . . . ."). Nevertheless, to the extent the dissent is concerned with other ALJs' rulemaking authority, we do not address the issue because our sole question is whether SEC ALJs are inferior officers.

5 U.S.C. §§ 556-57 (duties); *id.* § 5372(b) (salary); *id.* §§ 1302, 3105 (means of appointment).[14] SEC ALJs are not "hired . . . on a temporary, episodic basis." *Freytag*, 501 U.S. at 881. They receive career appointments and can be removed only for good cause. 5 U.S.C. § 7521; 5 C.F.R. § 930.204(a).

Third, SEC ALJs exercise significant discretion in performing "important functions" commensurate with the STJs' functions described in *Freytag*. SEC ALJs have "authority to do all things necessary and appropriate to discharge his or her duties."[15] This includes authority to shape the administrative record by taking testimony,[16] regulating document production and depositions,[17] ruling on the admissibility of evidence,[18] receiving evidence,[19] ruling on dispositive and procedural motions,[20] issuing subpoenas,[21] and presiding over trial-like hearings.[22] When presiding over trial-like

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[14] The SEC concedes that the way it appoints its ALJs does not comply with the Appointments Clause. SEC Release No. 9972, 2015 WL 6575665 at *19.

[15] 17 C.F.R. § 201.111.

[16] 5 U.S.C. § 556(b), (c)(4).

[17] 17 C.F.R. §§ 201.230, 201.233.

[18] *Id.* § 556(c)(3); 17 C.F.R. § 200.14(a)(3).

[19] 17 C.F.R. § 201.111(c).

[20] 5 U.S.C. § 556(c)(9); 17 C.F.R. §§ 200.14(a)(3), (7), 201.111(h), 201.220, 201.250.

[21] 5 U.S.C. § 556(c)(2); 17 C.F.R. §§ 200.14(a)(2), 201.111(b).

hearings, SEC ALJs make credibility findings to which the SEC affords "considerable weight" during agency review.[23]

They also have authority to issue initial decisions that declare respondents liable and impose sanctions.[24] When a respondent does not timely seek agency review, "the action of [the ALJ] shall, for all purposes, including appeal or review thereof, be deemed the action of the Commission."[25] Even when a respondent timely seeks agency review,

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[22] 5 U.S.C. § 556(b); 17 C.F.R. § 200.14(a).

[23] SEC Release No. 9972, 2015 WL 6575665, at *15 n.83 (deferring to SEC ALJ's credibility findings in the face of conflicting testimony). The dissent argues STJs exercise "significant authority" because the Tax Court was "'required to defer' to the [STJs'] factual and credibility findings 'unless they were clearly erroneous,'" Dissent at 3 (quoting *Landry*, 204 F.3d at 1133). But SEC ALJs' credibility findings also receive deference. The SEC affords their credibility findings "considerable weight and deference," Thomas C. Bridge, SEC Release No. 9068, 2009 WL 3100582, at *18 n.75 (Sept. 29, 2009), and accepts the findings "absent substantial evidence to the contrary," Steven Altman, SEC Release No. 63306, 2010 WL 5092725, at *10 (Nov. 10, 2010). *See also* Robert Thomas Clawson, SEC Release No. 48143, 2003 WL 21539920, at *2 (July 9, 2003) (stating the SEC "accepts" the ALJs' credibility findings "absent overwhelming evidence to the contrary"). Both the Tax Court and the SEC defer to credibility findings but are not required to accept those findings if they are undermined by other evidence. Thus, SEC ALJs, like STJs, exercise significant authority in part because the SEC defers to their credibility findings.

[24] 5 U.S.C. § 556(c)(10); 17 C.F.R. §§ 200.14(a)(8), 200.30-9(a), 201.111(i), 201.360; *see also* SEC Release No. 507, 2013 WL 5553898.

[25] 15 U.S.C. § 78d-1(c). The SEC and the dissent argue the SEC ALJs do not exercise significant authority when issuing initial decisions because the agency retains a right to review the decisions de novo. But this argument is incomplete. The agency has discretion to engage in de novo review, 15 U.S.C. § 78d-1(b), but also has discretion not

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the agency may decline to review initial decisions adjudicating certain categories of cases.[26]

Further, SEC ALJs have power to enter default judgments[27] and otherwise steer the outcome of proceedings by holding and requiring attendance at settlement conferences.[28] They also have authority to set aside, make permanent, limit, or suspend temporary sanctions that the SEC itself has imposed.[29]

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to engage in de novo review before an initial decision becomes final, 17 C.F.R. § 201.360(d)(2) (stating the agency can make an initial decision final by entering an order). In fact, the agency has no duty, based on the regulation's plain language, to review an unchallenged initial decision before entering an order stating the decision is final. 17 C.F.R. § 201.360(d)(2). Thus, SEC ALJs exercise significant authority in part because their initial decisions can and do become final without plenary agency review. Indeed, 90 percent of those initial decisions become final without plenary review. SEC, ALJ Initial Decisions, https://www.sec.gov/alj/aljdec.shtml (archiving initial decisions); *see also* Amici Br. at 13-14.

Further, an SEC ALJ's authority to issue an initial decision is significant because, even if reviewed de novo, the ALJ plays a significant role as detailed above in conducting proceedings and developing the record leading to the decision, and the decision publicly states whether respondents have violated securities laws and imposes penalties for violations. *Id.* § 201.360(c) (requiring the agency to publish the initial decision on the SEC docket).

[26] 17 C.F.R. § 201.411(b)(2).

[27] 17 C.F.R. § 201.155.

[28] 5 U.S.C. § 556(c)(6), (8); 17 C.F.R. § 201.111(e).

[29] 17 C.F.R. §§ 200.30-9, 201.531; *see also* 15 U.S.C. § 78u-3(c) (describing temporary order); 17 C.F.R. § 201.101(a)(11) (stating a temporary sanction is "a temporary cease-and-desist order or a temporary suspension of . . . registration"); *id.*

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In sum, SEC ALJs closely resemble the STJs described in *Freytag*. Both occupy offices established by law; both have duties, salaries, and means of appointment specified by statute; and both exercise significant discretion while performing "important functions" that are "more than ministerial tasks." *Freytag*, 501 U.S. at 881-82; *see also Samuels*, 930 F.2d at 986. Further, both perform similar adjudicative functions as set out above.[30] We therefore hold that the SEC ALJs are inferior officers who must be appointed in conformity with the Appointments Clause.[31]

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§§ 201.510(b), 201.512(a), 201.521(b), 201.522(a) (describing a temporary sanction and stating an SEC commissioner presides over the hearing and that the agency must issue the order); *id.* § 201.531(a)(1) (stating an initial decision "shall specify" which terms or conditions of a temporary sanction "shall become permanent"); *id.* § 201.531(a)(2) (stating an initial decision "shall specify" "whether a temporary suspension of a respondent's registration, if any, shall be made permanent"); *id.* § 201.531(b) (stating an order modifying a temporary sanction "*shall be effective* 14 days after service" (emphasis added)).

[30] The dissent complains that the majority opinion "lists the duties of SEC ALJs, without telling us which, if any, were more important to its decision than others and why." Dissent at 11. But this misses the point of our following *Freytag*. There, the Court identified four duties that supported the STJs' inferior officer status: "They take testimony, conduct trials, rule on the admissibility of evidence, and have the power to enforce compliance with discovery orders." 501 U.S. at 881-82. We point out above that SEC ALJs perform comparable duties, and we spell out even more of their discretionary functions.

[31] Those who challenge agency action typically have the burden to show prejudicial error. 5 U.S.C. § 706; *Shinseki v. Sanders*, 556 U.S. 396, 406-07 (2009). The error here is structural because the Supreme Court has recognized the separation of powers as a "structural safeguard." *Plaut v. Spendthrift Farm, Inc.*, 514 U.S. 211, 239 (1995) (emphasis omitted). Structural errors are not subject to prejudicial-error review.

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This holding serves the purposes of the Appointments Clause. The current ALJ hiring process whereby the OPM screens applicants, proposes three finalists to the SEC, and then leaves it to somebody at the agency to pick one, is a diffuse process that does not lend itself to the accountability that the Appointments Clause was written to secure. In other words, it is unclear where the appointment buck stops. The current hiring system would suffice under the Constitution if SEC ALJs were employees, but we hold under *Freytag* that they are inferior officers who must be appointed as the Constitution commands. As the Supreme Court said in *Freytag*, "The Appointments Clause prevents Congress from dispensing power too freely; it limits the universe of eligible recipients of the power to appoint." 501 U.S. at 880.

F. ***The SEC's Arguments***

1. **Final Decision-Making Power**

In rejecting Mr. Bandimere's Appointments Clause argument during agency review, the SEC's opinion concluded the ALJs are not inferior officers because they

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See Rivera v. Illinois, 556 U.S. 148, 161 (2009) (stating "constitutional errors concerning the qualification of the jury or judge" require automatic reversal (emphasis omitted)); *Intercollegiate Broad. Sys., Inc. v. Copyright Royalty Bd.*, 796 F.3d 111, 123 (D.C. Cir. 2015) ("[A]n Appointments Clause violation is a structural error that warrants reversal regardless of whether prejudice can be shown."); *United States v. Solon*, 596 F.3d 1206, 1211 (10th Cir. 2010) (stating structural errors are subject to automatic reversal).

Mr. Bandimere argues, "[The SEC ALJ] is an inferior officer whose unconstitutional appointment is a structural constitutional error that invalidates the proceeding." Aplt. Br. at 18. The SEC does not dispute that an Appointments Clause error here is structural and that there is no need to show prejudice.

cannot render final decisions and the agency retains authority to review ALJs' decisions de novo.

The SEC makes similar arguments here. It contends the *Freytag* Court relied on the STJs' final decision-making power when it held they were inferior officers. The agency draws on *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000), in which the D.C. Circuit attempted to distinguish *Freytag* and held that FDIC ALJs were employees. 204 F.3d at 1134. In *Landry*, the D.C. Circuit stated *Freytag* "laid exceptional stress on the STJs' final decisionmaking power." *Id.* The court therefore considered dispositive the FDIC ALJs' inability to render final decisions. *Id.*

This past August, the D.C. Circuit addressed the same question we face here. *Raymond J. Lucia Cos., Inc. v. SEC*, 832 F.3d 277, 283 (D.C. Cir. 2016). The D.C. Circuit followed *Landry* and concluded that SEC ALJs are employees and not inferior officers. *Id.* at 283-89. The holding was based on the court's conclusion that SEC ALJs cannot render final decisions. *Id.* at 285 ("[T]he parties principally disagree about whether [SEC] ALJs issue final decisions of the [SEC]. Our analysis begins, and ends, there."). We disagree with the SEC's reading of *Freytag* and its argument that final decision-making power is dispositive to the question at hand.

<u>First</u>, both the agency and *Landry* place undue weight on final decision-making authority. *Freytag* stated the government's argument that STJs should be deemed employees when they lacked the ability to enter final decisions "ignore[d] the significance of the duties and discretion that [STJs] possess." 501 U.S. at 881. The

Supreme Court held STJs are inferior officers because their office was established by law; their duties, salaries and means of appointments were "specified by statute"; and they "exercise[d] significant discretion" in "carrying out . . . important functions." *Id.* at 881-82.

Moreover, *Freytag* agreed with the Second Circuit's *Samuels* decision, *id.*, which held that STJs are inferior officers because they "exercise a great deal of discretion and perform important functions" in § 7443A(b)(4) cases, *Samuels*, 930 F.2d at 986. The Second Circuit did not rely on the STJs' ability to enter final decisions under § 7443A(b)(1), (2), and (3). *Id.* at 985-86. Rather, it said STJs are inferior officers even though "the ultimate decisional authority in cases under section 7443A(b)(4) rests with the Tax Court judges." *Id.* at 985. Like *Freytag*, *Samuels* hinged on the STJs' duties and not on final decision-making power.

After stating its holding that STJs are inferior officers based on their duties, the *Freytag* Court responded to the government's standing argument. 501 U.S. at 882. The Court stated, "*Even if* the duties of special trial judges under subsection (b)(4) were not as significant as we and the two courts have found them to be, our conclusion would be unchanged." *Id.* (emphasis added). This sentence reaffirms what the Court previously concluded: it "found" the duties of the STJs are sufficiently significant to make them inferior officers. *Id.* That conclusion did not depend on the STJs' authority to make final

decisions.[32]

Further, the Court's "even if" argument was a response to (1) the government's concession that STJs are inferior officers in § 7443A(b)(1), (2), and (3) cases, where they had final decision-making authority,[33] and (2) the government's argument that the petitioners lacked standing to rely on the STJs' authority in those types of cases to establish the STJs' inferior officer status in § 7443A(b)(4) cases.[34] Based on the

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[32] Judge Randolph rebutted the *Landry* majority by arguing the following:

> The [*Freytag*] Court introduced its alternative holding thus: "Even if the duties of special trial judges [just described] were not as significant as we and the two courts have found them to be, our *conclusion* would be unchanged." 501 U.S. at 882 (italics added). What "conclusion" did the Court have in mind? The conclusion it had reached in the preceding paragraphs—namely, that although special trial judges may not render final decisions, they are nevertheless inferior officers of the United States within the meaning of Article II, § 2, cl. 2. The same conclusion, the same holding, had also been rendered in [*Samuels*], a decision the Supreme Court cited and expressly approved. *See* 501 U.S. at 881. There the Second Circuit held that a special trial judge performing the same advisory function as the judge in *Freytag* was an inferior officer; the court of appeals did not mention the fact that in other types of cases, the judge could issue final judgments.

Landry, 204 F.3d at 1142 (Randolph, J., concurring).

[33] "The Commissioner concedes that in cases governed by subsections (b)(1), (2), and (3), special trial judges act as inferior officers who exercise independent authority." 501 U.S. at 882.

[34] "But the Commissioner urges that petitioners may not rely on the extensive power wielded by the [STJ] in declaratory judgment proceedings and limited-amount tax cases because petitioners lack standing to assert the rights of taxpayers whose cases are assigned to [STJs] under subsections (b)(1), (2), and (3)." *Id.*

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government's concession, the Court stated STJs could not transform to employees by "perform[ing] duties that may be performed by an employee not subject to the Appointments Clause." *Id.* The Court thus rejected the standing argument as "beside the point." *Id.*

The Court's rejection of the government's standing argument is a far cry from holding that final decision-making authority is the predicate for inferior officer status. Indeed, the Court did not hold that STJs are inferior officers because they have final decision-making authority in § 7443A(b)(1), (2), and (3) cases. Rather, it accepted the government's concession that STJs are inferior officers in those cases for the purpose of responding to the standing argument. Thus, the Court's "even if" argument did not modify or supplant its holding that STJs were inferior officers based on the "significance of [their] duties and discretion." *Id.* at 881.

The SEC reads *Freytag* as elevating final decision-making authority to the crux of inferior officer status. But properly read, *Freytag* did not place "exceptional stress" on final decision-making power.[35] To the contrary, it rebutted the government's argument that STJs were inferior officers when they lacked final decision-making power (i.e.,

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[35] *Compare Freytag*, 501 U.S. at 881-82 (rejecting the government's argument that STJs were employees when they lacked final decision-making power), *with Landry*, 204 F.3d at 1134 (asserting *Freytag* "laid exceptional stress on the STJs' final decisionmaking power").

§ 7443A(b)(4) cases) because the argument "ignore[d] the significance of the duties and discretion that [STJs] possess." *Freytag*, 501 U.S. at 881.

Final decision-making power is relevant in determining whether a public servant exercises significant authority. But that does not mean *every* inferior officer *must* possess final decision-making power. *Freytag*'s holding undermines that contention. In short, the Court did not make final decision-making power the essence of inferior officer status. Nor do we.

Second, the SEC's argument finds no support in other Supreme Court decisions describing inferior officers. In *Edmond*, the Supreme Court considered final decision-making power as relevant to the difference between a principal and inferior officer, not the difference between an officer and an employee. 520 U.S. at 665. The Court held Coast Guard Court of Criminal Appeals judges were inferior officers instead of principal officers because they "ha[d] no power to render a final decision on behalf of the United States unless permitted to do so by other Executive officers, and hence they [were] inferior within the meaning of Article II." *Id.* In other words, the Court classified the judges as inferior officers even though they had no final decision-making power. *Id.*

In *Buckley*, the Court held FEC commissioners were inferior officers because they exercised "significant authority," including the "responsibility for conducting civil litigation in the courts of the United States for vindicating public rights." 424 U.S. at 125-26, 140. The *Buckley* Court analyzed significant authority as a matter of degree without discussing final decision-making power. *Id.*; *see also Ass'n of Am. Railroads v.*

U.S. Dep't of Transp., 821 F.3d 19, 38 (D.C. Cir. 2016) (stating *Edmond* "clarified [that] the degree of an individual's authority is relevant in marking the line between officer and nonofficer, not between principal and inferior officer" (citing *Edmond*, 520 U.S. at 662)).

The Court has not equated significant authority with final decision-making power in *Buckley*, *Freytag*, *Edmond*, or elsewhere. Nor has it indicated that each of the officers it has deemed inferior possesses that power.[36] Further, Justice Breyer has stated that "efforts to define ['inferior Officer'] inevitably conclude that the term's sweep is unusually broad." *Free Enter. Fund*, 561 U.S. at 539 (Breyer, J., dissenting).

<u>Third</u>, supervision by superior officers is not unique to employees. It is a common feature of inferior officers as well.[37] The military judges at issue in *Edmond* were inferior

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[36] Whether SEC ALJs can enter final decisions is not dispositive to our holding because it was not dispositive to *Freytag*'s holding. Nevertheless, the SEC's argument that its ALJs can never enter final decisions is not airtight. Without a timely petition for review, SEC ALJ's actions are "deemed the action of the Commission." 15 U.S.C. § 78d-1(c). The agency retains authority to review initial decisions de novo and may determine the date on which an unchallenged initial decision is final. 15 U.S.C. § 78d-1(b); 17 C.F.R. § 201.360(d)(2); *Lucia*, 832 F.3d at 286-87. But the agency may simply enter an order stating an initial decision is final without engaging in any review. 17 C.F.R. § 201.360(d)(2). And the agency can also decline to review an initial decision even when there is a timely petition for review. 17 C.F.R. § 201.411(b)(2). Thus, the Exchange Act and the agency's regulations provide a path for an initial decision to become final without plenary agency review. In practice, most initial decisions follow that path—90 percent. *See* SEC, ALJ Initial Decisions, https://www.sec.gov/alj/aljdec .shtml.

[37] *Edmond*, 520 U.S. at 663 (stating an inferior officer is "directed and supervised at some level by others who were appointed by Presidential nomination with advice and consent of the Senate"); *Landry*, 204 F.3d at 1142 (Randolph, J., concurring) ("The fact that an ALJ cannot render a final decision and is subject to the ultimate supervision of the

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officers based on their inability to "render a final decision . . . unless permitted to do so by other Executive officers." 520 U.S. at 665. Thus, the fact that the SEC can reverse its ALJs does not mean they are employees rather than inferior officers.

2. **Deference to Congress**

The SEC further contends Congress intended its ALJs to be employees. It urges us to "accor[d] significant weight" to congressional intent in determining whether the ALJs are inferior officers. Aplee. Br. at 41.

The SEC overstates its arguments. In its brief, it has not cited statutory language expressly stating ALJs are employees for purposes of the Appointments Clause. Nor has it cited legislative history indicating Congress has specifically addressed the question whether ALJs are inferior officers. And to the extent the SEC seeks to infer congressional intent from congressional action, the evidence is mixed.

On the one hand, the SEC stresses that Congress was "deliberate" in constructing the statutory framework governing the hiring of ALJs and the powers ALJs have in relation to their agencies. Aplee. Br. at 27. This includes placing the position within the civil service and tasking the OPM to prescribe rules governing ALJ hiring. 5 U.S.C. §§ 1302, 3105, 3313; 5 C.F.R. § 930.201. The SEC argues this suggests congressional intent to classify ALJs as employees. But, on the other hand, and as detailed previously,

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FDIC shows only that the ALJ shares the common characteristic of an 'inferior Officer.'").

Congress granted significant authority to SEC ALJs in the APA and the Exchange Act and has authorized the agency to delegate "any of its [non-rulemaking] functions" to ALJs. 5 U.S.C. §§ 556, 557; 15 U.S.C. § 78d-1(a).

When it has faced a case or controversy concerning separation of powers, the Supreme Court has determined whether the legislative or executive branches or both have violated the Constitution. *See, e.g.*, *Bowsher v. Synar*, 478 U.S. 714 (1986); *INS v. Chadha*, 462 U.S. 919 (1983); *Buckley*, 424 U.S. at 1; *Marbury v. Madison*, 5 U.S. (1 Cranch) 137 (1803). This has been so even when a congressional scheme was carefully devised and effective. *Bowsher*, 478 U.S. at 736.[38] However "carefully devised" the ALJ system may be generally and the SEC ALJ program particularly, *see Lucia*, 832 F.3d at 289, that should not excuse failure to comply with the Appointments Clause. As a circuit court, we must follow Supreme Court precedent. *Hutto v. Davis*, 454 U.S. 370, 375 (1982) (per curiam) ("[A] precedent of [the Supreme] Court must be followed by the lower federal courts."). And as explained, *Freytag* governs our result here.

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[38] In *Bowsher*, the Court stated:

> No one can doubt that Congress and the President are confronted with fiscal and economic problems of unprecedented magnitude, but "the fact that a given law or procedure is efficient, convenient, and useful in facilitating functions of government, standing alone, will not save it if it is contrary to the Constitution. Convenience and efficiency are not the primary objectives—or the hallmarks—of democratic government."

478 U.S. at 736 (ellipsis omitted) (quoting *Chadha*, 462 U.S. at 944).

Moreover, the Supreme Court's treatment of the government's deference argument in *Freytag* is instructive here. The government contended the Supreme Court should "defer to the Executive Branch's decision that there has been no legislative encroachment on Presidential prerogatives under the Appointments Clause." 501 U.S. at 879. The Court rejected that argument: "[T]he Clause forbids Congress to grant the appointment power to inappropriate members of the Executive Branch. Neither Congress nor the Executive can agree to waive this structural protection. . . . The structural interests protected by the Appointments Clause are not those of any one branch of Government but of the entire Republic." *Id.* at 880; *see also NLRB v. Noel Canning*, 134 S. Ct. 2550, 2594 (2014) (Scalia, J., concurring in the judgment) ("[T]he political branches cannot by agreement alter the constitutional structure."). As stated, we question whether Congress has clearly classified SEC ALJs as employees. But even if it had, we would still follow *Freytag*.

G. ***The Dissent's Arguments***

We address three of the dissent's main arguments. First, it points out the STJs had "power to bind the Government and third parties," and the "SEC ALJs do not." Dissent at 1. This is the final authority argument the SEC makes here and that the D.C. Circuit relied on in *Landry* and *Lucia*. We have addressed this argument above.

Second, the dissent contends that "even where [STJs] could not enter final decisions, their initial decisions had binding effect." *Id.* at 2. The SEC did not make this argument. In any event, the contention is incorrect because it rests on a misapprehension

of the Tax Court judges' and STJs' roles in cases where the Tax Court judges must make the final decisions, such as *Freytag*. *See Ballard v. Comm'r of Internal Revenue*, 544 U.S. 40, 44 (2005) (citing 26 U.S.C. § 7443A(c)) (stating Tax Court judges must make the "[u]ltimate decision in cases involving tax deficiencies that exceed $50,000"). The dissent asserts that the STJs in effect made the final decisions in those cases because the Tax Court "purported to adopt its [STJs'] opinions verbatim in 880 out of 880 cases between 1983 and 2005." Dissent at 8. At first blush, that assertion suggests the Tax Court rubber stamped 880 STJ recommendations without making a single change. But a full reading of the dissent's cited sources shows that assertion is incorrect.

In *Ballard*, a case the dissent mistakenly relies on to attempt to differentiate STJs and SEC ALJs,[39] the Supreme Court described the Tax Court's process of reviewing STJ's recommendations based on the government's own explanation of how Tax Court judges and STJs worked together. 544 U.S. at 58, 65 (stating the government "describe[d] and defend[ed]" its process). Beginning in 1983, STJs submitted "reports" to the Tax Court judges tasked with making the final decision in each particular case. *Id.* at 58. In each case, the Tax Court judge treated the report as an "in-house draft" and engaged in a "collaborative process" with the STJ in which they "worked over" the report

[39] The dissent relies on *Ballard*, Dissent at 2-4, yet objects to our use of the case to rebut its argument that the Tax Court deferred to STJs on questions of law. *Id.* at 5 n.1. We do not rely on *Ballard* in reaching our holding or in responding to the SEC's arguments (because the SEC did not rely on it). We discuss the case only to respond to the dissent.

and produced an "opinion of the [STJ]." *Id.* at 57. "When the collaborative process [was] complete, the Tax Court judge issue[d] a decision in all cases agreeing with and adopting the opinion of the [STJ]." *Id.* (alterations and quotations omitted). In sum, the Tax Court judges adopted opinions they had a hand in supervising and producing.

The law review article the dissent cites explains why it is simply not true that the Tax Court rubber stamped 880 of 880 STJ opinions: "the Tax Court judge treated the report and recommendation of the [STJ] as a draft of an opinion that would, after a collaborative effort with the Tax Court judge, ultimately be adopted by the Tax Court." Christopher M. Pietruszkiewicz, *Conflating Standards of Review in the Tax Court: A Lesson in Ambiguity*, 44 Hous. L. Rev. 1337, 1360 (2008). The dissent's conclusion that the STJs' "initial report often decided the case," Dissent at 3, overstates the STJs' role. And their actual role hardly supports the notions that Tax Court judges "appeared to defer to its [STJs] on conclusions of law" or "that [the STJs] had as much authority as Tax Court judges themselves." *Id.* at 3, 6.[40] Even if the Tax Court did not review STJs'

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[40] The dissent states the Tax Court judge in *Freytag* adopted the STJ's report "verbatim." Dissent at 5 n.1. There is no indication that is true. By the time of the *Freytag* trial in 1987, the Tax Court had been practicing the "collaborative process" described above for four years. *See Ballard*, 544 U.S. at 57 (stating the Tax Court began the "collaborative process" in 1983). The Tax Court judge in *Freytag* received the STJ's "*report*" and within four months adopted the STJ's "*opinion*," *Freytag*, 501 U.S. at 872 n.2 (emphasis added), which, as we learn from *Ballard*, is the document produced by the STJ *and* the Tax Court judge collaboratively, *Ballard*, 544 U.S. at 58.

In other words, *Freytag* appears to be an example of the collaborative process at work—the STJ provided the Tax Court judge a "report," and the Tax Court judge later adopted the STJ's "opinion" that resulted from the joint efforts of the STJ and Tax Court

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recommendations in most cases, that would not distinguish STJs from SEC ALJs. Most of the SEC ALJs' initial decisions—about 90 percent—become final without any review or revision from an SEC Commissioner.[41]

The dissent is left with its argument that in certain cases the STJs "had the power to bind third parties and the government itself." *Id.* at 6 n.2. But, as previously explained, *Freytag* did not regard this ground as dispositive to hold the STJs are inferior officers.[42]

Moreover, even if the STJs exercise more authority than the SEC ALJs, it does not follow that the former are inferior officers and the latter are employees or that the latter do not exercise significant authority. We agree that ALJs are not identical to STJs. But,

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judge. Nevertheless, the dissent infers the Tax Court judge adopted the STJ's recommendation "verbatim," Dissent at 5 n.1, even though the Supreme Court declined "to assume 'rubber stamp' activity on the part of the [Tax Court judge]," *Freytag*, 501 U.S. at 872 n.2.

[41] Amici report and the agency does not dispute that approximately 90 percent of SEC ALJs' initial decisions issued in 2014 and 2015 became final without agency plenary review. Amici Br. at 13-14. Our review of the SEC's archives confirms this information. *See* SEC, ALJ Initial Decisions, https://www.sec.gov/alj/aljdec.shtml.

[42] The dissent does not state it disagrees with our reading of *Freytag*. Rather, it relies on passages from the petitioners' brief in *Freytag* to describe the characteristics of the STJs. What really counts, however, are the STJs' features the Supreme Court relied on to determine they are inferior officers. The *Freytag* opinion—not one side's advocacy brief—is the proper source for analysis. And, as our analysis shows, *Freytag* leads us to conclude the SEC ALJs are inferior officers.

as explained in detail above, STJs and ALJs closely resemble one another where it counts. SEC ALJs can still be inferior officers without possessing identical powers as STJs, just like STJs can still be inferior officers without possessing identical powers as FEC commissioners and assistant surgeons. *See Buckley*, 424 U.S. at 125-26; *Moore*, 95 U.S. at 762.[43]

Third, the dissent expresses concerns about "the probable consequences of today's decision." Dissent at 11. It goes on to raise issues that are not before us and that the parties did not brief.

We recognize that our holding potentially implicates other questions. But no other issues have been presented to us here, and we therefore cannot address them. Nothing in this opinion should be read to answer any but the precise question before this court: whether SEC ALJs are employees or inferior officers. Questions about officer removal, officer status of other agencies' ALJs, civil service protection, rulemaking, and retroactivity, *see* Dissent at 11-15, are not issues on appeal and have not been briefed by the parties. Having answered the question before us, and thus resolved Mr. Bandimere's petition, we must leave for another day any other putative consequences of that conclusion.

[43] The dissent does not explain or even acknowledge the differences between inferior and principal officers. Nor does it recognize that inferior officers are subordinates who are still considered officers even when a superior officer directs their actions or makes final decisions.

III. CONCLUSION

SEC ALJs "are more than mere aids" to the agency. *Samuels*, 930 F.2d at 986. They "perform more than ministerial tasks." *Freytag*, 501 U.S. at 881. The governing statutes and regulations give them duties comparable to the STJs' duties described in *Freytag*. SEC ALJs carry out "important functions," *id.* at 882, and "exercis[e] significant authority pursuant to the laws of the United States," *Buckley*, 424 U.S. at 126. The SEC's power to review its ALJs does not transform them into lesser functionaries. Rather, it shows the ALJs are inferior officers subordinate to the SEC commissioners. *Edmond*, 520 U.S. at 663.

The SEC ALJ held his office unconstitutionally when he presided over Mr. Bandimere's hearing. We grant the petition for review and set aside the SEC's opinion.

No. 15-9586, Bandimere v. SEC

BRISCOE, Circuit Judge, concurring.

I write not to differ with the rationale of the majority opinion, but rather to fully join it. My focus here is on the dissent. I group my concerns in two categories: (I) the dissent's predictions about speculative "repercussions" of the opinion, by which it reaches what appear to be several erroneous conclusions; and (II) its application of a truncated legal framework to a misstated version of the facts of record.

I

Underlying the dissent's position is a concern about the next case, and the one after that. The dissent suggests that a "probable consequence[]" of the opinion is that "all" 1,792 "federal ALJs are at risk of being declared inferior Officers." Dissent at 11 & n.5. But this was no less true when Freytag v. Commissioner of Internal Revenue was decided. 501 U.S. 868 (1991). A "risk" always exists that a court will be called on to decide whether *any* particular federal employee or group of employees has been delegated sufficient authority to fall within the ambit of the Appointments Clause, U.S. Const. art. II, § 2, cl. 2, the Constitution's structural safeguard tethering key personnel—Officers—to the sovereign power of the United States, and thus to the people. Answering that question in the affirmative as to the SEC's five ALJs does no "mischief" to bedrock principles of constitutional law. Dissent at 16.

Further, the majority has not affected "thousands of administrative actions," id. at 11, by answering that question. Freytag instead commands that courts engage in a case-by-case analysis. 501 U.S. at 880–82. Specifically, a court must determine whether a federal employee (or class of employees) is subject to the Appointments Clause by

answering whether the employee exercises "significant authority pursuant to the laws of the United States," and, in turn, by analyzing the aggregate "duties and functions" the employee performs or is authorized to perform. Id. at 881 (quotation marks and citations omitted). That power sometimes comes in the form of final decision-making authority, id. at 882; other times, not. Id. at 881–82. The majority merely and correctly applies Freytag's test to answer that question as to the SEC's five ALJs.

Relatedly, the dissent errs when it suggests that the majority is operating without "much precedent." Dissent at 16. The majority simply applies Freytag's framework, as all lower courts must do. In truth, the dissent takes issue with and devotes much of its analysis to suggesting that the majority ought to follow the D.C. Circuit's *misapplication* of Freytag wrought in Landry v. FDIC, 204 F.3d 1125 (D.C. Cir. 2000), and bolstered by Raymond J. Lucia Cos., Inc. v. Securities and Exchange Commission, 832 F.3d 277 (D.C. Cir. 2016). The critical difference between the majority and Landry and Lucia is that the majority recognizes that Freytag does *not* make final decision-making authority the *sine qua non* of inferior Officer status. 501 U.S. at 881–82.

The D.C. Circuit erroneously suggested as much in Landry when it said, over Judge Randolph's contrary view, that the Freytag Court saw final decision-making authority as "exceptional[ly]" important and "critical" to determining Officer status. 204 F.3d at 1134. And Lucia compounded that error when it acknowledged that the parties identified (as here) other powers the SEC's ALJs exercise but then narrowed its analysis to and rested its holding entirely on whether those ALJs can issue final decisions for the SEC. See 832 F.3d at 285 (acknowledging that "the parties principally," not only, "disagree[d] about whether" the SEC's "ALJs issue final decisions of the" SEC and explaining that the

court's "analysis begins, and ends," with that question); id. at 285–89 (analyzing only whether the SEC's ALJs can render final decisions). The majority applies precedent: Freytag, not Landry or Lucia.

The dissent also contends that the majority's opinion "will be used to strip all ALJs of their dual layer for-cause protection." Dissent at 14. This troubling statement calls for a response because the dissent essentially predetermines the holdings of hypothetical cases not before this court.

In some future case, a litigant may argue that all ALJs are inferior Officers. But as the majority here explains—and Freytag commands—whether a particular federal employee or class of employees are Officers subject to the Appointments Clause requires a position-by-position analysis of the authority Congress by law and a particular executive agency by rule and practice has delegated to its personnel. 501 U.S. at 881–82. Some ALJs within particular agencies may exercise so little authority and also be subject to such complete oversight (e.g., unlike here, de novo review) that they are not Officers. The majority rightly does not attempt to answer whether each ALJ in every federal agency is an Officer because Freytag disclaims such sweeping pronouncements, id., and, in any event, it is not necessary to do so to resolve Mr. Bandimere's appeal.

The dissent also does not stop after incorrectly stating that the majority has addressed an issue not before us. It instead goes on to suggest that the majority's non-answer to an unasked question may lead to the implosion of the federal civil service, at least as to all federal ALJs. But the dissent is wrong as to the outcome of such a hypothetical future case. And in suggesting that this outcome follows from the majority's opinion, the dissent unnecessarily sounds alarms which demand rejoinder.

Specifically, the dissent worries that the consequence of the majority's opinion is that all federal ALJs are inferior Officers, that all federal ALJs are thus afforded the double-for-good-cause-removal protection forbidden by Free Enterprise Fund v. PCAOB, 561 U.S. 477 (2010), and that, as a result, all federal ALJs will lose their civil service protections. Warning of the dangers of such a conclusion, the dissent suggests that the Social Security Administration will be impaired when its 1,537 ALJs lose their civil service protections. But there are at least two errors in the dissent's speculation about facts not before this court.

First, it may well be that within the Social Security Administration ALJs are removable in a manner that does not run afoul of Free Enterprise Fund. For example, if the person or persons responsible for firing those ALJs are not afforded good-cause removal protections, then the Administration's ALJs will retain their civil service protections even if they are inferior Officers. The dissent cannot say for certain whether this is so, because we have no briefing on the subject in this case, which deals only with the SEC.

Second, even assuming that *all* federal ALJs are Officers who are removable only for good cause and that they are *all* selected by Officers who are also removable only for good cause, the dissent knocks down a straw man by suggesting that Free Enterprise Fund might require stripping all ALJs of their civil service protections. Rather, as Free Enterprise Fund reminds us, courts normally are required to afford the *minimum* relief necessary to bring administrative overreach in line with the Constitution:

> Generally speaking, when confronting a constitutional flaw in a statute, we try to limit the solution to the problem, severing any problematic portions while leaving the remainder intact. Because the unconstitutionality of a part of an Act does not necessarily defeat or affect the validity of its remaining

> provisions, the normal rule is that partial, rather than facial, invalidation is the required course. . . . Concluding that the removal restrictions are invalid leaves [an Officer] removable . . . at will, and leaves the President separated from [the Officer] by only a single level of good-cause tenure.

Id. at 508–09 (quotation marks, alterations, and citations omitted).

The D.C. Circuit just recently employed this principle in PHH Corp. v. Consumer Financial Protection Bureau, 839 F.3d 1 (D.C. Cir. 2016). There, the court held, *inter alia*, that the Consumer Financial Protection Bureau (CFPB) was so structured as to violate Article II because it was headed by a single director who was removable only for good cause. Id. at 12–39. But the remedy for this unconstitutional structure was not—as the petitioners had urged—the abrogation of the CFPB. Id. at 37. Applying Free Enterprise Fund and other Supreme Court precedents, the D.C. Circuit instead struck the single offending clause from the CFPB's implementing legislation and rendered the director removable by the President at will, rather than for good cause. Id. at 37–39.

Thus, contrary to the dissent's suggestions, the majority's opinion portends no change to any ALJ's robust protections. The dissent states that all *1,792* federal ALJs are removable only by the United States Merit Systems Protect Board (MSPB), "and only for good cause." Dissent at 14. Assuming *arguendo* that is always correct, see 5 U.S.C. § 7521, cursory research on this un-briefed issue reveals that the MSPB is composed of *three* members, each of whom are appointed directly by the President but removable only for good cause. 5 C.F.R. § 1200.2. So even if this court were faced with the hypothetical future case that troubles the dissent, there is no cause for alarm that the administrative state will be eroded (and of course, that is of no import to whether the government is following Article II). See Free Enterprise Fund, 561 U.S. at 499. A court faced with such a challenge would be empowered only to order the minimal remedy effective to cure the

Article II error, id. at 508–10: rendering the MSPB's three members removable by the President at will. While the dissent opines on the hypothetical consequences of the majority's opinion, today's decision will have *none* of the consequences to the nationwide civil service that the dissent predicts.

Additionally, the dissent is incorrect when it argues that the majority is not showing appropriate "deference to Congress," Dissent at 16, on this structural constitutional question, as when it states: "Whether federal ALJs should receive such dual for-cause protections is perhaps a question that could be debated, but Congress has already decided this question in favor of protecting ALJs . . . ." Id. at 14 n.8. Freytag rejected this exact argument and recognized that "[t]he structural interests protected by the Appointments Clause are not those of any one branch of Government but of the entire Republic." 501 U.S. at 880. With respect to removal specifically, even if Congress sought to insulate all federal ALJs from Executive control by placing them behind double layers of good-cause removal protection, Free Enterprise Fund holds that a court would be obliged to afford that decision *no* deference and instead to strike the unsound architecture. 561 U.S. at 497.

In any event, the dissent's dire predictions about hypothetical consequences of the majority's holding are exaggerated.

II

Turning to the dissent's proposal for deciding this case on the facts here, the dissent appears to *sub silentio* urge this court to adopt Landry and Lucia's misstatement of Freytag's test for determining whether a federal employee is an inferior Officer. That is, the dissent focuses almost exclusively on whether the SEC's ALJs exercise final decision-making authority, calling it the "[m]ost important[]" consideration that "makes all the

difference" in deciding whether the ALJs are Officers. Dissent at 1 (citing, *inter alia*, Lucia, 832 F.3d at 285–87); see id. at 6 n.2 (arguing that "[d]elegated sovereign authority has long been understood to be a key characteristic of a federal 'office'"); id. at 7–8 (contending, absent citation to authority, that this question "is not about" the SEC's delegation to its ALJs of "day-to-day discretion" because "the Appointments Clause does not care about *that*").

But as the majority points out, this mode of analysis—and the D.C. Circuit's repeated application of it—is wrong. Freytag instead compels courts, as the majority does here, to examine all of the "duties and functions" a federal employee has been delegated and then to determine whether that person is exercising the authority of the United States (an Officer) or simply carrying out "ministerial" government tasks (an employee). 501 U.S. at 881–82. Here, the distinction is exemplified by whether the government employee in question was engaged in the ministerial task of transcribing the record at Mr. Bandimere's hearing or was the person who decided on behalf of the United States that his testimony there was not believable and in what respects, critical issues to determining whether he ought to incur civil penalties. See id.

Likewise, final decision-making authority is but one sovereign power, albeit an important one that is typically *sufficient* to render an employee an Officer. See, e.g., id. at 882. Though final decision-making authority might be *sufficient* to make an employee an Officer, that does not mean such authority is *necessary* for an employee to be an Officer, contrary to the dissent's suggestion and Lucia's holding—by its refusal to consider any of the SEC's ALJs' other duties and functions. 832 F.3d at 285. Conducting the correct, nuanced analysis of the powers Congress by statute and the SEC by rule and practice have afforded its ALJs, the majority correctly reasons that the SEC's ALJs exercise significant

authority and are thus inferior Officers, subject to the Appointments Clause. The dissent therefore errs—as do Landry and Lucia—by applying a truncated version of Freytag's legal framework.

Further, even as to its analysis of the SEC's ALJs' decision-making authority, the dissent mischaracterizes the factual record in a manner that it is imperative to correct. Specifically, the dissent states and then repeatedly relies on the fact that the SEC is not required to afford its ALJs any deference and that it conducts de novo review of their decisions to conclude that the ALJs do not "have the sovereign power to bind the Government and third parties." Dissent at 1. The dissent also calls this a "difference that makes all the difference" between the SEC's ALJs and "the special trial judges at issue in" Freytag. Id.

The dissent additionally states that "even where special trial judges" in Freytag "could not enter binding decisions, their initial decisions had binding effect" because the Tax Court was "*required* to presume correct" their "factual findings, including findings of intent, and to defer to [a] special trial judge's determinations of credibility." Id. at 2 (citations omitted). The dissent is undoubtedly correct that "[s]uch deference was a delegation of significant authority to the special trial judges." Id. As the dissent goes on to explain, "[m]any cases before the Tax Court . . . involve critical credibility assessments, rendering the appraisals of the special trial judge who presided at trial vital to the Tax Court's ultimate determination. And . . . findings of fact often conclusively decide tax litigation, as they did in" Freytag. Id. at 2–3(quotation marks, alteration, and citation omitted). The dissent is also correct that, "it cannot be reasonably disputed that findings of fact 'may well be determinative of guilt or innocence.'" Id. (quoting Napue v. Illinois,

360 U.S. 264, 269 (1959)). Indeed, as Napue emphasized, assessing the "truthfulness and reliability of a given witness" during live testimony is one such critical factual determination. 360 U.S. at 269.

The dissent rightly points out that if an agency deferred to its personnel on such critical issues, "the Appointments Clause would be offended." Dissent at 5 n.1. But the dissent then applies these statements in an attempt to distinguish the special trial judges imbued with that authority from the SEC's ALJs: "The Securities and Exchange Commission, by contrast, is not required to give its ALJs any deference" and "may review its ALJs' conclusions of law and findings of fact de novo." Id. at 6. At the same time, however, the dissent admits that the "SEC may sometimes defer to the credibility determinations of its ALJs." Id. at 7 n.3. And the dissent does not attempt to reconcile that concession with its earlier-stated admission that credibility assessments may be outcome determinative. Lucia relied in part on this same distinction. 832 F.3d at 286 (stating that the SEC conducts "*de novo* review" of its ALJs' decisions); id. at 288 (stating that the SEC "reviews an ALJ's decisions *de novo*," but acknowledging that the SEC "may sometimes defer to the credibility determinations of its ALJs," and citing Landry, 204 F.3d at 1133, and the SEC's own regulations and orders sanctioning this practice).

This characterization of the SEC's actual process of reviewing its ALJs' decisions is wrong, notwithstanding its attempt to characterize its review as "de novo." David F. Bandimere, SEC Release No. 9972, 2015 WL 6575665, at *20 (Oct. 29, 2015). In footnotes 83 and 114 of its opinion in Mr. Bandimere's case, the SEC reveals the full effect of affording its ALJs the very deference that the dissent explains runs afoul of the Appointments Clause. Id. at *15 n.83, *20 n.114. Specifically, the SEC determined that

Mr. Bandimere's "falsely telling [Mr.] Loebe that excess profits would go to a Christian charity rather than to pay him [was] evidence of [his] intent to deceive." Id. at *15. In making that determination, the SEC explained that Mr. "Bandimere testified that he did not remember making this statement to [Mr.] Loebe, but the ALJ found [Mr.] Loebe's testimony more credible than [Mr.] Bandimere's as to this issue." Id. at *15 n.83. Then, instead of rendering its own credibility determination with respect to the conflicting testimony, the SEC applied its rule that "[a]n ALJ's credibility findings are entitled to considerable weight." Id. (citations omitted). The SEC thus engages in deferential, not de novo review of key aspects of its ALJs' decisions.

The SEC admitted as much when it addressed Mr. Bandimere's Appointments Clause challenge. It professed to review its "ALJs' decisions de novo." Id. at *20. The dissent simply takes the SEC at its word. Yet the SEC added the following caveat to that statement: "We do not view the fact that we accord Commission ALJs deference in the context of demeanor-based credibility determinations to afford our ALJs with the type of authority that would qualify them as inferior officers." Id. at *20 n.114. The SEC attempted to shore up its conclusion on this Article II question with the disclaimer that it "will disregard explicit determinations of credibility when [its] de novo review of the record as a whole convinces [it] that a witness's testimony is credible (or not) or that the weight of the evidence warrants a different finding as to the ultimate facts at issue." Id. (quotation marks and citations omitted).

But that proviso is cold comfort to a defendant, like Mr. Bandimere, whose liability for massive civil penalties depends in no small part on the United States's assessment of his credibility during live testimony, credibility determined by the only government

employee designated to preside over that testimony—an ALJ. And whatever the SEC means by its disclaimer, it does not equate to de novo review. Rather, whether the SEC disagrees with its ALJs' credibility determinations triggers its own rule that an ALJ's evaluation of a witness's live testimony is entitled to "considerable weight." Id. at *15 n.83. Thus, at minimum, the SEC's ALJs exercise significant discretion over issues of credibility, unchecked by faux "de novo" review.

As the dissent concedes, affording bureaucrats such deference permits them to exercise the sovereign authority of the United States in an often-outcome-determinative fashion that is incompatible with the Appointments Clause. Therefore, even under the dissent's (and Lucia's) truncated Freytag analysis, the majority correctly holds that the SEC's ALJs are inferior Officers.

15-9586, Bandimere v. SEC

McKAY, Circuit Judge, dissenting

Notwithstanding the majority's protestations otherwise, today's opinion carries repercussions that will throw out of balance the teeter-totter approach to determining which of all the federal officials are subject to the Appointments Clause. While the Supreme Court perhaps opened the door to such an approach in *Freytag v. Commissioner*, 501 U.S. 868 (1991), I would not throw it open any further, but in my view that is exactly what the majority has done. I do not believe *Freytag* mandates the result proposed here, and the probable consequences are too troublesome to risk without a clear mandate from the Supreme Court. I respectfully dissent.

The majority compares SEC ALJs to the Tax Court's special trial judges, and it reasons that because the duties of an ALJ are enough like those of a special trial judge, ALJs must be "Officers" too. But the similarities between *Freytag* and this case matter far less than the differences. Most importantly, the special trial judges at issue in *Freytag* had the sovereign power to bind the Government and third parties. SEC ALJs do not. And under the Appointments Clause, that difference makes all the difference. *See Officers of the United States Within the Meaning of the Appointments Clause*, 31 Op. O.L.C. 73, 73–74 (2007); *Raymond J. Lucia Companies v. SEC*, 832 F.3d 277, 285–87 (D.C. Cir. 2016).

The requirements of the Appointments Clause are "designed to preserve political accountability relative to important Government assignments." *Edmond v. United States*, 520 U.S. 651, 663 (1997). It ensures that members of the executive branch cannot

"escape responsibility" for significant decisions by hiding behind unappointed officials or otherwise "pretending that" those decisions "are not [their] own." *Free Enter. Fund v. Public Co. Accounting Oversight Bd.*, 561 U.S. 477, 497 (2010). Such government officials— "those who exercise the power of the United States" —must be "accountable to the President, who himself is accountable to the people." *Dep't of Transp. v. Ass'n of Am. R.Rs.*, 135 S. Ct. 1225, 1238 (2015) (Alito, J., concurring).

It is not surprising, then, that the Tax Court's special trial judges were held to be officers in *Freytag*. 501 U.S. at 881–82. It is clear from the context, if not the *Freytag* opinion, that these special trial judges had been delegated significant authority—much more authority than SEC ALJs. In some cases, special trial judges could enter final decisions on behalf of the Tax Court. *Freytag*, 501 U.S. at 882. In those cases, it was conceded in *Freytag* that the special trial judges acted as inferior officers. *Id.* But even where special trial judges could not enter final decisions, their initial decisions had binding effect.

Where the special trial judges did not issue a final decision, the Tax Court was still *required* to presume correct the special trial judge's factual findings, including findings of intent, and to defer to the special trial judge's determinations of credibility. *See Landry v. FDIC*, 204 F.3d 1125, 1133 (D.C. Cir. 2000). Such deference was a delegation of significant authority to the special trial court judges. Many cases before the Tax Court, including the ones at issue in *Freytag*, "involve critical credibility assessments, rendering the appraisals of the [special trial] judge who presided at trial vital to the Tax Court's ultimate determinations." *Ballard v. Comm'r*, 544 U.S. 40, 60 (2005). In

Ballard, for example, "[t]he Tax Court's decision repeatedly [drew] outcome-influencing conclusions regarding the credibility of Ballard . . . and several other witnesses." *Id.* And as the *Freytag* petitioners argued, "[f]indings of fact often conclusively decide tax litigation, as they did in [that] case. Pet'rs' Br. at 23, *Freytag v. Comm'r*, 501 U.S. 868 (1991) (No. 90-762), 1991 WL 11007938. Thus, even when the special trial judge was not authorized to enter a final decision, his initial report often decided the case. The majority says this overstates the role of special trial judges, but it cannot be reasonably disputed that findings of fact "may well be determinative of guilt or innocence." *Napue v. Illinois*, 360 U.S. 264, 269 (1959).

The majority barely mentions that 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. But the powers of the special trial judges must be understood in context. As *Freytag* illustrates, a special trial judge's initial decision is not like an ALJ's—it is the difference between chiseling in stone and drafting in pencil.

The majority also fails to appreciate that the Tax Court appeared to defer to its special trial judges on conclusions of law as well. But this point was squarely before the Supreme Court. As the *Freytag* petitioners argued, "[i]n practice, special trial judge factual findings and legal opinions are routinely adopted verbatim by the regular Tax Court judges to whom they are assigned." Brief for Petitioner, *supra*, at 7. Between 1983 and 1991, when *Freytag* was decided, every initial report submitted by a special trial judge was purportedly adopted verbatim—a fact made known to the *Freytag* Court. *See* Pet'rs' Br., *supra*, at 6–10.

Every reported decision, including the Tax Court's decision in *Freytag*, "invariably beg[an] with a stock statement that the Tax Court judge 'agrees with and adopts the opinion of the special trial judge.'" *Ballard*, 544 U.S. at 46 (citation omitted) (original brackets omitted); *see, e.g., Freytag v. Comm'r*, 89 T.C. 849, 849 (1987) ("The Court agrees with and adopts the opinion of the Special Trial Judge that is set forth below."). Following that disclaimer was an opinion issued in the name of the special trial judge.

Freytag thus illustrates another point that the majority misses: the Tax Court may not have even reviewed the supposedly nonfinal decisions of its special trial judges. As the *Freytag* petitioners argued before the Supreme Court, that case was "a perfect example of how special trial judges routinely do the Tax Court's work with only the most cursory supervision, if any." Pet'rs' Br., *supra*, at 23. There, "after one of the longest trials in Tax Court history," which involved "14 weeks of complex financial testimony spanning two years of trial" and which produced "9,000 pages of transcript and . . . 3,000 exhibits," the Tax Court purported to adopt the special trial judge's report—verbatim—and filed it as the Tax Court's decision on the very same day it received the report. *Id.* at 23, 9. As the *Freytag* petitioners argued to the Supreme Court, "[t]he special trial judge's filing of his report and its verbatim adoption by [Tax Court] Chief Judge Sterrett appear from the record to have been virtually simultaneous." *Id.* at 8. That decision resolved several unsettled, important legal questions. Yet, according to the docket, the Tax Court

judge filed the decision as his own on the same day that the special trial judge filed his proposed findings and opinions. *See id.*[1]

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[1] The majority's emphasis on *Ballard* is misplaced; that case has little to do with the question before us. In *Ballard*, a case decided 14 years after *Freytag*, the government averred that a Tax Court special trial judge's report was treated as an "in-house draft to be worked over collaboratively by the regular [Tax Court] judge and the special trial judge." *See* 544 U.S. 40, 57. The majority puts this averment forward as fact, but the *Ballard* Court "[did] not know what happened in the Tax Court, a point that is important to underscore here." *Ballard*, 544 U.S. at 67 (Kennedy, J., concurring). Indeed, the Court could not have known: the special trial judges' initial reports were not disclosed even to the Supreme Court. As the concurring opinion clarified, *Ballard* should be interpreted "as indicating that there might be such a practice, not that there is." *Id.* The majority ignores this. The majority also fails to explain why *Ballard* should color an interpretation of *Freytag* when the purported practice had not yet been disclosed, let alone put in front of the *Freytag* Court.

The majority next states that there is "no indication" the Tax Court judge in *Freytag* adopted the STJ's report "verbatim"—but the Tax Court judge purported to do just that. *Freytag*, 89 T.C. at 849. Indeed, "[i]n the 880 cases heard between . . . 1983 and . . . 2005, there appear to be no instances in which a special trial judge issued a report and recommendation that the Tax Court publicly modified or rejected." Christopher M. Pietruszkiewicz, *Conflating Standards of Review in the Tax Court: A Lesson in Ambiguity*, 44 Houston L. Rev. 1337, 1360 (2008). What's more, after *Ballard* was decided, the Tax Court tried to make good by releasing the undisclosed reports from every case heard initially by a special trial judge since 1983. Louise Story, *Tax Court Lifts Secrecy, Putting Some Cases in New Light*, N.Y. Times, Sept. 24, 2005, at C6. It could find initial reports in only 117 of the 923 cases. *Id.* Of those 117 cases, the Tax Court modified the special trial judges' recommendations only 4 times. *Id.* Such figures demonstrate the level of deference afforded to special trial judges.

Following its lengthy discussion of the Tax Court's purported collaborative practice, the majority says "[w]hat really counts . . . are the STJs features the Supreme Court relied on" in *Freytag*. Maj. Op. at 35. But *Freytag* did not "rely" on this purported practice—indeed; it had not yet been disclosed by the Tax Court. Taking the majority at its word, its own reliance on *Ballard* seems out of place. Instead, we should look to what was actually before the *Freytag* Court.

In any event, whether the Tax Court in practice deferred to the special trial judges on both facts and law, or whether it directed the outcome of a case while escaping responsibility by disclaiming the decision is a distinction without a difference. Either way, the Appointments Clause would be offended.

The *Freytag* petitioners' point was that special trial judges had as much authority as Tax Court judges themselves. The petitioners referred to them as "full-fledged surrogates for the Tax Court judges," who "exercise virtually the same powers as presidentially-appointed Tax Court judges." *Id.* at 12, 27. The Supreme Court, then, was thoroughly briefed on the true power of the special trial judges: In some cases, special trial judges could enter final decisions on behalf of the Tax Court. In others, special trial judges had, by rule, near-final say on outcome-determinative facts. And in practice they had de facto power "to issue findings and opinions that may be adopted verbatim by the Tax Court without meaningful review even in the most complex, significant and far-reaching cases, as they were [in *Freytag*]." *Id.* at 27. Thus, the special trial judges exercised "significant authority pursuant to the laws of the United States." *Freytag*, 501 U.S. at 881 (quoting *Buckley v. Valeo*, 424 U.S. 1, 126 (1976)).[2]

The majority says that "SEC ALJs closely resemble the STJs described in *Freytag*." Maj. Op. at 21. But that is simply not the case. The Securities and Exchange Commission, by contrast, is not required to give its ALJs any deference. The Commission may review its ALJs' conclusions of law and findings of fact de novo. 17 C.F.R. § 201.411(a). It employs ALJs in its discretion, and all final agency orders are those of the Commission, not of its ALJs. An ALJ serving as a hearing officer prepares

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[2] Put another way, the special trial judges had been delegated a portion of the sovereign powers of the federal government; they could act on behalf of the Tax Court, and they had the power to bind third parties and the government itself. *See Lucia*, 832 F.3d at 285. Delegated sovereign authority has long been understood to be a key characteristic of a federal "office." *See* 31 Op. O.L.C. 73 (reviewing historical precedents leading up to *Buckley*). And it is delegated sovereignty that is lacking here.

only an "initial decision." *Id.* § 201.360(a)(1). And at any time during the administrative process, the Commission may "direct that any matter be submitted to it for review." *Id.* § 201.400(a). The Commission thus "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." Mendenhall, Exchange Act Release No. 74532, 2015 WL 1247374, at *1 (Mar. 19, 2015).[3]

On appeal, the Commission is not limited by the record before it. It "may expand the record by hearing additional evidence" itself or it may "remand for further proceedings." Bandimere, SEC Release No. 9972, 2015 WL 6575665 (Oct. 29, 2015) (internal quotation marks and brackets omitted). The Commission "may affirm, reverse, modify, set aside" the initial decision or remand, "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." 17 C.F.R. § 201.411(a). If "a majority of participating Commissioners do not agree to a disposition on the merits, the initial decision shall be of no effect." *Id.* § 201.411(f).

The majority says that, like special trial judges, SEC ALJs also "exercise significant discretion." Maj. Op. at 19. But again the majority misses the point. It is not

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[3] It is true, as the majority points out, that the Commission may sometimes defer to the credibility determinations of its ALJs. But because the Commission has retained plenary authority over its ALJs, it is "not required to adopt the credibility determinations of an ALJ." *Lucia*, 832 F.3d at 288 (citation omitted). By contrast, the Tax Court was *required* to defer to its special trial judges. In my estimate, this power to bind the government is, in large part, what separates "purely recommendatory power" from "significant authority," and ALJs from special trial judges.

about day-to-day discretion—the Appointments Clause does not care about *that*. Special trial judges "exercise[d] significant discretion" in setting the record because the Tax Court was required to defer to its special trial judges' findings. We say, for example, that a "district court has significant discretion in sentencing" because we "review for abuse of discretion." *United States v. Tindall*, 519 F.3d 1057, 1065 (10th Cir. 2008); *see also, e.g.*, *Murphy v. Deloitte & Touche Grp. Ins. Plan*, 619 F.3d 1151, 1164 (10th Cir. 2010) (recognizing that a district court has "substantial discretion in handling discovery requests," because our standard of review is highly deferential). Similarly, a special trial judge had "significant discretion" because the Tax Court had to review its findings equally deferentially. The Commission, by contrast, does not have to review its ALJ's opinions with any deference. An SEC ALJ, thus, does not exercise "significant discretion" in any meaningful way.

SEC ALJs, then, possess only a "purely recommendatory power," *Landry*, 204 F.3d at 1132, which separates them from constitutional officers. The Supreme Court has suggested as much. *See Free Enter. Fund*, 561 U.S. at 507. In *Free Enterprise Fund*, the Court explained that its holding "does not address that subset of independent agency employees who serve as administrative law judges" and that "unlike members of the [Public Company Accounting Oversight] Board," who *were* officers, "many administrative law judges . . . perform adjudicative rather than enforcement or policymaking functions, or possess purely recommendatory powers." *Id.* at 507 n.10 (citation omitted).

The results speak for themselves: Unlike the Tax Court, which purported to adopt its special tax judges' opinions verbatim in 880 out of 880 cases between 1983 and 2005, the Commission followed its ALJs' recommendations in their entirety in only 3 of the 13 appeals decided thus far in 2016.[4] In the other 10 cases, the Commission disagreed with its ALJs for various reasons: In one case, the Commission reversed its ALJ because the SEC Enforcement Division failed to meet its burden; in another, it held that civil penalties, which the ALJ had recommended, were not available due to the statute of limitations.

In the end, then, it is the Commission that "ultimately controls the record for review and decides what is in the record." *Lucia,* 832 F.3d at 288 (citation omitted); *see also Nash v. Bowen*, 869 F.2d 675, 680 (2d Cir. 1989) (recognizing that, under 5 U.S.C. § 557(b), the agency "retains 'all the powers which it would have in making the initial decision'"). It is the Commission that enters the final order—in all cases—and it is the commissioners who shoulder the blame.

The majority argues that the current process for selecting ALJs "does not lend itself to . . . accountability," Maj. Op. at 23, but it is quite clear where the buck stops.

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4 *See* Grossman, Release No. 10227, 2016 WL 5571616 (Sept. 30, 2016); Schalk, Release No. 10219, 2016 WL 5219501 (Sept. 21, 2016); Cohen, Release No. 10205, 2016 WL 4727517 (Sept. 9, 2016); optionsXpress, Inc., Release No. 10125, 2016 WL 4413227 (Aug. 18, 2016); Gonnella, Release No. 10119, 2016 WL 4233837 (Aug. 10, 2016); Aesoph, Release No. 78490, 2016 WL 4176930 (Aug. 5, 2016); Malouf, Release No. 10115, 2016 WL 4035575 (July 27, 2016); J.S. Oliver Capital Management, L.P., Release No. 10100, 2016 WL 3361166 (June 17, 2016); Riad, Release No. 78049, 2016 WL 3226836 (June 13, 2016); Page, Release No. 4400, 2016 WL 3030845 (May 27, 2016); Doxey, Release No. 10077, 2016 WL 2593988 (May 5, 2016); Young, Release No. 10060, 2016 WL 1168564 (March 24, 2016); Wulf, Release No. 77411, 2016 WL 1085661 (Mar. 21, 2016).

Because the Commission is not bound in any way by its ALJ's decisions, unlike the Tax Court, the blame for its unpopular decisions will fall squarely on the commissioners and, in turn, the president who appointed them. So long as the commissioners have been validly appointed, the Appointments Clause is satisfied.

Putting aside that the Commission is not bound—in any way—by an ALJ's recommendations, amici's attempt to analogize SEC ALJs to magistrate judges only serves to highlight the difference between ALJs and constitutional officers. Unlike ALJs, magistrate judges have been delegated sovereign authority and have the power to bind the government and third parties. Magistrate judges are authorized to issue arrest warrants, 18 U.S.C. § 3041; determine pretrial detention, *id.* §§ 3141, 3142; detain a material witness, *id.* § 3144; enter a sentence for a petty offense, without the consent of the United States or the defendant, 28 U.S.C. § 636(a)(4); and issue final judgments in misdemeanor cases and all civil cases with the consent of the parties, *id.* §636(a)(5), (c); 18 U.S.C. §3401. Magistrate judges may also impose sanctions for contempt. 28 U.S.C. § 636(e). SEC ALJs can do none of these things.

The majority's reliance on Supreme Court decisions from the nineteenth century and early twentieth century is equally problematic. The majority's casual citation to these cases might lead one to believe there is a body of caselaw to which we can analogize. But these decisions "often employed circular logic, granting officer status to an official based in part upon his appointment by the head of a department." *Landry*, 204 F.3d at 1132–33. For example, *United States v. Mouat*, 124 U.S. 303 (1888), cited by the majority, held that "[u]nless a person . . . holds his place by virtue of an appointment by

the President, or of one of the courts of justice or heads of Departments authorized by law to make such an appointment, he is not, strictly speaking, an officer of the United States." *Id.* at 307; *see also Free Ent. Fund*, 561 U.S. at 539 (Breyer, J., dissenting) (quoting commentary that described "early precedent as 'circular' and [the Court's] later law as 'not particularly useful'").

Finally, I began this dissent by expressing my fears of the probable consequences of today's decision. It does more than allow malefactors who have abused the financial system to escape responsibility. Under the majority's reading of *Freytag*, all federal ALJs are at risk of being declared inferior officers. Despite the majority's protestations, its holding is quite sweeping, and I worry that it has effectively rendered invalid thousands of administrative actions. Today's judgment is a quantitative one—it does not tell us how much authority is too much. It lists the duties of SEC ALJs, without telling us which, if any, were more important to its decision than others and why. And I worry that this approach, and the end result, leaves us with more questions than it answers.

Are all federal ALJs constitutional officers? Take, for example, the 1,537 Social Security Administration (SSA) ALJs,[5] who collectively handle hundreds of thousands of hearings a year.[6] SSA ALJs, like SEC ALJs, are civil service employees in the "competitive service" system. 5 C.F.R. § 930.201(b). In addition to presiding over

[5] *See* Office of Pers. Mgmt., *ALJs by Agency*, https://www.opm.gov/services-for-agencies/administrative-law-judges/#url=ALJs-by-Agency (last visited Oct. 31, 2016). According to the Office of Personnel Management's latest count, there are 1,792 total federal administrative law judges. *Id.*

[6] *See* SSA, *Annual Performance Report 2014-2016*, Table 3.1h, at 82, available at http://www.ssa.gov/agency/performance/2016/FINAL_2014_2016_APR_508_compliant.pdf.

sanctions actions, which are adversarial, *see* 20 C.F.R. § 404.459, SSA ALJs conduct nonadversarial hearings to review benefits decisions, *see id.* §§ 404.900, 405.1(c), 416.1400. In these proceedings, the claimant may appear, submit evidence, and present and question witnesses. *Id.* §§ 404.929, 404.935, 416.1429, 416.1435. Like SEC ALJs, SSA ALJs "regulate the course of the hearing and the conduct of representatives, parties, and witnesses." *Id.* § 498.204(b)(8). Like SEC ALJs, SSA ALJs administer oaths and affirmations, *see id.* § 404.950, and examine witnesses, *id.* § 498.204(b)(9). Like SEC ALJs, SSA ALJs may receive, exclude, or limit evidence. *Id.* § 498.204(b)(10).

If a claimant is dissatisfied with an SSA ALJ's decision, he may seek the SSA's Appeals Council's review. The Appeals Council may then deny or dismiss the request for review or grant it. *Id.* §§ 404.967, 416.1467. Like the Securities and Exchange Commission, the Appeals Council may also review an ALJ's decision on its own motion. *Id.* §§ 404.969(a), 416.1469(a). After it has reviewed all the evidence in the ALJ's hearing record and any additional evidence received, the Appeals Council will make a decision or remand the case to an ALJ. *Id.* §§ 404.977, 404.979, 416.1477, 416.1479. The Appeals Council may affirm, modify or reverse the ALJ's decision. *Id.* If no review is sought and the Appeals Council does not review the ALJ's decision on its own motion, the ALJ's decision becomes final. *See id.* §§ 404.955, 404.969, 416.1455, 416.1469.

This should all sound familiar. SSA ALJs have largely the same duties as SEC ALJs, and the appeals process appears similar as well. But the parallels between SEC ALJs and SSA ALJs do not end there. Like SEC ALJs, SSA ALJs can hold prehearing conferences, *id.* § 405.330; punish contemptuous conduct by excluding a person from a

hearing, *see* Social Security Administration Hearings, Appeals and Litigation Law Manual (HALLEX), I-2-6-60 (Jan. 15, 2016)[7]; rule on dispositive and procedural motions, 20 C.F.R. § 498.204(b); rule on sanctions, *see* HALLEX, I-2-10-16; and take depositions, *see* HALLEX, I-2-6-22. Like SEC ALJs, an SSA ALJ "may, on his or her own initiative or at the request of a party, issue subpoenas for the appearance and testimony of witnesses and for the production of books, records, correspondence, papers, or other documents that are material to an issue at the hearing." 20 C.F.R. § 404.950. Like SEC ALJs, though, SSA ALJs cannot enforce or seek enforcement of a subpoena; the SSA itself would have to get an order from a federal district court to compel compliance. *See* 42 U.S.C. § 405(e).

This is all to say that SEC ALJs are not unique. I cannot discern a meaningful difference between SEC ALJs and SSA ALJs under the majority's reading of *Freytag*. Indeed, litigants have already begun drawing this precise comparison between SEC ALJs and SSA ALJs. *See, e.g., Manbeck v. Colvin*, No. 15 CV 2132 (VB), 2016 WL 29631 (S.D.N.Y. Jan. 4, 2016). Insofar as SSA ALJs are not appointed by the president, a court of law, or the head of a department, *cf. O'Leary v. Office of Pers. Mgmt.*, No. DA-300A-12-0430-B-1, 2016 WL 3365404 (M.S.P.B. June 17, 2016), today's decision risks throwing much into confusion. "Does every losing party before an ALJ now have grounds to appeal on the basis that the decision entered against him is unconstitutional?" *Free Enter. Fund*, 561 U.S. at 543 (Breyer, J., dissenting). It certainly seems that way.

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7 Available at https://www.ssa.gov/OP_Home/hallex/hallex-I.html.

And what of the ALJs going forward? When understood in conjunction with *Free Enterprise Fund,* I worry today's opinion will be used to strip ALJs of their dual layer for-cause protection. In *Free Enterprise Fund,* the Supreme Court held that "dual for-cause limitations on the removal" of some inferior officers is unconstitutional. 561 U.S. at 492. Presently, SEC ALJs (and SSA ALJs) have such dual for-cause protection: An SEC ALJ may only be removed by the Merit Systems Protection Board and only for good cause. *See* 5 U.S.C. § 7521(a), (b). The members of the Merit Systems Protection Board are themselves protected from at-will removal. *Id.* at § 1202. I appreciate that this issue is not before the court, but today's decision makes it more likely that either ALJs or the Board, or both, will lose this civil service protection. *See Free Enter. Fund.*, 561 U.S. 477, 542, 525 (2010) (Breyer, J., dissenting).[8]

I am similarly concerned about what the majority's decision portends for untold rules and regulations. "Although almost all rulemaking is today accomplished through informal notice and comment, the APA actually contemplated a much more formal process for most rulemaking. To that end, it provided for elaborate trial-like hearings in which proponents of particular rules would introduce evidence and bear the burden of proof in support of those proposed rules." *Perez v. Mortg. Bankers Ass'n,* 135 S. Ct. 1199, 1222 n.5 (2015) (Thomas, J., concurring) (citing 5 U.S.C. § 556).

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[8] Whether federal ALJs should receive such dual for-cause protections is perhaps a question that could be debated, but Congress has already decided this question in favor of protecting ALJs, and the majority opinion shows little concern for the way its decision will overturn congressional intent and disrupt a system that has been in place for decades.

Formal rulemaking proceedings must be presided over by an agency official or an ALJ. An ALJ's function in formal rulemaking is nearly identical to its function in formal adjudications. *See* 5 U.S.C. §§ 556, 557. So, if ALJs are officers for purposes of formal adjudication, as the majority so holds, they must also be officers for formal rulemaking. *See also Freytag*, 501 U.S. at 882 ("Special trial judges are not inferior officers for purposes of some of their duties under § 7443A, but mere employees with respect to other responsibilities. . . . If a special trial judge is an inferior officer for purposes of subsections (b)(1), (2), and (3), he is an inferior officer within the meaning of the Appointments Clause and he must be properly appointed."). Though formal rulemaking is much rarer today, *see Perez* 135 S. Ct. at 1222 n.5, this was not always the case. And I worry that rules and regulations that were promulgated via formal rulemaking before an agency ALJ and are still enforced today are now constitutionally suspect.[9]

Today's holding risks throwing much into disarray. Since the Administrative Procedures Act created the position of administrative law judge in 1946, the federal government has employed thousands of ALJs to help with the day-to-day functioning of the administrative state. *Freytag*, which was decided 25 years ago, has never before been extended by a circuit court to any ALJ. And yet, the majority is resolved to create a

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[9] Some of these questions could, perhaps, be resolved by an explicit statement that the opinion does not apply retroactively. *See e.g., Buckley*, 424 U.S. at 142 (holding that the appointment of some Commissioners violated the Appointments Clause, but that the "past acts of the Commission are therefore accorded de facto validity," even though "[t]he issue [was] not before [the Court]." *Id.* at 744 (Burger, C.J., concurring in part and dissenting in part)). *But see* Maj. Op. 36 ("Questions about . . . retroactivity are not issues on appeal . . . . we must leave for another day any putative consequences of [our] conclusion.'").

circuit split. When there are competing understandings of Supreme Court precedent, I would prefer the outcome that does the least mischief.

Furthermore, faced with such uncertainty, "we must hesitate to upset the compromises and working arrangements that the elected branches of Government themselves have reached." *NLRB v. Noel Canning*, 134 S. Ct. 2550, 2560 (2014). Judicial review must fit the occasion. In a close case regarding the application of a constitutional rule in a discrete factual setting, and without much precedent to guide us, deference to Congress seems particularly relevant. I respectfully dissent.

FILED
United States Court of Appeals
Tenth Circuit

December 27, 2016

Elisabeth A. Shumaker
Clerk of Court

UNITED STATES COURT OF APPEALS

FOR THE TENTH CIRCUIT

DAVID F. BANDIMERE,

Petitioner,

v.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION,

Respondent.

IRONRIDGE GLOBAL IV, LTD; IRONRIDGE GLOBAL PARTNERS, LLC,

Amici Curiae.

No. 15-9586
(SEC No. 3-15124)
(Securities & Exchange Commission)

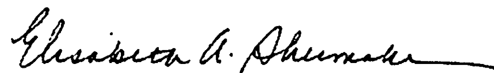
JUDGMENT

Before **BRISCOE**, **McKAY**, and **MATHESON**, Circuit Judges.

This petition for review originated from the United States Securities and Exchange Commission and was argued by counsel.

It is the judgment of this Court that the SEC ALJ held his office unconstitutionally when he presided over Mr. Bandimere's Hearing. The petition for review is granted and the SEC's opinion is set aside.

Entered for the Court



ELISABETH A. SHUMAKER, Clerk

CERTIFICATE OF COMPLIANCE

I certify that this petition complies with the type-volume limitation set forth in Federal Rule of Appellate Procedure 35(b)(2), because it contains 3,824 words, excluding the parts of the petition exempted by Federal Rule of Appellate Procedure 32(f) and 10th Circuit Rule 32(b). I also certify that this petition complies with the typeface and type-style requirements of Federal Rule of Appellate Procedure 32(a)(5) and (6) because it uses a proportionally-spaced, 14-point typeface.

/s/ Melissa N. Patterson
MELISSA N. PATTERSON

March 13, 2017

CERTIFICATE OF ELECTRONIC SUBMISSION

I certify that with respect to the foregoing petition:

(1) All required privacy redactions have been made under 10th Circuit Rule 25.5;

(2) The paper copies submitted to the Court are exact copies of the version submitted electronically; and

(3) The electronic submission has been scanned for viruses with the most recent version of a commercial virus scanning program, Symantec Endpoint Protection version 12.1.6, and according to the program is free of viruses.

/s/ Melissa N. Patterson
MELISSA N. PATTERSON

March 13, 2017

CERTIFICATE OF SERVICE

I hereby certify that on March 13, 2017, I electronically filed the foregoing petition with the Clerk of the Court for the United States Court of Appeals for the Tenth Circuit by using the CM/ECF system. Service on all parties was accomplished on the same date through the CM/ECF system.

I also certify that on the same date, I caused six copies of the foregoing to be delivered to the Clerk of Court via Federal Express.

/s/ Melissa N. Patterson
MELISSA N. PATTERSON