[INITIAL VERSION]

ORAL ARGUMENT NOT YET SCHEDULED
No. 15-1345

**UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT**

RAYMOND J. LUCIA COMPANIES, INC.,
AND RAYMOND J. LUCIA,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition For Review Of A Decision and Order
Of The Securities and Exchange Commission

OPENING BRIEF FOR PETITIONERS

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CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

Pursuant to Circuit Rule 28, Petitioners Raymond J. Lucia Companies, Inc. ("RJLC"), and Raymond J. Lucia ("Lucia," and collectively with RJLC, "petitioners"), respectfully submit this Certificate as to Parties, Rulings, and Related Cases:

A. Parties

The parties that appeared before the United States Securities and Exchange Commission ("SEC" or "Commission") are Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, who are petitioners in this Court.

The Commission is the respondent in this Court.

There are currently no *amici* and no intervenors.

B. Rulings Under Review

Petitioners seek review of the final decision and order of the Commission, captioned *In the Matter of Raymond J. Lucia Companies, Inc., et al.*, Opinion of the Commission, Release No. 75,837, Admin. Proc. File No. 3-15006, 2015 WL 5172953 (Sept. 3, 2015) (J.A.__); *In the Matter of Raymond J. Lucia Companies, Inc., et al.*, Order Imposing Remedial Sanctions, Release No. 75,837, Admin. Proc. File No. 3-15006 (Sept. 3, 2015) (J.A.__). The Commission's decision and order—issued over the dissent of two Commissioners, *see* Opinion of Commissioner Gallagher and Commissioner Piwowar, Dissenting from the Opinion of the Commission (Oct. 2, 2015) (J.A.__)—affirmed in part and reversed in part an initial

decision issued by an administrative law judge, captioned *In the Matter of Raymond J. Lucia Cos., Inc.*, Initial Decision on Remand, Release No. 540, Admin. Proc. File No. 3-15006, 2013 WL 6384274 (ALJ Dec. 6, 2013) (J.A.__). The December 6, 2013, initial decision was issued to "supplemen[t]" and "updat[e]" (*id.* at *1-2 (J.A.__)) a prior initial decision by the same administrative law judge, *In the Matter of Raymond J. Lucia Cos., Inc.*, Initial Decision, Release No. 495, Admin. Proc. File No. 3-15006, 2013 WL 3379719 (ALJ July 8, 2013) (J.A.__), after the Commission remanded the case for further findings, *see* Initial Decision on Remand, 2013 WL 6384274, at *2 (J.A.__) (citing *In the Matter of Raymond J. Lucia Cos., Inc.*, Order Remanding Case for Issuance of Initial Decision Pursuant to Rule of Practice 360, Admin. Proc. File No. 3-15006 (Aug. 8, 2013) (J.A.__)).

C. Related Cases

This matter has not previously been before this Court. Counsel for petitioners are not aware of any related cases currently pending in this Court or in any other court within the meaning of Circuit Rule 28(a)(1)(C).

Counsel for petitioners note, however, that one of the legal issues presented in this case—*viz.*, the constitutionality of the method of appointment of the Commission's administrative law judges—has been raised in a number of other proceedings in courts around the country, including the following:

- *Pierce v. SEC*, No. 15-901 (U.S.)

- *Timbervest, LLC v. SEC*, No. 15-1416 (D.C. Cir.)
- *Chau v. SEC*, No. 15-461 (2d Cir.)
- *Duka v. SEC*, No. 15-2732 (2d Cir.)
- *Tilton v. SEC*, No. 15-2103 (2d Cir.)
- *Bennett v. SEC*, No. 15-2584 (4th Cir.)
- *Feathers v. SEC*, No. 15-7012 (9th Cir.)
- *Gray Financial Group Inc. v. SEC*, No. 15-13738 (11th Cir.)
- *Hill v. SEC*, No. 15-12831 (11th Cir.) (consolidated with *Gray Financial*, No. 15-13738, *supra*)
- *Imperato v. SEC*, No. 15-11574 (11th Cir.)
- *Ironridge Global IV, Ltd. v. SEC*, No. 15-CV-2512 (N.D. Ga. Nov. 17, 2015) (stayed pending Eleventh Circuit decisions in *Gray* and *Hill*, *supra*)

In addition, the following proceedings pending before the Commission were previously identified by either petitioners or the Commission as involving the same constitutional issue:

- *In the Matter of John J. Aesoph, CPA, and Darren M. Bennett, CPA*, File No. 3-15168
- *In the Matter of Bama Biotech, Inc.*, File No. 3-16456
- *In the Matter of David F. Bandimere*, File No. 3-15124
- *In the Matter of Laurie Bebo & John Buono, CPA*, File No. 3-16293
- *In the Matter of Bennett Group Financial Services, LLC & Dawn J. Bennett*, File No. 3-16801
- *In the Matter of Gregory T. Bolan, Jr.*, File No. 3-16178
- *In the Matter of Frank H. Chiappone, et al.*, File No. 3-15514

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- *In the Matter of Gray Financial Group, Inc., et al.*, File No. 3-16554
- *In the Matter of Harding Advisory LLC & Wing F. Chau*, File No. 3-15574
- *In the Matter of Charles L. Hill, Jr.*, File No. 3-16383
- *In the Matter of Ironridge Global Partners, LLC & Ironridge Global IV, Ltd.*, File No. 3-16649
- *In the Matter of John Thomas Capital Management Group LLC d/b/a Patriot28, & George R. Jarkesy, Jr.*, File No. 3-15255
- *In the Matter of J.S. Oliver Capital Management, L.P., & Ian O. Mausner*, File No. 3-15446
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- *In the Matter of Miller Energy Resources, Inc., et al.*, File No. 3-16729
- *In the Matter of Steven J. Muehler, et al.*, File No. 3-16836
- *In the Matter of Natural Blue Resources, Inc.*, *et al.*, File No. 3-15974
- *In the Matter of optionsXpress, Inc., et al.*, File No. 3-14848
- *In the Matter of Edgar R. Page & PageOne Financial Inc.*, File No. 3-16037
- *In the Matter of Gordon Brent Pierce*, File No. 3-13109
- *In the Matter of Phillip Cory Roberts & Bay Peak, LLC*, File No. 3-16888
- *In the Matter of Spring Hill Capital Markets, LLC*, File No. 3-16353
- *In the Matter of Lynn Tilton, et al.*, File No. 3-16462

CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1 and this Court's Rule 26.1, petitioners respectfully submit the following corporate disclosure statement:

Petitioner Raymond J. Lucia Companies, Inc. ("RJLC"), is a California corporation, formerly operated as a registered investment adviser, but which currently has no ongoing operations. RJLC has no parent company, and no publicly held corporation has a 10% or greater ownership interest in RJLC.

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* Authorities upon which we chiefly rely are marked with asterisks.

GLOSSARY

ALJ	Administrative law judge
APA	Administrative Procedure Act
Commission (or SEC)	Respondent Securities and Exchange Commission
Division	Securities and Exchange Commission Enforcement Division
FDIC	Federal Deposit Insurance Corporation
FINRA	Financial Industry Regulatory Authority
Lucia	Petitioner Raymond J. Lucia
RJLC	Petitioner Raymond J. Lucia Companies, Inc.

INTRODUCTION

The federal government's officers exert extraordinary authority over innumerable facets of American life. Long before the advent of the modern administrative state, the Framers understood that curbing abuses of executive power requires carefully cabining the prerogative to *appoint* those who wield it. They accordingly specified in the Constitution who may appoint which officers (and how), recognizing the danger that a diffuse appointment power could produce an army of officials beholden to no one but themselves. That danger was realized in this case.

The Securities and Exchange Commission ("SEC" or "Commission") flouted the Constitution's explicit requirements by vesting significant federal authority in a corps of "hearing officers," or administrative law judges ("ALJs"), without following Article II's appointment protocol. The SEC tried to shoehorn its unconstitutional appointments regime into a decision in which a divided panel of this Court held that ALJs of a *different* agency exercising *different* powers under a *different* statute were exempt from the Appointments Clause. *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000). But the factors *Landry* found lacking—authority to issue final decisions and deferential agency review—are *present* here. And extending *Landry* to shield the SEC's ALJs from the Constitution's requirements would contradict Supreme Court precedent. *See Freytag v. Comm'r*, 501 U.S. 868, 881-82 (1991).

The SEC's unconstitutional process, moreover, yielded an illegal and arbitrary result in this case. The ALJ, on the thinnest of allegations and nonexistent proof, found intentional securities fraud based on purported misrepresentations in presentations to prospective investors, even though the facts supposedly concealed were *disclosed dozens of times*. In sustaining that decision by a 3-2 vote, the Commission imposed financial penalties and a lifetime bar—"'the securities industry equivalent of capital punishment'" (*Saad v. SEC*, 718 F.3d 904, 906 (D.C. Cir. 2013) (citation omitted))—on a well-respected investment professional with an unblemished 40-year record, notwithstanding the Commission's finding that its Enforcement Division had not proved that a single investor had been harmed. That irrational outcome, which cannot be reconciled with the facts or the law, is not the product of responsible, accountable decisionmaking.

The SEC's conferral of significant authority upon—and its acceptance of a ruling rendered by—an improperly appointed officer violated the Constitution. The resulting decision contravened the securities laws and has no basis in the record. For both reasons, the decision and order under review should be vacated.

STATEMENT OF JURISDICTION

The SEC's decision and order under review were issued September 3, 2015. J.A.__[SEC.Op.1; SEC.Order.1]. On October 2, 2015, petitioners timely filed a petition for review in this Court, which has jurisdiction under 15 U.S.C. § 78y.

STATEMENT OF THE ISSUES

1. Whether the ALJ who presided over the trial and rendered the initial decisions is an "Office[r] of the United States" who was not appointed in accordance with the Appointments Clause.

2. Whether the Commission's determinations as to both liability and sanctions are contrary to law, arbitrary or capricious, or unsupported by substantial evidence.

CONSTITUTIONAL, STATUTORY, AND REGULATORY PROVISIONS

Pertinent constitutional, statutory, and regulatory provisions are reproduced in the separately bound Addendum.

STATEMENT OF THE CASE

The Enforcement Division charged petitioners with violating the Investment Advisers Act of 1940 and SEC rules by making alleged misrepresentations in presentations to prospective clients regarding the relative merits of alternative retirement strategies. The case proceeded to trial before an ALJ, who found that these presentations contained intentionally fraudulent statements and omissions in violation of Sections 206(1), (2), and (4) of that Act and sanctioned petitioners. The SEC granted discretionary review and—by a 3-2 vote—sustained the ALJ's findings of violations, found an additional violation, and affirmed the ALJ's sanctions.

1. Petitioner Raymond J. Lucia is a 65-year-old investment professional with an unblemished record spanning nearly forty years. J.A.__[ALJ.Initial. Decision.On.Remand.3-4, 60]. Lucia has worked variously as an investment adviser, registered representative of a broker-dealer, and public speaker, maintaining a spotless disciplinary record and sterling reputation. J.A.__[ALJ.Initial.Decision. On.Remand.3-4, 60]. Until 2010, Lucia owned petitioner Raymond J. Lucia Companies, Inc. ("RJLC"), then an SEC-registered investment adviser. J.A.__[ALJ. Initial.Decision.On.Remand.4].

Lucia has not worked recently as a securities professional. He sold RJLC in 2010, two years before these proceedings commenced; RJLC currently conducts no operations. J.A.__[ALJ.Initial.Decision.On.Remand.7, SEC.Op.2 n.1]. Because of these proceedings, Lucia is no longer registered as an investment adviser or licensed as a registered representative of a securities broker, effectively ending his career. J.A.__[SEC.Op.35-36]. Indeed, Lucia's reputation has been irretrievably damaged by the liability determinations, and the sanctions order renders him unemployable in his lifelong profession; as a result, he is now on the verge of bankruptcy.

On Lucia's radio show, in his books, and in presentations he gave at free retirement-planning seminars, Lucia advocated a retirement strategy colorfully named the "Buckets of Money" approach. J.A.__[ALJ.Initial.Decision.On.

Remand.7-8]. The strategy recommended that investors diversify their investments among several types ("buckets") of assets of varying degrees of risk and liquidity; and that, upon retiring, investors spend liquid, lower-risk investments first to give riskier, more volatile investments time to grow. *Id.* One might invest in a mix of low-risk CDs and treasury bills to provide steady income for the first few years of retirement, and moderately safe investments (*e.g.*, other bonds and fixed annuities) and higher-risk investments (*e.g.*, stocks and real-estate investment trusts) to provide income in later years. J.A.__[SEC.Op.6].

At the investment seminars, Lucia used a slideshow to outline this retirement strategy. J.A.__[DX-1; RX-3]. To illustrate how it differed from other approaches, the slides included hypothetical examples comparing "fictional investors" following Lucia's strategy in various scenarios with investors following other strategies (*e.g.*, the "Conservative Campbells" and the "High Rolling Hendersons"). J.A.__[ALJ.Initial.Decision.On.Remand.9-10]. The slideshow stated clearly that "[t]he following examples are for hypothetical purposes only" and "[t]he following scenarios are not actual investors." J.A.__[DX-1.151].

Two hypotheticals, which the slides described as "backtests," were based partly on historical periods, using historical Standard & Poor's 500 Index data for certain stock returns but continuing to employ assumptions regarding inflation and rates of return on real-estate and other investments.

The first example was designed to illustrate the buckets-of-money strategy for a fictional couple who retired in the "'73/'74 Grizzly Bear" period of heavy stock-market losses. The slides explained that an investment of $1 million allocated using the buckets-of-money strategy—based on a mixture of historical data and assumed rates of return and inflation—would have grown to $1,544,789 by 1994. The slides stated explicitly that they were "hypothetical" and "not representative of an actual investment." J.A.__[DX-1.152-213, DX-1.176-201].

The second example compared different strategies for fictional couples who retired in 1966. Again, it clearly identified that the figures were drawn from both historical data and fictional assumptions. J.A.__[DX-1.204].

Petitioners stressed that these examples were hypothetical. Slides illustrating the examples were emblazoned: "This is a hypothetical illustration and is not representative of an actual investment." J.A.__[DX-1.152-213]. And slides outlining the buckets-of-money strategy noted that "[r]ates of return are hypothetical in nature and are for illustrative purposes only." J.A.__[DX-1.176-201]; *see* J.A.__[SEC.Op.4 n.10, 6 n.14]. Lucia himself "'expressly informed seminar attendees that he was using *hypothetical, pretend, assumed* rates of return.'" J.A.__[SEC.Op.23] (emphasis added); *see*, *e.g.*, J.A.__[SEC.Op.7].

The seminars did not identify or recommend any particular securities, and no securities were offered or sold at the seminars. J.A.__[Hearing.Tr.1281:16-

17]. Instead, seminar attendees interested in a "complimentary financial planning consultation" could complete a response card requesting to be contacted. J.A.__ [SEC.Op.4 n.6]. On average, attendees who chose to do so met with an RJLC representative 3-4 times over six months before becoming clients. J.A.__[Hearing. Tr.1285:9-15]. There is no contention that attendees who ultimately became clients were provided with any false or misleading information in connection with any securities trading conducted through RJLC.

Before Lucia's slideshow was publicly distributed, it was reviewed by Financial Industry Regulatory Authority ("FINRA") registered broker-dealers, who repeatedly approved the slides and raised no concerns that they were misleading. J.A.__[SEC.Op.27, Hearing.Tr.565-67, 1305:2-23]. In 2003, the Commission's examination staff reviewed a similar version of Lucia's slideshow and raised no concerns that it was misleading. J.A.__[SEC.Op.27, Hearing.Tr.1305]. Indeed, none of approximately 50,000 seminar attendees over the years lodged any complaint that the slideshow was misleading. J.A.__[ALJ.Initial.Decision.On.Remand. 8, 47; Hearing.Tr.671-72, 677, 1274-75, 1477-78, 1557].

In 2010, the Commission's examination staff sent a letter to petitioners expressing concerns about the slideshow. J.A.__[DX-3; RX-6]. Out of an abundance of caution, petitioners immediately (and voluntarily) stopped using the dis-

puted slides, and Lucia even withdrew his books—not part of this proceeding—from circulation. J.A.__[RX-7.8; RX-8.5].

2. The Enforcement Division instituted this proceeding against petitioners in September 2012. J.A.__[Order.Instituting.Proceedings.1]. It alleged (as relevant) that petitioners made misleading representations and omissions in the presentations in violation of Sections 206(1), (2), and (4) of the Investment Advisers Act, 15 U.S.C. § 80b-6(1)-(2), (4), which prohibit investment advisers from defrauding current or prospective clients. J.A.__[Order.Instituting.Proceedings.9]. The Division further alleged that petitioners violated SEC Rule 206(4)-1(a)(5), 17 C.F.R. § 275.206(4)-1(a)(5), which prohibits false or misleading "advertisement[s]." *Id.*; *see* J.A.__[Order.Instituting.Proceedings.9].

The allegations focused on the presentations' description of the 1973 and 1966 hypotheticals as "backtests." J.A.__[SEC.Op.17]. Although no law or regulation defines "backtesting," the Enforcement Division alleged that this term can be used to refer only to analysis of exclusively historical data, not hypotheticals based partly on assumptions; because the results described in the presentations were not derived exclusively from historical data, the Division maintained, they were necessarily misleading. J.A.__[Order.Instituting.Proceedings.3-8]. The Division also alleged that the slides did not reflect the effect of reallocating in-

vestments after buckets of assets were serially exhausted (*i.e.*, "rebucketizing"). J.A.__[Order.Instituting.Proceedings.8-9].

a. The Commission can bring an enforcement action either in federal district court or in an administrative proceeding. 15 U.S.C. § 78d-1(a). When it proceeds administratively, the Commission may elect to have an ALJ act as a hearing officer. 5 U.S.C. § 3105; 15 U.S.C. § 78d-1; 17 C.F.R. § 201.110. SEC ALJs are not selected by the Commission itself, but by the Office of the Chief Administrative Law Judge.

ALJs have significant authority to "conduc[t] hearings in proceedings instituted by the Commission" pursuant to the authority vested in them by "the Administrative Procedure Act and the federal securities laws." 17 C.F.R. § 200.14(a); *see also id.* § 201.111. After the hearing, the ALJ issues an initial decision, subject to review (discretionary, in most cases) by the Commission. *Id.* §§ 201.360, .411(b)(2). If the Commission denies review—or if no party timely seeks review and the SEC does not grant review *sua sponte*—"then the action of any … administrative law judge … shall, for all purposes, including appeal or review thereof, be deemed the action of the Commission." 15 U.S.C. § 78d-1(c).

b. The Commission chose the administrative route here—as it has done in many other cases in recent years[1]—and the case was assigned to an ALJ. After a hearing and an interlocutory remand, the ALJ issued two initial decisions finding that petitioners violated Sections 206(1), (2), and (4) by making misrepresentations in the presentations regarding retirement strategies, but rejecting the Division's allegations that petitioners engaged in misleading advertising. J.A.__[ALJ. Original.Initial.Decision.1, 36; ALJ.Initial.Decision.On.Remand.2-3, 25-56]. The ALJ imposed sanctions (i) barring Lucia for life from associating with an investment adviser, broker, or dealer; (ii) revoking petitioners' investment-adviser registrations; (iii) ordering petitioners to cease and desist from further violations; and (iv) imposing civil penalties totaling $300,000. J.A.__[ALJ.Initial.Decision.On. Remand.61-62].

3. Petitioners timely sought Commission review, challenging the ALJ's initial decisions on the merits and arguing that the ALJ is a federal "Officer" who had to be (but was not) appointed pursuant to the Appointments Clause. J.A.__ [Supplemental.Briefing.In.Support.Of.Appeal.4-12]. The Division cross-appealed the ALJ's finding that petitioners did not engage in misleading advertising. J.A.__ [Division.Of.Enforcement.Cross-Petition.8-16]. The Commission granted review

[1] Jean Eaglesham, *SEC Is Steering More Trials to Judges It Appoints*, Wall St. J. (Oct. 21, 2014), http://tinyurl.com/z7uef8p (all Internet sites last visited Feb. 1, 2016).

and, over a rare written dissent, rejected petitioners' constitutional challenge, sustained the ALJ's findings of violations, agreed with the Division on cross-appeal, and affirmed the sanctions. J.A.__[SEC.Op.16-40; Dissent.1-2].

a. The Commission majority held that the Appointments Clause does not apply to its ALJs. Relying almost exclusively on *Landry*, 204 F.3d 1125, it reasoned that its ALJs are not constitutional "Officers," but "mere employees" exempt from the Clause. J.A.__[SEC.Op.28-33].

On the merits, the Commission majority said that the presentations' description of the 1973 and 1966 hypotheticals as "backtests" was misleading because (according to the SEC) a backtest must "use historical data," but the hypotheticals relied partly on assumptions for certain variables, such as inflation. J.A.__[SEC.Op.17-18]. Because these assumptions did not track historical data, the Commission found, the resulting calculations were misleading. J.A.__[SEC.Op.18]. The Commission also found that the hypotheticals misleadingly failed to account for the effect of reallocating assets as each "bucket" was exhausted, and that the results presented for the 1973 illustration were inaccurate and misleading. J.A.__[SEC.Op.18-19]. And it concluded that the presentations were "advertisements." J.A.__[SEC.Op.21-23].

The Commission affirmed the ALJ's sanctions. J.A.__[SEC.Op.34-40]. It declined to stay the sanctions other than monetary penalties pending this appeal. J.A.__[SEC.Stay.Order].

b. Commissioners Gallagher and Piwowar dissented, J.A.__[Dissent.1-2]—the *only* written dissent from an SEC opinion in 2015. They explained that, while "the Commission is free to express its views on Constitutional issues," "it is appropriate that Article III federal judges," not the agency itself, "ultimately resolve" this "important" question. J.A.__[Dissent.2].

On the merits, the dissenters sharply disagreed with the majority's analysis. The majority "create[d] from whole cloth specific requirements for advertisements that include the word 'backtest,'" a term with no "statutory or regulatory definition," and applied to petitioners a new rule deeming it a "fraudulent or deceptive practice if a backtest fails to use actual historical rates—even if the slideshow presentation specifically discloses the use of assumed rates for certain components." J.A.__[Dissent.1]. "In the context" here, the dissenters continued, "the use of the word 'backtest' and assumed inflation rates were not misleading," given the presentations' and Lucia's repeated, consistent disclaimers. *Id.*

SUMMARY OF ARGUMENT

I. The Commission's decision cannot stand because the ALJ who presided over and decided this case was an "Officer" who was not appointed pursuant to constitutional requirements.

A. "Officers of the United States" can be appointed only pursuant to the Appointments Clause, U.S. Const. art. II, § 2, cl. 2. The ALJ here undisputedly was not. The SEC's sole defense of that failure is its contention that the ALJ is not an officer, but a mere employee, and so exempt from the Clause. That contention contradicts Supreme Court precedent. All officials in posts "established by law" who exercise "significant authority" are "'Officer[s]'"—full stop. *Buckley v. Valeo*, 424 U.S. 1, 126 (1976) (per curiam). That includes officials who act as first-line trial judges—even if they *cannot* render final decisions, and certainly if they *can*. *See Freytag*, 501 U.S. at 881-82. The wide range of officials the Supreme Court has deemed "officers" confirms as much. *See*, *e.g.*, *Ex parte Hennen*, 38 U.S. (13 Pet.) 230, 258 (1839).

The SEC's ALJs fit comfortably within the Supreme Court's broad definition of officers. Their positions and powers are established by law; indeed, federal statutes and SEC regulations *refer* to them as officers. SEC ALJs also exercise broad authority: They oversee hearings and related proceedings and issue initial decisions that by statute can—and in most cases do—become the final decision of

the SEC itself. Their authority is at least as great as other adjudicators the Supreme Court, in a long line of decisions exemplified by *Freytag*, has concluded are constitutional officers.

B. The Commission staked its contrary view on this Court's divided decision in *Landry*, 204 F.3d 1125. That wager was unwise.

On its own terms, *Landry* undercuts the Commission's position. *Landry* held that ALJs of a different agency, the Federal Deposit Insurance Corporation ("FDIC"), were not officers because they could not issue final decisions and the FDIC owed zero deference even to their factual findings. *Neither* is true of the SEC's ALJs: They *can* and *do* issue final decisions; indeed, the SEC, unlike the FDIC in *Landry*, does not review most ALJ rulings at all, and when it does it defers to ALJs' credibility findings. What *Landry* found lacking thus is present here.

Landry could not be *extended* to SEC ALJs without revisiting the soundness of that decision. And, as Judge Randolph explained at the time, neither requirement *Landry* posited for an adjudicator to constitute an "Officer"—finality of decision and deferential review—can be squared with Supreme Court precedent.

II. The Commission's decision and order independently should be vacated because both its determinations on the merits and the sanctions it imposed are arbitrary and capricious, contrary to law, and unsupported by substantial evidence.

The SEC failed to identify any materially misleading statement made by petitioners with scienter. Indeed, its principal bogey-man—passing descriptions of historically inspired hypotheticals as "backtests"—could not have been false (as the Commission concluded) by dint of petitioners' use of certain assumptions: There was and is no settled definition of that term; the SEC made up its own definition here, and arbitrarily punished petitioners for using the term differently years earlier. In any event, petitioners *expressly disclosed* that the hypotheticals were based on some assumed figures and some historical facts.

The SEC also fell far short of showing that the extreme, punitive sanctions—including a lifetime bar—were justified by the isolated statements challenged by the Enforcement Division and voluntarily withdrawn by petitioners.

STANDARD OF REVIEW

This Court reviews legal and constitutional questions *de novo* and "owes no deference to [an] agency's pronouncement on a constitutional question." *J.J. Cassone Bakery, Inc. v. NLRB*, 554 F.3d 1041, 1044 (D.C. Cir. 2009) (internal quotation marks omitted). It will uphold the SEC's factual findings only if supported by substantial evidence, 15 U.S.C. § 78y(a)(4); *see*, *e.g.*, *Howard v. SEC*, 376 F.3d 1136, 1149 (D.C. Cir. 2004), and will set aside the agency's decision if it is "'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law,'" *Rapoport v. SEC*, 682 F.3d 98, 103 (D.C. Cir. 2012) (quoting 5 U.S.C.

§ 706(2)(A)). SEC action, including a sanction, is arbitrary if (*inter alia*) the SEC fails to comply with its "own standard." *WHX Corp. v. SEC*, 362 F.3d 854, 859 (D.C. Cir. 2004).

STANDING

Petitioners have standing as "person[s] aggrieved by a final order of the Commission." 15 U.S.C. § 78y(a)(1); *see Sierra Club v. EPA*, 292 F.3d 895, 900 (D.C. Cir. 2002).

ARGUMENT

The decision and order under review should be vacated because the ALJ who rendered the initial decisions was an "Office[r] of the United States" but was not appointed pursuant to the Appointments Clause; and because both the liability determinations and sanctions are arbitrary and unsupported by substantial evidence.

I. THE SEC'S HEARING OFFICER WAS UNCONSTITUTIONALLY APPOINTED.

The Framers considered "'the power of appointment to offices'" to be "'the most insidious and powerful weapon of eighteenth century despotism.'" *Freytag*, 501 U.S. at 883 (citation omitted). The "'manipulation of official appointments' had long been one of the American revolutionary generation's greatest grievances against executive power." *Id.* (citation omitted). To prevent such manipulations, the Framers "carefully husband[ed] the appointment power" to "limit its diffusion"

and to "ensure that those who wielded it were accountable to political force and the will of the people." *Id.* at 883-84. The result was the Appointments Clause of Article II, which provides that "[t]he 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 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 prescribes the exclusive means for appointing any "Officer of the United States," *i.e.*, any government official whose position is "established by Law" and who exercises "significant authority pursuant to the laws of the United States." *Buckley*, 424 U.S. at 126. "Unless their selection is elsewhere provided for" in the Constitution—such as the President himself—"*all* officers of the United States are to be appointed in accordance with the Clause"; "[n]o class or type of officer is excluded because of its special functions." *Id.* at 132. Only mere employees who wield no significant federal authority or serve temporarily are exempt. *See*, *e.g.*, *Auffmordt v. Hedden*, 137 U.S. 310, 327 (1890) (holding that "merchant appraiser" chosen "to aid in ascertaining the value of [imported] goods … is not an 'officer,' within the meaning of the [Appointments] [C]lause" because "[h]e has no general functions, nor any employment which has any dura-

tion as to time," "[h]is position is without tenure, duration, continuing emolument, or continuous duties, and he acts only occasionally and temporarily").

The Appointments Clause recognizes two types of officers—principal and inferior officers—and permits varying methods of appointment for each. *See United States v. Germaine*, 99 U.S. 508, 509-10 (1879). Principal officers—including ambassadors, ministers, heads of departments, judges, and others who report directly to the President, *see Edmond v. United States*, 520 U.S. 651, 659 (1997)—can be appointed only by the President with the Senate's consent. Other ("inferior") officers may be appointed, if Congress so provides, by the President alone, a Department head, or in appropriate contexts, the courts. U.S. Const. art. II, § 2, cl. 2; *Buckley*, 424 U.S. at 125, 132; *see also Morrison v. Olson*, 487 U.S. 654, 670 (1988). But in no event may *any* officer be appointed by anyone other than the President, a Department head, or a court. *Buckley*, 424 U.S. at 132-33.

This explicit constitutional limitation is much "more than a matter of 'etiquette or protocol'": It is a crucial "structural safeguar[d] of the constitutional scheme." *Edmond*, 520 U.S. at 659. "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. The Appointments Clause's restrictions "preserv[e] … the Constitution's structural integrity by preventing the diffusion of the appointment power." *Id.* at 878.

This "structural safeguar[d]" (*Edmond*, 520 U.S. at 659) is so fundamental that the invalidity of an officer's appointment "goes to the validity of the [underlying] proceeding" itself. *Freytag*, 501 U.S. at 879; *see also United States v. L.A. Tucker Truck Lines, Inc.*, 344 U.S. 33, 38 (1952) (defect in the appointment of officer is "an irregularity which would invalidate a resulting order"). Like other "'structural'" defects, the participation of an adjudicator exercising authority in violation of Article II impugns the entire proceeding, irrespective of whether the aggrieved party demonstrates "a direct causal link between the error" in the mode of appointment "and the adverse decision." *Landry*, 204 F.3d at 1131 (citation omitted); *see also Plaut v. Spendthrift Farm, Inc.*, 514 U.S. 211, 239 (1995) ("separation of powers is a *structural safeguard* rather than a remedy to be applied only when specific harm, or risk of specific harm, can be identified.… [I]t is a prophylactic device, establishing high walls and clear distinctions because low walls and vague distinctions will not be judicially defensible").[2]

These principles compel vacatur of the Commission's decision here. As the Commission conceded, "[i]t is undisputed that" the SEC's ALJs—including the

[2] Although the Commission half-heartedly suggested that the unconstitutional appointment of an adjudicative officer can be cured by "'*de novo* review,'" J.A.__[SEC.Op.32 n.115], that position is foreclosed by *Freytag*, which (as *Landry* explained) "indicates that judicial review of an Appointments Clause claim will proceed even where any possible injury is radically attenuated." 204 F.3d at 1131-32 (citing *Freytag*, 501 U.S. at 871-72 & n.2, 882).

ALJ who decided this case—are "*not* appointed by the President, the head of a department, or a court of law." J.A.__[SEC.Op.29] (emphasis added). Instead, SEC ALJs are hired by the Commission's Office of Administrative Law Judges, with input from the Chief Administrative Law Judge and other staff, who may only choose among candidates approved by the Office of Personnel Management. *See* Notice of Filing 1-3, *In the Matter of Timbervest, LLC*, Admin. Proc. File No. 3-15519 (June 4, 2015), https://www.sec.gov/litigation/apdocuments/3-15519-event-139.pdf; *see also* 5 C.F.R. § 930.204(a) (ALJs must either be chosen from "list of eligibles provided by [the Office of Personnel Management]" or be specially approved by that Office). Although the full Commission when it acts as a body is a "Head of a Department" under the Appointments Clause, *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 512-13 (2010) (internal quotation marks and brackets omitted), none of the SEC personnel involved in selecting SEC ALJs is.

The Commission, however, took the position below that its ALJs are exempt from the Appointments Clause altogether: "[A] Commission ALJ," it asserted, "is a 'mere employee'—not an 'officer'—and thus the appointment of a Commission ALJ is not covered by the Clause." J.A.__[SEC.Op.3]. That self-aggrandizing assertion cannot be squared with binding precedent or the realities of the Commission's own practice.

A. SEC ALJs Are "Officers" Subject To The Appointments Clause.

As every court to consider the question has concluded, SEC ALJs are "Officers" subject to the Appointments Clause. *See Ironridge Glob. IV, Ltd. v. SEC*, __ F. Supp. 3d. __, 2015 WL 7273262 (N.D. Ga. Nov. 17, 2015), *appeal docketed*, No. 16-10205 (11th Cir.); *Duka v. SEC*, __ F. Supp. 3d __, 2015 WL 4940083 (S.D.N.Y. Aug. 12, 2015), *appeal docketed*, No. 15-2732 (2d Cir.); *Gray Fin. Grp., Inc. v. SEC*, 15-CV-492, Dkt. 56 (N.D. Ga. Aug. 4, 2015), *appeal docketed*, No. 15-13738 (11th Cir.); *Hill v. SEC*, __ F. Supp. 3d __, 2015 WL 4307088 (N.D. Ga. June 8, 2015), *appeal docketed*, No. 15-12831 (11th Cir.).[3] That conclusion follows directly from Supreme Court precedent and SEC ALJs' authority and role in the administrative scheme.

1. Officials Whose Positions Are Established By Law And Who Exercise Significant Federal Authority Are "Officers."

Every federal-government official whose position is "established by Law" and who exercises "significant authority pursuant to the laws of the United States is an 'Officer of the United States,' and must, therefore, be appointed in the manner prescribed by" the Appointments Clause. *Buckley*, 424 U.S. at 126, 132. That simple, expansive definition is consistent with the Clause's text. *See*, *e.g.*, 2 Sam-

[3] These cases were brought by respondents seeking to stay SEC administrative proceedings pending federal-court review of the Appointments Clause issue. *Cf. Jarkesy v. SEC*, 803 F.3d 9, 15-30 (D.C. Cir. 2015) (holding that such review may only be had in a court of appeals following an adverse SEC decision).

uel Johnson, *A Dictionary of the English Language*, s.v. "officer" (6th ed. 1785) ("A man employed by the publick"); 2 Noah Webster, *An American Dictionary of the English Language*, s.v. "officer" (1828) ("A person commissioned or authorized to perform any public duty"). And it honors the Clause's purpose of "preventing the diffusion of the appointment power" (*Freytag*, 501 U.S. at 878), which a crabbed definition of "officer" would invite.

Buckley's controlling definition was drawn from over a century of Supreme Court precedent holding a wide range of officials to be "officers" and therefore subject to the Appointments Clause, including:

- district-court clerks, *Hennen*, 38 U.S. (13 Pet.) at 258;
- "commissioners of the circuit courts" who "t[ook] bail for the appearance of persons charged with crime," *United States v. Allred*, 155 U.S. 591, 594 (1895);
- "thousands of clerks in the Departments of the Treasury, Interior and the othe[r]" departments, *Germaine*, 99 U.S. at 511, responsible for "the records, books, and papers appertaining to the office," *Hennen*, 38 U.S. (13 Pet.) at 259;
- a clerk to an "assistant treasurer" in Boston, *United States v. Hartwell*, 73 U.S. (6 Wall.) 385, 393-94 (1868);
- an "assistant-surgeon" and "cadet-engineer" appointed by the Secretary of the Navy, *United States v. Moore*, 95 U.S. 760, 762 (1878); *United States v. Perkins*, 116 U.S. 483, 484 (1886);
- election monitors, *Ex parte Siebold*, 100 U.S. 371, 397-99 (1880);
- federal marshals, *Siebold*, 100 U.S. at 397; and,

- U.S. attorneys, *Myers v. United States*, 272 U.S. 52, 159 (1926).

The Supreme Court's post-*Buckley* cases confirm the Appointments Clause's broad scope and reaffirm that the touchstones are whether an office is "established by Law" and empowers the incumbent to exercise "significant authority." And the Court has consistently held that government officials who preside over adjudicative proceedings in the role of a trial judge exercise just such authority, and so constitute "inferior Officers."

The critical decision is *Freytag*, 501 U.S. 868, which squarely addressed whether non-Article III judges employed to oversee trials and to recommend dispositions—"special trial judges" of the U.S. Tax Court—are "officers" under the Appointments Clause. *Id.* at 880-82. Special trial judges were authorized to oversee litigation and conduct trials in any case assigned to them by the Tax Court's Chief Judge. *Id.* at 873. While in certain types of cases they could render decisions "subject to such conditions and review as the [Tax Court] may provide," 26 U.S.C. § 7443A(b)-(c) (1988), in the type of case at issue in *Freytag*, the judge could only "propos[e] findings and an opinion," on which a Tax Court judge rendered the "actual decision." 501 U.S. at 873.

Freytag unanimously held that special trial judges are officers and therefore must be appointed pursuant to the Clause. 501 U.S. at 880-82; *accord id.* at 901 (Scalia, J., concurring in part and concurring in the judgment). Special trial judges,

the Court explained, satisfied both of *Buckley*'s requirements for "officers." *Id.* at 881 (majority op.). "The office of special trial judge is 'established by Law'"; unlike special masters appointed on a "temporary, episodic basis," "the duties, salary, and means of appointment for" special trial judges "are specified by statute." *Id.* (citation omitted). *Freytag* also "agree[d]" with lower courts that those judges' "authority" was "so 'significant' that it was inconsistent with the classifications of 'lesser functionaries' or employees." *Id.* (citation omitted).

The Supreme Court expressly rejected the same argument that the Commission accepted here—*i.e.*, that special trial judges were mere "employees" because in many cases, including *Freytag* itself, they did "no more than assist the Tax Court judge in taking the evidence and preparing the proposed findings and opinion" and "lack[ed] authority to enter a final decision." 501 U.S. at 880-81. This argument, *Freytag* held, "ignore[d] the significance of the duties and discretion that special trial judges possess." *Id.* at 881. Beyond recommending decisions, these judges "perform more than ministerial tasks"—*e.g.*, "tak[ing] testimony," "conduct[ing] trials," and "rul[ing] on the admissibility of evidence." *Id.* at 881-82.

As an alternative holding, *Freytag* concluded that, "*[e]ven if* the duties of special trial judges … were not *as significant as we … have found them to be*," the outcome "would be *unchanged*": In certain types of cases, special trial judges had

"independent authority" to render decisions by themselves. 501 U.S. at 882 (emphases added). The government conceded that in such cases "special trial judges act as inferior officers." *Id.* The Court explained that, "[i]f a special trial judge is an inferior officer for purposes of" those cases, "he is an inferior officer within the meaning of the Appointments Clause and he must be properly appointed." *Id.*

The Supreme Court has since recognized that the Appointments Clause applies to military judges as well. In *Weiss v. United States*, 510 U.S. 163 (1994), it explained that, "because of the authority and responsibilities [military judges] possess"—which included ruling on procedural and legal issues and adjudicating offenses under the Uniform Code of Military Justice—military judges "act as 'Officers' of the United States." *Id.* at 167-69. Indeed, the parties did not even dispute the point. In *Ryder v. United States*, 515 U.S. 177 (1995), the Court held that the *de facto*-officer doctrine could not cure the invalid method of appointment of a military judge on the Coast Guard Court of Military Review. *Id.* at 180-88. And *Edmond*, 520 U.S. 651, held that certain intermediate appellate military judges were inferior officers. *Id.* at 662-63.

These cases confirm that, as *Freytag* held, the fact that an official cannot render final decisions, but only rulings subject to others' review, does not take them outside of the Appointments Clause. Military judges were not *principal* officers, *Edmond* explained, because they were subordinate to a presidential appoin-

tee and could not render final decisions. 520 U.S. at 664-65. But these same factors established that the military judges *were* inferior officers:

> Generally speaking, 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.… [I]n the context of a Clause designed to preserve political accountability relative to important Government assignments, we think it evident that "inferior officers" are officers whose work is directed and supervised at some level by others who were appointed by Presidential nomination with the advice and consent of the Senate.

Id. at 662-63.

Indeed, it was precisely because the military "judges … ha[d] no power to render a final decision on behalf of the United States unless permitted to do so by other Executive officers" that they were "'inferior officers.'" *Edmond*, 520 U.S. at 665-66 (citation omitted). Notwithstanding their lack of authority to issue final decisions, the Court had no doubt that the judges "exercis[e] significant authority on behalf of the United States." *Id.* at 662; *see also Morrison*, 487 U.S. at 671-73 (removability and limitations on officer's duties, jurisdiction, and tenure are badges of inferior-officer status).

Supreme Court precedent thus makes clear that the Appointments Clause applies to any federal official who holds a post established by law and exercises significant federal authority. The Court's cases further demonstrate that officials who oversee trials and recommend decisions readily qualify—even if their power is exercised only in preliminary proceedings or if their decisions are subject to

review by superiors. Those factors bear on whether the officer is *principal or inferior*, not on whether he is an officer at all.[4]

2. SEC ALJs Hold Offices Established By Law And Exercise Significant Authority.

SEC ALJs are "Officers" because their offices are "'established by law'" and they exercise "'significant authority.'" *Freytag*, 501 U.S. at 881 (quoting U.S. Const. art. II, § 2, cl. 2, and *Buckley*, 424 U.S. at 126). They therefore cannot be appointed except in the manner prescribed in the Appointments Clause.

a. SEC ALJs' Offices Are Established By Law.

The positions held by SEC ALJs are indisputably "'established by Law.'" *Freytag*, 501 U.S. at 881 (citation omitted). Like the special trial judges in *Freytag*, their "duties, salary, and means of appointment" are all "are specified by statute." *Id.* The U.S. Code establishes the positions of SEC ALJs as permanent employees, who can be removed only for cause, and specifies their duties, salary, and

[4] Contrary to the SEC's position, the Department of Justice has recognized that one who holds "any position … , however labeled," that is both "continuing" and "invested by legal authority with a portion of the sovereign powers of the federal Government" constitutes an "'Office[r] of the United States' [subject] to the procedures specified in the Appointments Clause." *Officers of the U.S. Within the Meaning of the Appointments Clause*, 31 Op. O.L.C. 73, 73-74 (2007). Even "'independent discretion' is not a necessary attribute of delegated sovereign authority," and "[t]he question … is simply whether a position possesses delegated sovereign authority to act in the first instance, *whether or not that act may be subject to direction or review* by superior officers." *Id.* at 93, 95 (emphasis added); *see*, *e.g.*, *Sec'y of Educ. Review of Admin. Law Judge Decisions*, 15 Op. O.L.C. 8, 14 (1991) (concluding that ALJs are inferior officers).

method of appointment. *See* 5 U.S.C. §§ 556-557 (establishing ALJs' position and powers in hearings); *id.* § 5372 (establishing salaries); *id.* § 3105 (establishing hiring practices). An ALJ's position is also "continuing," 31 Op. O.L.C. at 74, as ALJs "receiv[e] a career appointment," 5 C.F.R. § 930.204(a).

The duties of SEC ALJs are further delineated in the securities laws and Commission regulations. Federal statutes establish that the SEC may "delegate … any of its functions to … an administrative law judge." 15 U.S.C. § 78d-1(a). It has done so, adopting regulations specifying ALJs' powers, 17 C.F.R. § 200.14, including adjudicative authority, *id.* § 200.30-9, and providing that the authority delegated to SEC ALJs is as broad as the Administrative Procedure Act ("APA") permits, *id.* § 201.111.

Indeed, the securities laws and SEC rules each *refer* to ALJs as "officers." The Securities Act of 1933 states that "[a]ll hearings … may be held before the Commission or an *officer* or *officers* of the Commission designated by it." 15 U.S.C. § 77u (emphases added); *see also id.* §§ 78v, 80a-40, 80b-12 (same). "[C]onduct[ing] hearings" is precisely what ALJs do. 17 C.F.R. § 200.14(a). That undoubtedly is why the SEC's own rules define a "hearing *officer*" as including "*administrative law judge[s]*." *Id.* § 201.101(a)(5) (emphases added).

This characterization of ALJs who conduct hearings as "officers" was no accident. When Congress uses terms like "officer" that have a settled legal meaning,

courts presume that Congress adopted that meaning, absent clear evidence to the contrary. *See Beck v. Prupis*, 529 U.S. 494, 500-01 (2000). And Congress had this settled understanding of "officer" in mind when it amended the APA to define an "officer" as (*inter alia*) "an individual who is … required by law to be appointed in the civil service by … *the head of an Executive agency*." 5 U.S.C. § 2104(a)(1)(C) (emphasis added). Congress had the same understanding in crafting the securities laws. It referred to the "officers" who hold hearings in cases before the Commission, *i.e.*, ALJs, in direct relation to *principal* constitutional officers (the members of the Commission) who "designat[e]" them, 15 U.S.C. § 77u. This direct "relationship with … higher ranking," Senate-confirmed "officer[s]" is a hallmark of constitutional-officer status. *Edmond*, 520 U.S. at 662-63. There can be no dispute that SEC ALJs hold offices established by law.

b. SEC ALJs Exercise Significant Federal Authority.

The SEC's ALJs also unquestionably "'exercis[e] significant authority pursuant to the laws of the United States.'" *Freytag*, 501 U.S. at 881 (quoting *Buckley*, 424 U.S. at 126). The Commission has endowed them with a litany of substantive and procedural powers involving the exercise of broad discretion in enforcement proceedings, which closely parallel the authority of the special trial judges in *Freytag*.

SEC ALJs are responsible for "conduct[ing] hearings in proceedings instituted by the Commission" pursuant to authority vested in them by "the Administrative Procedure Act and the federal securities laws." 17 C.F.R. § 200.14(a). In overseeing these proceedings, ALJs exercise authority over a wide range of matters at every stage of the case, including:

- amending charging documents, *id.* § 201.200(d)(2);
- entering orders of default, *id.* § 201.155;
- consolidating proceedings, *id.* § 201.201(a);
- "[a]dminister[ing] oaths and affirmations," *id.* §§ 200.14(a)(1), 201.111(a);
- "[i]ssu[ing] subpoenas," *id.* §§ 200.14(a)(2), 201.111(b);
- ordering depositions and acting as the "deposition officer," *id.* §§ 201.233-.234;
- ordering production of evidence and regulating document production, *id.* §§ 201.111(b), .230, .232;
- issuing protective orders, *id.* § 201.322;
- "[r]ul[ing] upon motions," including motions for summary disposition, *id.* §§ 200.14(a)(7), 201.111(h), .250;
- rejecting filings for procedural noncompliance, *id.* § 201.180(b);
- granting extensions of time and stays, *id.* § 201.161;
- "[h]old[ing] pre-hearing conferences" and "requir[ing]" attendance at such conferences, *id.* §§ 200.14(a)(6), 201.111(e), .221(b);
- ordering prehearing submissions, *id.* § 201.222(a);

- "[r]egulat[ing] the course of [the] hearing," *id.* §§ 200.14(a)(5), 201.111(d);
- receiving "relevant evidence" and ruling upon admissibility, *id.* § 201.111(c);
- "[r]ul[ing] on offers of proof," *id.* §§ 200.14(a)(3), 201.111(c);
- "[e]xamin[ing] witnesses," *id.* § 200.14(a)(4);
- regulating the scope of cross-examination, *id.* § 201.326;
- regulating "the conduct of the parties and their counsel," *id.* § 201.111(d); and
- imposing sanctions for "contemptuous conduct," *id.* § 201.180(a).

At the hearing's conclusion, unless the Commission directs otherwise or the parties waive an ALJ ruling, the ALJ must "prepare an initial decision containing the conclusions as to the factual and legal issues presented" and "issue an appropriate order." 17 C.F.R. §§ 200.14(a)(8), 201.111(i), .141(b), .360(a). The ALJ must also prescribe the deadline for seeking review of that decision by the Commission, which the ALJ may "exten[d]" "for good cause shown." *Id.* § 201.360(b).

Although the parties may request review of the ALJ's initial decision by the Commission, 17 C.F.R. § 201.410(a), such review is the exception, not the rule. The SEC issues in each case a "Notice That Initial Decision Has Become Final," stating whether review was sought and granted (either upon request or *sua sponte*). *See*, *e.g.*, *In the Matter of Horizon Wimba, Inc.*, Release No. 75,929 (Sept. 16, 2015). A review of those notices from 2014 and 2015 shows that in approximately

90% of such cases, no further review was conducted. *See* SEC, ALJ Initial Decisions, https://www.sec.gov/alj/aljdec.shtml. Parties do not always seek review. And even when a private party seeks Commission review, review is generally discretionary: Aside from certain specific categories of cases reviewable as matter of right enumerated in SEC regulations—such as Commission action suspending trading in a security, and denials of requests for Commission action regarding registration statements, *see* 17 C.F.R. § 201.411(b)(1)(i)-(iii)—the Commission can "decline to review any other decision[s]," *id.* § 201.411(b)(2). In deciding whether to review an ALJ's decision, moreover, the Commission employs a "clearly erroneous" standard for factual findings. *Id.* § 201.411(b)(2)(ii)(A). A respondent thus may have to show clear error just to *receive* SEC review. And although the Commission may grant review *sua sponte*, *id.* § 201.411(c), such review is similarly purely "discretionary," 15 U.S.C. § 78d-1(b).

When the Commission does *not* grant discretionary review—for whatever reason—the ALJ's initial decision itself is the agency's final word by statute: In such cases, "the action of any … administrative law judge … shall, for all purposes, including appeal or review thereof, be deemed *the action of the Commission*." 15 U.S.C. § 78d-1(b)-(c) (emphasis added). SEC regulations echo this, providing that, "[i]f a party … entitled to review fails to file timely a petition for review … , and if the Commission does not order review of a decision on its own initiative, the

Commission *will* issue an order that the *decision has become final* as to that party." 17 C.F.R. § 201.360(d)(2) (emphases added). The SEC simply tacks on a pro forma, ministerial order confirming that fact. This process parallels the APA, under which, absent a proper appeal, ALJs' "initial decisions" automatically become final "*without further proceedings*." 5 U.S.C. § 557(b) (emphasis added).[5]

The Supreme Court, in fact, has specifically noted that "the role of the … administrative law judge … is 'functionally comparable' to that of a judge.… He may issue subpoenas, rule on proffers of evidence, regulate the course of the hearing, and make or recommend decisions." *Butz v. Economou*, 438 U.S. 478, 513 (1978). It is thus no surprise that a majority of the current Supreme Court has concluded that, as a general matter, ALJs are inferior officers. *See Freytag*, 501 U.S. at 910 (Scalia, J., joined by O'Connor, Kennedy, and Souter, JJ., concurring in part and concurring in the judgment) (federal government's "corps of administrative law judges numbering more than 1,000 … are all executive officers") (emphasis omitted); *Free Enterprise Fund*, 561 U.S. at 542 (Breyer, J., joined by Stevens, Ginsburg, and Sotomayor, JJ., dissenting) (same).

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[5] ALJs also "have long exercised the authority to enter default orders that make findings, order payment of penalties and disgorgement, and order a party to cease and desist," and which are immediately enforceable in federal court. *In the Matter of Alchemy Ventures, Inc.*, Release No. 70,708, 2013 WL 6173809, at *4 (Oct. 17, 2013).

SEC ALJs, in short, have most of the powers of federal district judges, whom no one would describe as mere "aides" (J.A.__[SEC.Op.29]) to appellate courts. Their authority mirrors—and in some ways, exceeds—that of the special trial judges in *Freytag*, whom the Supreme Court held are officers by dint of their ability to "take testimony, conduct trials, rule on the admissibility of evidence, and … enforce compliance with discovery orders." 501 U.S. at 881-82. SEC ALJs can do all of those things, and more. And SEC ALJs have even greater authority than the military judges in *Weiss*, *Ryder*, and *Edmond*. They hear evidence, resolve factual issues, apply legal principles, decide outcomes, and employ broad, effectively unreviewable discretion overseeing discovery, issuing subpoenas, and sanctioning parties.

Since the Supreme Court has held that those other adjudicators—and countless other officials from clerks to election monitors—are inferior officers, *a fortiori* the SEC's ALJs are officers as well. *Cf. Buckley*, 424 U.S. at 126 ("If a postmaster first class, and the clerk of a district court, are inferior officers of the United States within the meaning of the Appointments Clause, as they are, surely the Commissioners before us are at the very least such 'inferior Officers' within the meaning of that Clause") (citations omitted).

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SEC ALJs possess both of the defining characteristics of constitutional "officers": They hold offices established by law and exercise significant federal authority. Under settled Supreme Court precedent, that should end the analysis.

B. The SEC's Reliance On *Landry* Was Misplaced.

The SEC's sole authority for exempting its ALJs from the Appointments Clause (J.A.__[SEC.Op.3, 28-33]) was this Court's decision in *Landry*, 204 F.3d 1125. As the Justice Department has explained, however, *Landry* "did not purport to establish any categorical rule that administrative law judges are employees rather than 'inferior Officers' for purposes of the Appointments Clause," but instead "focuse[d] on the role of a particular ALJ, and his relationship to higher agency authority, within a specific decision-making structure." Br. in Opp. 7, *Landry v. FDIC*, No. 99-1916 (U.S. Aug. 28, 2000), 2000 WL 34013905. The Commission's hearing officers differ from the FDIC's ALJs in the very respects *Landry* deemed critical. And as Judge Randolph pointed out in his *Landry* concurrence, those considerations were themselves suspect and should not be extended.

1. SEC ALJs Differ Critically From The ALJs In *Landry*.

In the SEC's own telling, *Landry* held that FDIC ALJs are not "officers" because they lack "power to issue 'final decisions,'" and the FDIC does not defer to ALJs' factual findings, J.A.__[SEC.Op.29] (citation omitted), but "makes its own." *Landry*, 204 F.3d at 1133. The SEC's analogy to *Landry* fails because the Com-

mission's hearing officers share *neither* of those attributes. Unlike FDIC ALJs, SEC ALJs *do* issue decisions that become final. The SEC (unlike the FDIC), moreover, need not (and does not) review most ALJ decisions, and when it does grant review, the Commission defers to its ALJs' credibility findings. Under *Landry*'s own reasoning, the SEC's ALJs are officers for the very reasons the FDIC's were not.

a. SEC ALJs Can Issue Final Decisions.

Landry relied heavily on the fact the FDIC's ALJs—unlike the special trial judges in *Freytag*—could "never render the decision of the FDIC," but could only submit a "'*recommended* decision, *recommended* findings of fact, *recommended* conclusions of law, and a *proposed* order.'" 204 F.3d at 1133 (brackets and citation omitted). "Final decisions are issued *only* by the FDIC Board of Directors." *Id.* (emphasis added). The SEC's attempt to wrap itself in the cloak of *Landry* fails, however, because the Commission's ALJs *can* issue decisions of the Commission that become final.

The "*initial* decision[s]" (17 C.F.R. § 201.360(b) (emphasis added)) that ALJs issue are *not* merely "'*recommended* decision[s]'" like those issued by FDIC ALJs. *Landry*, 204 F.3d at 1133 (emphasis added) (citation omitted). As noted above, the initial decision becomes the *final* word *of the agency* unless further review is granted. 15 U.S.C. § 78d-1(c). The ALJ's decision is not *replaced* by a

final agency order; the ALJ decision *itself* "become[s] final." 17 C.F.R. § 201.360(d)(2). SEC ALJs therefore *do* have authority—like the special trial judges deemed "officers" in *Freytag*, 501 U.S. at 882, but unlike the FDIC judges in *Landry*, 204 F.3d at 1133—to issue final decisions of the agency in some (and in practice, most) circumstances. As both *Landry* and *Freytag* underscore, it makes no difference to the constitutional question whether the ALJ exercised that authority *here*. *See id.*; 501 U.S. at 882.

The Commission suggested that, under its own regulation, its ALJs' decisions "'becom[e] final' only 'upon issuance of [an] order' by the Commission" confirming that the ALJ's decision has become final. J.A.__[SEC.Op.30-31] (quoting 17 C.F.R. § 201.360(d)(2)). But the Commission's regulation does not transform ALJ decisions into mere recommendations. A federal *statute* mandates that the ALJ's "action," when not reviewed, "*shall*, for all purposes, including appeal or review thereof, *be deemed* the action of the Commission." 15 U.S.C. § 78d-1(c) (emphases added). The SEC's own regulation states that "[t]he Commission *will* issue an order that the decision has become final," 17 C.F.R. § 201.360(d)(2) (emphasis added), not that it "*may*" (or may not) do so as it pleases. The SEC's confirmatory order is a ministerial formality, akin to a court clerk's automatic issuance of the mandate after the time for seeking appellate review has expired; it simply provides clarity as to the effectiveness and timing of the agen-

cy's action. At minimum, Congress has indisputably *permitted* the SEC to treat unappealed ALJ decisions as final—which Congress assuredly could not do unless ALJs were constitutional "officers."

The Commission also suggested that ALJs rarely have occasion to exercise their power to issue final decisions because of the SEC's "'practice'" of "'grant[ing] virtually all petitions for review'" and the Commission's authority to grant review in other cases "on [its] own initiative." J.A.__[SEC.Op.30] (citation omitted). Even if the Commission could support that assertion empirically, parties may elect not to seek Commission review for a variety of reasons: The costs of an administrative appeal may be prohibitive, particularly for one whose career has been disrupted or ended by an enforcement action; an appeal may further prolong the case's economic and personal costs; or a party may conclude that the odds of prevailing before the same Commission which authorized the original enforcement action (and which historically has affirmed most ALJ decisions) render an appeal fruitless.

Even where review is sought, nothing compels the SEC to grant it. SEC rules underscore that "[t]he Commission may decline to review any [ALJ] decision." 17 C.F.R. § 201.411(b)(2). And whatever the SEC's policy in exercising that discretion today, the SEC could (subject to the APA) change its policy tomorrow. The constitutional status of its hearing officers cannot wax and wane as the

Commission—which must balance appellate review with the press of other business, budget and staffing concerns, and other exogenous considerations—varies its discretionary position on how many of their decisions to review.

In any event, "[t]he fact that an inferior officer on occasion performs duties that may be performed by an employee not subject to the Appointments Clause does not transform his status under the Constitution." *Freytag*, 501 U.S. at 882. If an ALJ "is an inferior officer for purposes of" cases where his decisions become final, then "he is an inferior officer within the meaning of the Appointments Clause," period. *Id.* He therefore "must be properly appointed." *Id.*

b. The SEC Does Not Review ALJ Decisions *De Novo*.

The SEC also asserted that, like the FDIC in *Landry*, it does not defer to ALJ decisions, but reviews them "*de novo*." J.A.__[SEC.Op.31]. That is incorrect.

The SEC's analogy to the FDIC's ALJs again overlooks key differences between the two agencies' adjudicators: Precisely because the FDIC's ALJs issue only *recommended* rulings, and the FDIC itself issues the agency's final decision, the FDIC must consider every case. *See* 12 C.F.R. § 308.40(a), (c); *Landry*, 204 F.3d at 1133. The SEC, in contrast, can choose not to review a case at all, 17 C.F.R. § 201.411(b)(2), and in such cases, there is no opportunity for the Commission to "'cur[e]'" "'procedural errors,'" "'hear additional evidence,'" or "'make any findings or conclusions.'" J.A.__[SEC.Op.31] (citation omitted).

When the SEC grants review, moreover, it does not "mak[e] its own factual findings" or review the ALJ's factual findings *de novo*, as the FDIC does. *Landry*, 204 F.3d at 1133. To the contrary, the SEC will "accept [its ALJ's] credibility finding absent *overwhelming evidence to the contrary*." *In the Matter of Clawson*, Release No. 48,143, 2003 WL 21539920, at *2 (July 9, 2003) (emphasis added); *see also*, *e.g.*, *In the Matter of Bridge*, Release No. 9068, 2009 WL 3100582, at *18 n.75 (Sept. 29, 2009) ("The credibility determination of an initial fact finder [*i.e.*, an ALJ] is entitled to considerable weight and deference"). Indeed, even before review is granted, the SEC first considers whether, among other factors, the record contains "[a] finding or conclusion of material fact that is *clearly erroneous*." 17 C.F.R. § 201.411(b)(2)(ii)(A) (emphasis added). Requiring a respondent to make a reasonable showing of clear error *before* obtaining review has no analogue in the FDIC process.

The Commission's limited review of ALJs' factual findings is not merely a policy choice, but also the product of the practical realities of the appellate process. Unlike the ALJ, who observes witnesses' testimony and other evidence firsthand, the SEC reviews only a cold record—itself shaped by the ALJ's rulings on motions, objections, and discovery disputes. *Cf. Anderson v. Bessemer City*, 470 U.S. 564, 575 (1985). And the SEC's ability to do even that is constrained by the Commissioners' extensive *other* duties monitoring and regulating the securities

markets and their participants. *See* SEC, *FY 2016 Congressional Budget Justification* 6 (2015), https://www.sec.gov/about/reports/secfy16congbudgjust.pdf.

Unsurprisingly, ALJs' rulings are in fact rarely disturbed. The ALJ here, for example, has apparently *never* been reversed by the SEC in more than 50 cases. Sarah N. Lynch, *SEC Judge Who Took on the "Big Four" Known for Bold Moves*, Reuters (Feb. 3, 2014), http://tinyurl.com/hlu76fl; *see also* Jean Eaglesham, *SEC Wins With In-House Judges*, Wall St. J. (May 6, 2015), http://tinyurl.com/o9vsozr (finding that in four and-a-half year period SEC ruled for the agency in 95% of its cases (53 of 56)—including 88% of cases where the underlying conduct was disputed—and remanded 5 others). *De novo* review, indeed.

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Both factors that *Landry* deemed dispositive in holding that adjudicators of another agency were not officers cut the opposite way here: SEC ALJs *can* issue final decisions, and the SEC *does* defer to their findings.[6] *Landry* thus lends no support to the SEC's position that its ALJs are exempt from the Appointments Clause.

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[6] *Jarkesy* said in passing that "[t]he Commission reviews ALJ decisions de novo, and it alone possesses the authority to issue a final order." 803 F.3d at 12-13. These points were not at issue in *Jarkesy*, and the Court apparently took this statement from the Commission's brief. *See* SEC Br. 4, *Jarkesy v. SEC*, No. 14-5196 (D.C. Cir. Jan. 28, 2015), 2015 WL 364734. As established in the text, the SEC's characterizations of the applicable statutory and regulatory regime, both in this case and in *Jarkesy*, are legally erroneous.

2. Extending *Landry* To SEC ALJs Would Contravene Supreme Court Precedent.

Because neither *Landry*'s holding nor its reasoning applies to the SEC's ALJs, the Court need not confront here whether *Landry* was correctly decided if it vacates the decision and order under review, as it should. *Sustaining* that decision and order, however, *would* require the Court to address the validity of *Landry*'s reasoning before extending it to SEC ALJs. In that event, petitioners respectfully submit that *Landry* should be revisited and overruled. As Judge Randolph explained in his *Landry* concurrence, neither factor the majority deemed dispositive—authority to issue final decisions, and the agency's standard of review—"survives close attention." 204 F.3d at 1140-43.

a. Authority To Issue Final Decisions Is Unnecessary.

The *Landry* majority mistakenly concluded that special trial judges' "power of final decision … was critical to the [*Freytag*] Court's decision," and that because the FDIC ALJs lacked such power, they were not inferior officers. 204 F.3d at 1134. Although *Freytag* discussed that power, 501 U.S. at 882, the *Landry* "majority neglect[ed] to mention" that the Supreme "Court clearly designated this as an *alternative* holding." 204 F.3d at 1142 (Randolph, J., concurring in part and concurring in the judgment) (emphasis added).

After explaining why special trial judges were "officers" based on *other* duties and attributes of their positions—including the authority to issue *non*-final

decisions under the relevant statute—the Supreme Court stated that, "*[e]ven if* the duties of special trial judges … were not as significant *as we … have found them to be*, our *conclusion* would be *unchanged*." 501 U.S. at 882 (emphases added). That "conclusion" was "[t]he conclusion" the Supreme Court "had reached in the preceding paragraphs"—and that lower-court decisions that *Landry* approved had also reached—"namely, that although special trial judges may not render final decisions, they are nevertheless inferior officers of the United States." 204 F.3d at 1142 (Randolph, J., concurring in part and concurring in the judgment); *see Freytag*, 501 U.S. at 881 (citing *Samuels, Kramer & Co. v. Comm'r*, 930 F.2d 975 (2d Cir. 1991)). "Only after it concluded [special trial judges] were inferior officers did *Freytag* address the [judge's] ability to issue a final order; the [judge's] limited authority to issue final orders was only an additional reason, not *the* reason." *Ironridge*, 2015 WL 7273262, at *15.

The *Landry* majority's assumption that an inability to render final decisions takes officials outside the scope of "officers" would turn the Supreme Court's Appointments Clause jurisprudence upside-down. The Supreme Court has made clear that an official's inability to issue final agency decisions does not disqualify the official from being an officer. To the contrary, it is often a *defining feature* of *inferior* officers that distinguishes them from *principal* officers. *See Edmond*, 520 U.S. at 665-66; *see also Dep't of Transp. v. Ass'n of Am. R.Rs.*, 135 S. Ct.

1225, 1238 (2015) (Alito, J., concurring) ("Inferior officers can do many things, but nothing final should appear in the Federal Register unless a Presidential appointee has at least signed off on it"). As the United States itself has explained in a brief joined by the SEC, "*Edmond* makes clear [that] the Board's inability to render a final decision … is itself indicative of inferior, not principal, officer status." U.S. Br. 32 n.10, *Free Enterprise Fund v. Pub. Co. Accounting Oversight Bd.*, No. 08-861 (U.S. Oct. 13, 2009), 2009 WL 3290435 (emphasis omitted). A defining feature of one type of "officer" cannot *exempt* officials from the Appointments Clause.

b. The Agency's Standard Of Review Is Irrelevant.

Landry also placed great weight on the fact that the FDIC—unlike the Tax Court in *Freytag*—did not defer to its ALJs' factual findings. 204 F.3d at 1132-33. *Freytag* itself, however, ascribed no significance to the agency's standard of review. *See* 501 U.S. at 880-82. Indeed, the Court stressed that the Tax Court's rule prescribing that deferential standard was "not relevant to [its] grant of certiorari." *Id.* at 874 n.3; *see also* 204 F.3d at 1142 (Randolph, J., concurring in part and concurring in the judgment).

It would have been remarkable, in fact, if the *Freytag* Court *had* attributed constitutional significance to the degree of deference an agency applies in reviewing decisions of those to whom it has delegated authority. In cases where the ini-

tial adjudicator's decision becomes the agency's final word without review, the standard of internal review is irrelevant.

Moreover, in many cases—including *Freytag* and this case—the standard of review is the agency's own creation. The Tax Court applied deferential review based on an "internal rule of procedure," and that court "had discretion to pick whatever standard of review it saw fit." 204 F.3d at 1142 (Randolph, J., concurring in part and concurring in the judgment). Whether the Constitution's appointments protocol applies to an adjudicator cannot turn on how thoroughly the agency *chooses* to review the adjudicator's decisions. The Constitution entrusts the decisions of whether to create inferior officers—and whether to exempt them from the default requirements of presidential appointment and Senate confirmation—to *Congress*, not to agencies themselves.

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The Appointments Clause establishes a vital "structural safeguar[d]" against unaccountable exercises of federal power. *Edmond*, 520 U.S. at 659. Rigorous application of its requirements is essential to the integrity and legitimacy of the administrative state. Some cases present close questions of the Clause's outer limits. This is not one of them.

II. THE COMMISSION'S LIABILITY DETERMINATIONS AND SANCTIONS SHOULD BE VACATED.

Even if the decision and order under review were not doomed by the participation of an unconstitutionally appointed officer, the Commission's liability determinations and sanctions should be vacated because both are legally erroneous and factually unsupported. A calling card of agency arbitrariness is the imposition of punishment for conduct that was not unlawful at the time it occurred; that is what the Commission did here, approving a lifetime bar on Lucia for using a word that had no regulatory meaning until this decision, that was entirely accurate in the context of petitioners' presentations, and that caused no loss to anyone.

The Enforcement Division's entire case was built on the allegation that the word "backtest" encompasses only historical data and therefore petitioners misled investors by describing as "backtests" *hypothetical* scenarios that expressly used a mix of historical data and assumptions regarding rates of return. This theory, as the dissenting Commissioners observed, was "create[d] from whole cloth." J.A.__[Dissent.1]. No law or regulation defines "backtest"; and even if the Commission's new definition were correct in the abstract, petitioners' presentations made clear that *their* "backtested" hypotheticals incorporated specified assumptions. It was not materially misleading—and certainly did not amount to *intentional* securities fraud that could support an industry bar—to use the term in this way.

The two other concerns the Commission expressed with petitioners' presentations were mere window-dressing. One—an inadvertent miscalculation regarding the 1973 hypothetical—was not even charged by the Enforcement Division, undoubtedly because the error *undercounted* the benefits of petitioners' retirement strategy. The other—the alleged omission of the effect of reallocating ("rebucketizing") assets over time—is not actionable because the presentations contained no representation that rebucketizing was a necessary part of the strategy. Even if these aspects of the presentations could be considered misleading in the abstract, there was no proof that either was material or made with scienter.

This Court should set aside all of the Commission's liability determinations as contrary to law and unsupported by substantial evidence. The sanctions would thereby become moot. In the alternative, the Court should vacate the scienter-based liability determinations and remand to the Commission for a recalculation of monetary sanctions. At minimum, the Court should vacate the sanction of a lifetime bar—the industry equivalent of the death penalty—as arbitrary and capricious.

A. Petitioners Made No Material Misrepresentations Or Omissions.

The SEC strained to find deception where none existed. None of the supposed misrepresentations it identified was materially misleading, especially in the context of petitioners' multiple written and spoken disclaimers.

1. Using The Term "Backtest" Was Not Misleading In The Context Of The Presentations.

The SEC seized on a single word—"backtest"—that appeared just twice in a 126-page slideshow. J.A.__[SEC.Op.17-18]; *see* J.A.__[DX-1.170, 200]; *cf.* J.A.__[DX-1.092-218]. The Commission concluded that, in describing the two historically inspired hypotheticals as "backtests," petitioners intentionally misled prospective investors to believe that these scenarios were based *exclusively* on historical data. *Id.* The use of that word, in the SEC's view, also rendered misleading the hypothetical *results* presented that, as the presentations themselves disclosed, were based on assumptions (rather than historical data) regarding inflation and real-estate investment return rates. J.A.__[SEC.Op.18]. That conclusion is insupportable.

a. "Backtest" Had No Settled Meaning.

As the dissenting Commissioners explained, there is no "statutory or regulatory definition of what constitutes a 'backtest.'" J.A.__[Dissent.1]. The majority did not dispute this point. Until the decision and order under review were released, the SEC had never before defined the term or sanctioned anyone for using it.

The SEC nevertheless concluded that petitioners committed intentional securities fraud by twice using the word "backtest" in connection with their hypothetical investment scenarios. According to the Commission, "backtests" must rely *exclusively* on historical data and cannot employ assumptions. J.A.__[SEC.Op.17-

18]. The SEC's on-the-fly creation of a new legal definition for that term—and its imposition of severe sanctions for its purported misuse—was so extreme that it drew the only written dissent from an enforcement decision of 2015.

The sole support the SEC offered for its novel definition was its statement that "[t]he parties' experts agreed that backtests *use* historical data." J.A.__[SEC. Op.17] (emphasis added). But the pivotal question is not whether backtests *use* (*i.e.*, include) historical data, as petitioners' presentations did; it is whether referring to a hypothetical as a "backtest" fraudulently suggests that it is based *entirely* on actual historical data. The SEC "pointed to *no* evidence, and therefore obviously not to *substantial* evidence" (*Comcast Cable Commc'ns, LLC v. FCC*, 717 F.3d 982, 987 (D.C. Cir. 2013) (emphases added)), for its novel historical-data-*only* definition. Petitioners, in contrast, presented evidence that "backtests" that rely partly on historical data and partly on assumed data are not unique. For example, one of the country's largest mutual-fund companies, American Funds, disseminated promotional materials that backtested a particular strategy from 1961 to 2010 based on an assumed, not actual, 4% inflation rate. J.A.__[SEC.Op.10].

It is not misleading to use a term with no settled meaning simply because an agency *later* announces a different, idiosyncratic definition that it has never before made public. Whatever the scope of the SEC's authority to regulate the use of the term "backtest" *prospectively*, it had no authority or basis to punish *past* uses of

that term at a time when no established definition existed. Indeed, by sanctioning petitioners for violating newly minted restrictions on a term's use that did not previously exist, the Commission contravened "[t]raditional concepts of due process incorporated into administrative law" that "preclude an agency from penalizing a private party for violating a rule without first providing adequate notice of [its] substance." *Satellite Broad. Co. v. FCC*, 824 F.2d 1, 3 (D.C. Cir. 1987); *see*, *e.g.*, *Trinity Broad. of Fla., Inc. v. FCC*, 211 F.3d 618, 628-32 (D.C. Cir. 2000). The Commission's finding that petitioners misled prospective investors by twice using the term "backtest" to describe certain hypotheticals cannot stand.

b. Petitioners Made Clear That The Hypotheticals Involved Some Assumed Figures.

Even assuming the SEC's authority to provide a regulatory definition for the term "backtest" in the context of adjudication, *and* its authority to apply that definition retroactively, petitioners made unmistakably clear what *they* meant when using the term in their presentations. Thus, even if "backtest" *ordinarily* refers to analyses based solely on historical data, petitioners' use of it could not have been misleading given their repeated, explicit disclosures—in the slides and in Lucia's statements—that the examples were *hypothetical* and relied in part on *assumed* (*i.e.*, not exclusively historical) rates of return.

As the First Circuit recently reiterated in overturning another SEC ruling, "[c]ontext makes a difference" in assessing whether a statement or omission is

misleading. *Flannery v. SEC*, __ F.3d __, 2015 WL 8121647, at *8 (1st Cir. Dec. 8, 2015). Individual statements—particularly those in lengthy presentations that are a prelude to (and expressly not part of) an investment-adviser relationship—cannot be viewed in isolation, but must be considered among the "total mix of information" presented. *Id.* (holding that SEC abused its discretion in finding one potentially misleading slide "of a presentation of at least twenty" to be materially misleading where slides "are not intended to present a complete picture," but serve as "starting points" for potential investors who "understand that [they] could specifically request additional information") (internal quotation marks omitted). *A fortiori*, even if a word has an ordinary meaning, a speaker does not mislead in departing from that definition so long as the non-standard meaning is made clear.

The two isolated uses of "backtest" on which the Commission seized here were clarified by nearly *forty* disclaimers that "[r]ates are hypothetical in nature and for illustrative purposes only," that "[t]his is a hypothetical illustration and is not representative of an actual investment," and the like. J.A.__[DX-1.152-213, DX-1.176-201]. The slides stated explicitly that certain statistics used in the hypothetical scenarios were based on actual data, while others were not. The 1966 example, for instance, described stock and bond returns as "based on actual market returns," but noted that real-estate returns and inflation rates were merely "[a]ssumptions." J.A.__[DX-1.204]; *supra* pp. 5-6.

Lucia's verbal statements also foreclose any possible ambiguity about the hypothetical nature of the examples, stressing that some figures used were assumptions, not historical fact. The SEC's expert witness at trial relied exclusively on the slides alone, conceding that he never saw an actual seminar presentation. J.A.__[Hearing.Tr.963-64]. But a transcribed webinar introduced into evidence confirmed that Lucia repeatedly highlighted to his audience that he was using assumptions, not historical data. For example, when presenting the buckets-of-money strategy, Lucia showed a slide depicting all the assumed rates of return he was using, J.A.__[RX-3.113], and stated that "there, of course, is the summary of all of the different assumptions that we made," J.A.__[Webinar.Tr.46:14-16]. When he introduced the 1966 illustration, he stated that, "once again, these are the assumptions that we used." J.A.[Webinar.Tr.48:5-7].

Likewise, Lucia described his use of an assumed inflation rate by explaining, "let's pretend that from that point forward, inflation was 3 percent. We know it was more. But we wouldn't have known that at the time." J.A.__[Webinar.Tr. 48:5-49:2]. As even the ALJ recognized, "seminar attendees would understand that a flat 3% rate did not reflect year-by-year historical rates, especially because attendees were mostly retirees and near-retirees who lived through the tumultuous high-inflation years of the late 1970s and early 1980s, and would understand that inflation varies year to year." J.A.__[ALJ.Initial.Decision.on.Remand.34].

The Commission majority gave all of this evidence the back of its hand, dismissing the numerous express disclosures and disclaimers with the question-begging assertion that they "did not change the overall impression that [petitioners] had performed backtests." J.A.__[SEC.Op.23]. That bootstrapping response *assumes* that prospective investors would have taken "backtest" to refer to analysis of exclusively historical data. But the key question is precisely *whether* reasonable listeners would have understood the references to "backtests," in context, to bear that meaning in the first place. And the disclaimers here made clear that petitioners were *not* presenting purely historical calculations. No reasonable seminar attendee could have understood petitioners' description of their hypotheticals as "backtests" to mean a type of analysis that petitioners said explicitly they had not performed.[7]

c. The Results Presented Were Not Misleading.

For the same reasons, the SEC's corollary conclusion that the "backtest" label made the "results" petitioners presented "misleading" (J.A.__[SEC.Op.18]) must be rejected as well. The Commission asserted that the results were fraudulent

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[7] The Commission noted that two former clients testified that they subjectively believed petitioners backtested using historical data. But whether a representation or omission is misleading turns on an objective, not subjective, inquiry. *See SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1992). Tellingly, out of approximately 50,000 attendees of the presentations, the Enforcement Division marshaled just *two* who asserted (long after the fact) an understanding that departed from the actual presentations.

because the fictional assumptions the hypotheticals employed did not track historical data; for example, the "use of a flat 3% inflation rate" was lower and less volatile than actual inflation in the period covered. J.A.__[SEC.Op.18-19]. But that is the whole point of a disclosed assumption. The Commission's misleading-"results" argument is the same baseless "backtest" contention in different packaging.

2. Petitioners Never Represented That The Hypotheticals Involved "Rebucketizing" Assets.

The Commission's conclusion that the hypothetical illustrations were misleading because they did not "rebucketize," or rebalance, the assets after the buckets were serially exhausted (J.A.__[SEC.Op.24]) similarly fails because petitioners never asserted that the examples *did* rebucketize assets. The SEC reasoned that audience members would have assumed that the examples did rebucketize because rebucketizing is (the SEC asserted) "a key aspect of the [buckets-of-money] strategy." J.A.__[SEC.Op.24]. But the Commission pointed to nothing in the presentations describing rebucketizing as a necessary step. Nor could it.

Nothing in the slideshow described rebucketizing as essential. Only after twenty-seven slides illustrating the buckets-of-money strategy—which never mentioned rebucketizing—does the slideshow contain a single line referring to it without elaboration. J.A.__[DX-1.171-198]. The webinar transcript confirms that Lucia, during that part of the presentation, said nothing about rebucketizing as part

of the strategy. J.A.__[Webinar.Tr.46:20-47:6]. Rather, only after completing all of the illustrations did Lucia verbally describe rebucketizing as an additional *option*—"a little more sophisticated" approach, and "something I would work" on "with [a] financial advisor." J.A.__[Webinar.Tr.80:15-81:19]. The presentations could not have been misleading merely by omitting a step that was never represented to prospective investors as a necessary part of the proposed strategy.

3. The Error In The 1973 Example Was Never Charged And Was Not Material.

The SEC's final fraud finding concerns a calculation error in the 1973 hypothetical. The trial evidence suggested that the valuation set forth in the presentations using the buckets-of-money approach ($1,544,789) was inaccurate. J.A.__[SEC.Op.19]. In fact, the figure presented was too *low*. That error cannot support the SEC's liability finding for at least two reasons: It was never charged, and—because it *undervalued* the proposed approach's returns—it was not material.

a. The Error In The 1973 Example Was Not Charged.

The error in the 1973 example was never charged, and petitioners accordingly had no notice of it. The SEC undisputedly was required to afford petitioners a hearing before imposing sanctions. 15 U.S.C. §§ 78*o*(b)(6)(A)(i), 80b-3(e)-(f), (i)(1)(A). And "for the hearing requirement to have any meaning, the notice provision must be interpreted to require that [a] respondent [in SEC proceedings] have 'fair notice' of the claim lodged against it 'and the grounds upon which it rests.'"

Jaffee & Co. v. SEC, 446 F.2d 387, 394 (2d Cir. 1971) (citation omitted). Indeed, because "suspension or revocation of a professional license" constitutes "a penalty," the SEC was constitutionally required to afford petitioners "due process protections such as fair notice of the charge." *Johnson v. SEC*, 87 F.3d 484, 488-89 n.6 (D.C. Cir. 1996) (citing *In re Ruffalo*, 390 U.S. 544, 550 (1968)).

The SEC's charging document, however, never mentioned the inaccuracy regarding the 1973 example. *See generally* J.A.__[Order.Instituting.Proceedings]. And the SEC's reliance on this uncharged error unfairly prejudiced petitioners' ability to present a defense. The ALJ mentioned the error only in passing, *see* J.A.__[ALJ.Initial.Decision.On.Remand.22, 37, 43], and petitioners consequently did not address it directly on appeal to the SEC, *see* J.A.__[Petrs.Reply.On. Appeal.16 n.7]. Had petitioners known the Commission would rely on that error as an independent basis for liability, they could have explained why it could not have been material. The Commission could not lawfully punish petitioners based on the uncharged error in the 1973 example.

b. The Undervaluation Of Returns Was Not Material.

Even if the 1973 example's error were not out-of-bounds, it would add nothing to the Commission's case because it could not possibly be material. As the SEC acknowledged, a statement is immaterial absent a "'substantial likelihood that the disclosure of the omitted fact'" would have "'significantly altered the total mix

of information made available.'" J.A.__[SEC.Op.19] (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988)). If the omitted fact would not be "'significant to the trading decision of a reasonable investor,'" it cannot support liability. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1317-19 (2011) (citation omitted).

Although the potential returns set forth in the slideshow were incorrect using the stated assumptions, the SEC's decision neglects to mention that the *correct* figure using those assumptions would have been *higher*. The SEC staff's *own analysis* concluded that "the performance presented in the seminar presentation was *substantially lower* than the staff's recalculation based on the hypothetical scenario offered by the presentation." J.A.__[RX-50.20 n.11] (emphasis added); *see also* J.A.__[Hearing.Tr.88:25-89:9]. The inadvertently erroneous figure thus could not have affected the investment decisions of a reasonable investor.

B. The SEC Failed To Prove Scienter Under Section 206(1).

To find liability under Section 206(1)—and to justify extreme sanctions—the Commission was further required to find that petitioners acted with scienter, "an 'intent to deceive, manipulate, or defraud.'" *Steadman*, 967 F.2d at 641, 643 n.5, 647 (citation omitted).

The Commission asserted that petitioners "acted at least recklessly" in presenting the "backtests" because "Lucia knew that the backtests were not based on

historical data" alone, but partly on assumptions that diverged from historical facts, and "knew or must have known that using hypothetical data in the backtests would not reflect historical results." J.A.__[SEC.Op.19-20, 27]. But even assuming the SEC's novel, idiosyncratic definition of "backtest" were well-founded *today*, the Commission cannot credibly contend that petitioners intentionally misused that term in presentations *years before* the SEC announced that definition in this case. Any suggestion that petitioners intentionally concealed that their illustrations were based partly on specified assumptions is further belied by the slides' and Lucia's repeated, explicit disclaimers of that very fact.

The SEC's contention that petitioners "knew that the backtests … did not rebucketize" (J.A.__[SEC.Op.20]) fails for a similar reason: Petitioners did not intend to *conceal* that fact because they never asserted that rebucketizing was part of the recommended approach. Even if petitioners' belief about what seminar attendees would glean from the slides were mistaken, that hardly proves that they acted with scienter.

The surrounding circumstances obliterate any possible inference of intent to deceive. Petitioners submitted their presentations for review to both the Commission's staff, who raised no concerns, and two FINRA-registered broker-dealers who had oversight of RJLC, who approved the presentations in advance. The Commission dismissed petitioners' lack of notice of any impropriety on the ground

that petitioners did not specifically call the "backtests" and use of "assumed" rates to their attention. J.A.__[SEC.Op.27-28]. But those purportedly misleading statements were apparent on the face of the slides. J.A.__[DX-1.171-212]. If they were material (as the Commission asserts), they should have been readily apparent to the examination staff trained to seek out misrepresentations. That the Commission's own in-house examiners saw nothing amiss refutes any suggestion that the petitioners had any reason to believe they were misleading potential investors.

Given the Commission's inability to muster any evidence that petitioners knew or should have known their statements would later be deemed misleading, and given petitioners' good-faith steps to seek advance approval and to avoid investor confusion, the Commission's finding of scienter has no explanation but caprice.

C. The Sanctions Are Unjustified.

The Commission's caprice carried over to its inexplicable choice of a grossly disproportionate, punitive sanction on Lucia in addition to exacting substantial monetary penalties from both petitioners. In a case that turned on the use of a single word that was previously undefined, the SEC imposed a *lifetime* industry bar—"'the securities industry equivalent of capital punishment,'" *Saad*, 718 F.3d at 906 (citation omitted). This "most drastic" sanction "in the Commission's 'arsenal'" is rightly reserved for the most "egregiou[s]" cases, and in imposing it the

SEC thus must carry the "greater burden to show with particularity" why it is warranted and "why less severe action would not serve to protect investors." *Steadman v. SEC*, 603 F.2d 1126, 1137, 1139-40 (5th Cir. 1979), *aff'd*, 450 U.S. 91 (1981). The SEC did not come close in this case to justifying the extreme sanction of a lifetime bar.

As the Commission conceded, J.A.__[SEC.Op.34], the appropriateness of a bar turns on:

> the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

Steadman, 603 F.2d at 1140 (internal quotation marks omitted). *None* of those factors supports a career-ending bar on Lucia here.

Lucia did not act "egregiously" in referring to two hypothetical scenarios as "backtests" while simultaneously making clear that those scenarios incorporated both historical data and assumptions. His only failure was not foreseeing the Commission's *future* definition of a term that at the time had no established or term-of-art meaning. Lack of omniscience about which way an agency will later swerve hardly justifies a bar from the industry for life. Even if the Court were to conclude that Lucia was negligent in his use of investment terminology, and thereby sustain the Commission's liability determination under a provision of the Ad-

visers Act that does not require scienter, the lifetime bar could not stand (and the financial penalties would have to be recalculated).

Moreover, the SEC itself found that the supposed misrepresentations did not injure *anyone*: The Enforcement Division, it concluded, never proved that petitioners' "clients or prospective clients suffered *any* losses," or even "were at significant *risk* of suffering substantial losses." J.A.__[SEC.Op.40 n.154] (emphases added). And there is no present risk that the references to "backtests" in the presentations could "present opportunities" for *future* harm to investors; Lucia has withdrawn the offending slides, and RJLC is defunct. The Commission wrote off as irrelevant the absence of any actual injury or even risk of injury, asserting that "the absence of investor injury is not mitigating," even though "its existence" can support a finding of "egregiousness." J.A.__[SEC.Op.37 & n.139]. That heads-I-win-tails-you-lose approach is the definition of agency arbitrariness. If the effect on investors is relevant when it cuts in the agency's favor, it cannot be irrelevant when it cuts the other way.

The statements the SEC deemed misleading, moreover, were isolated terms in a 100-plus-page slideshow that was on the whole entirely unobjectionable. Lucia obtained advance review of the slideshow from the brokerage firms that were ultimately responsible for supervising him, and voluntarily withdrew the relevant slides as soon as the SEC's staff raised concerns. To be sure, Lucia has not "rec-

ognized" the "wrongful nature" of his acts; but that is because he sincerely (and correctly) believes that he violated none of the securities laws in his presentations, and will not confess to a violation he did not commit.

Lucia's spotless 40-year record is further testament to his earnestness, and further reason why a lifetime bar is out of whack with the conduct at issue here. That sanction is "usually reserved for those defendants *who intentionally engaged in prior securities violations* under circumstances suggesting the likelihood of future violations." *SEC v. Benger*, 64 F. Supp. 3d 1136, 1138 (N.D. Ill. 2014) (emphasis added). Throughout his long career, Lucia has never been found to have committed *any* violation, and the Commission's evidence of scienter here is nonexistent. For the Commission to tarnish the reputation of such a man, preclude him from his lifelong profession, and potentially force him into bankruptcy is, on this record, not merely unjust: It is unconscionable.

The Commission was unable to identify even a single case involving comparable alleged facts where it imposed this sanction. And petitioners cited a raft of cases involving similar allegations concerning marketing materials, none of which resulted in a lifetime bar. *See*, *e.g.*, *In the Matter of Modern Portfolio Mgmt., Inc.*, Release No. 3702, 2013 WL 5740461 (Oct. 23, 2013); *In the Matter of Equitas Capital Advisors, LLC*, Release No. 3704, 2013 WL 5740460 (Oct. 23, 2013); *In the Matter of New England Inv. & Ret. Grp., Inc.*, Release No. 3516, 2012 WL

6591597 (Dec. 18, 2012). The agency brushed them all aside because they involved settlements, J.A.__[SEC.Op.37 n.140], but that only underscores the agency's caprice: While agencies may take appropriate account of parties' willingness to settle, punishing a respondent for taking his case to trial—especially where, as here, that trial exposed the sheer novelty of a liability theory that commanded only a 3-2 majority of the Commission, and that would never have resulted in a liability judgment had the Commission elected to proceed in federal district court—is yet another example in this record of arbitrary and capricious agency action.

CONCLUSION

For these reasons, the Court should grant the petition for review and should hold unlawful and vacate the Commission's decision and order.

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CERTIFICATE OF COMPLIANCE

1. This brief complies with the type-volume requirement of Federal Rule of Appellate Procedure 32(a)(7) because this brief contains 13,986 words, as determined by the word-count function of Microsoft Word 2010, excluding the parts of the brief exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii); and

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CERTIFICATE OF SERVICE

I hereby certify that, on this 1st day of February, 2016, I electronically filed the foregoing Opening Brief for Petitioners with the Clerk for the United States Court of Appeals for the District of Columbia Circuit using the appellate CM/ECF system. Service was accomplished by the CM/ECF system on the following counsel, who are registered CM/ECF users:

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