



## Securities Litigation ADVISORY ■

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### SEC's In-House Court System in Jeopardy After Two Major Developments

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For decades, companies and individuals have been forced to defend themselves against reputation-damaging, costly, and potentially career-ending allegations of securities fraud, accounting fraud, and other financial malfeasance in a quasi-judicial system where the Securities and Exchange Commission (SEC) is not only the prosecutor, but also the judge and the jury.

When the SEC brings a contested enforcement action, it can choose to file in federal court, where defendants receive protections such as the right to a trial by a jury of one's peers. Or it can choose to file that same action in an administrative proceeding before one of the in-house administrative law judges (ALJs) appointed by the Commission, where it has historically won cases at a much higher rate.<sup>1</sup> These ALJs have extraordinarily broad powers—including not just the power to impose penalties and disgorgement, but also the ability to permanently bar financial advisors and other market participants from the securities industry, and the ability to permanently bar certified public accountants (CPAs) and securities lawyers from practicing before the Commission.

Defendants frequently object that this system is unfair at best and unconstitutional at worst. Their objections are finally getting traction in the courts, including in two recent decisions that represent some of the biggest developments in this area for several years. First, on May 18, 2022, the U.S. Court of Appeals for the Fifth Circuit [issued](#) a landmark decision in *Jarkesy v. SEC*, holding that the SEC's in-house court system is unconstitutional in its current form for a number of independent reasons. Second, on May 16, the U.S. Supreme Court [agreed to hear](#) *SEC v. Cochran*, a procedural case that may allow defendants to go directly to federal court to challenge the constitutionality of the SEC's in-house court system rather than enduring a full administrative proceeding and an appeal to the Commission before doing so. Both developments may bring increased rights for SEC defendants and fundamentally reshape the way the SEC litigates its cases.

<sup>1</sup> See, e.g., Jean Eaglesham, *SEC Wins with In-House Judges*, Wall St. J. (May 6, 2015), <https://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803> (finding "[t]he SEC won against 90% of defendants before [ALJs] in contested cases from October 2010 through March [2015]," which "was markedly higher than the 69% success the [SEC] obtained against defendants in federal court over the same period").

## Fifth Circuit Finds SEC's In-House Court System Unconstitutional

On May 18, 2022, a divided panel of the Fifth Circuit Court of Appeals in *Jarkesy v. SEC*<sup>2</sup> dealt a severe blow to the SEC's use of administrative proceedings to resolve contested enforcement actions. The Fifth Circuit held that (1) the "in-house adjudication" of violations of the securities laws by an SEC ALJ violated the defendants' Seventh Amendment right to a jury trial; (2) Congress had "unconstitutionally delegated legislative power" to the SEC because it failed to provide "an intelligible principle" by which the SEC could exercise that delegated power; and (3) the statutory removal restrictions on SEC's ALJs violated Article II of the U.S. Constitution.<sup>3</sup>

### ***Issues on appeal***

The defendants in *Jarkesy* were accused by the SEC of misrepresenting the assets and operations of two hedge funds. Defendants sought to enjoin agency proceedings, arguing that they violated their constitutional rights.<sup>4</sup> The District Court for the District of Columbia and U.S. Court of Appeals for the D.C. Circuit refused to issue an injunction.<sup>5</sup> The administrative proceeding thereafter ran its course with the ALJ finding that the defendants had committed securities fraud, a conclusion that was ultimately affirmed by the Commission which awarded civil penalties, disgorgement, and an industry bar.<sup>6</sup> The defendants thereafter successfully petitioned for review by the Fifth Circuit.

### ***Court's ruling on appeal***

Before the Fifth Circuit, the defendants raised several constitutional challenges to the SEC's enforcement proceeding. As noted above, the Court sided with defendants on the issue of whether they had been deprived their Seventh Amendment right to a jury trial. The Court held that the rights the SEC sought to vindicate through its enforcement action and the award of civil penalties arose "at common law" under the terms of the Seventh Amendment.<sup>7</sup> The Court also held that an exception to the rule that allows for agency proceedings known as the "public-rights doctrine" did not apply. This was so because, *inter alia*, SEC enforcement actions are not new actions unknown to common law nor would allowing jury trials of such matters "dismantle the statutory scheme" or "impede swift resolution."<sup>8</sup>

A further constitutional violation was found with respect to what the Court held was an improper delegation of legislative power to the SEC, which "gave the SEC the unfettered authority to choose whether to bring enforcement actions in Article III courts or within the agency."<sup>9</sup> This delegation of authority violated the

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<sup>2</sup> *Jarkesy v. SEC*, No. 20-61007 (5th Cir. May 18, 2022).

<sup>3</sup> *Jarkesy*, No. 20-61007, at 2.

<sup>4</sup> *Id.*

<sup>5</sup> See *Jarkesy v. SEC*, 48 F. Supp. 3d 32, 40 (D.D.C. 2014), *aff'd*, 803 F.3d 9, 12 (D.C. Cir. 2015).

<sup>6</sup> *Jarkesy*, No. 20-61007, at 2-3.

<sup>7</sup> See *Jarkesy*, No. 20-61007, at 8-11. The fact that some of the relief sought was equitable in nature was not dispositive because the Supreme Court had previously held that the Seventh Amendment applies to "mix[ed]" proceedings with both legal and equitable claims. *Id.* at 10-11.

<sup>8</sup> *Id.* at 11-18.

<sup>9</sup> *Id.* at 18.

so-called “non-delegation doctrine” because Congress had delegated power to an agency that qualified as “legislative power” but failed to provide “an intelligible principle” to guide this use of delegated power.<sup>10</sup> The Court focused on the fact the SEC has “absolute discretion to decide” whether to bring enforcement actions within the agency or in an Article III court and Congress provided no guidance as to “how the SEC should make that call in any given case.”<sup>11</sup> The Court reasoned that “a total absence of guidance” from Congress must necessarily flunk the “intelligible principle standard[.]”<sup>12</sup>

According to the Fifth Circuit, the final constitutional infirmity arose from the statutory removal restrictions for all SEC ALJs.<sup>13</sup> The Court held that ALJs are protected from removal by the President by “at least two layers of for-cause protection” – meaning the ALJs could only be removed “for cause” as is also the case for those parties who could decide in favor of an ALJ’s removal (*i.e.*, the SEC Commissioners and the Merit Systems Protection Board).<sup>14</sup> The Court determined that prior Supreme Court precedent forbids there being such an impediment to the President’s power to control the appointment and approval of executive officers under Article II of the Constitution.

### **Next steps and implications**

Many people expect the SEC will petition the Fifth Circuit for rehearing *en banc*, particularly in light of the fact that the opinion was not unanimous.<sup>15</sup> The SEC could also seek review by the Supreme Court depending on how further proceedings before the Fifth Circuit play out. The decision also has potential implications for other agencies that similarly employ ALJs. In the wake of the Supreme Court’s decision in *Lucia v. SEC*,<sup>16</sup> which was decided in 2018 and covered in a previous Alston & Bird [advisory](#), the SEC has brought the bulk of its contested enforcement actions in federal court.<sup>17</sup> If *Jarkesy* were to become the law in other Circuits, what may have been a temporary move to federal court could become permanent, given the continued success defendants are having in raising constitutional challenges to administrative proceedings.

## **Supreme Court Considers Fast-Tracking Challenges to SEC’s In-House Court System**

On May 16, 2022, the U.S. Supreme Court [granted](#) the government’s [petition](#) for a writ of certiorari (cert petition) in *SEC v. Cochran*, agreeing to resolve a circuit split on an important procedural issue that could fast-track further constitutional challenges to the SEC’s in-house court system. In sum, the Supreme Court

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<sup>10</sup> *Id.* at 18-19, 22-23.

<sup>11</sup> *Id.* at 24-25.

<sup>12</sup> *Id.* at 25.

<sup>13</sup> *Id.* at 25-30.

<sup>14</sup> *Id.* at 27, 30.

<sup>15</sup> Circuit Judge W. Eugene Davis filed a dissenting opinion. *See id.* at 31-54.

<sup>16</sup> *Lucia v. SEC*, 138 S. Ct. 2044 (2018) (holding that ALJs were not mere employees of the SEC, but rather “Officers of the United States” who must be appointed by the Commission itself, rather than SEC staff, under the Constitution’s Appointments Clause).

<sup>17</sup> *See, e.g.*, Dave Michaels, *Judges Deal Latest Blow to SEC’s In-House Courts*, Wall St. J. (May 18, 2022), <https://www.wsj.com/articles/judges-deal-latest-blow-to-secs-in-house-courts-11652910919> (“The SEC has pared back its use of its administrative courts in the years since defense attorneys, defendants and libertarian advocacy groups began attacking them. In September 2015, the SEC had 236 cases pending before the [ALJs]. At the end of March [2022], it only had nine, according to SEC records.”).

will decide if a defendant in an ongoing SEC administrative proceeding can go directly to a federal district court to challenge the SEC's adjudication as unconstitutional (as permitted by the Fifth Circuit<sup>18</sup>)—or, alternatively, if a federal court can hear such claims only after the defendant has endured a full hearing before the ALJ, appealed the ALJ's decision to the Commission, and then appealed the Commission's final order to a U.S. Court of Appeals (as required by the five other Circuits to address this issue<sup>19</sup>). The *Cochran* defendant went straight to federal district court, and the Supreme Court will now decide if that approach was permissible.

### ***Procedural history and issues on appeal***

In *Cochran*, the procedural history and issues on appeal are intertwined. In 2016, the SEC instituted administrative proceedings against CPA Michelle Cochran, alleging that she violated auditing standards when performing quarterly reviews and annual audits between 2010 and 2013. After a full hearing, the ALJ imposed a \$22,500 civil penalty against Cochran and barred her from practicing before the SEC for five years. Cochran appealed to the Commission, but the Supreme Court decided *Lucia* before the Commission had issued a final order. Because Cochran's ALJ had been unconstitutionally appointed under *Lucia*, the SEC [reassigned](#) her case to a new ALJ and initiated a new hearing, meaning she would have to retry her entire case from scratch.

But Cochran fought back. In January 2019, Cochran filed suit against the SEC in the U.S. District Court for the Northern District of Texas, seeking to enjoin the SEC's proceedings as unconstitutional under the same removability grounds discussed above in *Jarkesy*. However, without deciding the merits, the district court determined that it had no choice but to dismiss Cochran's challenge because it lacked subject-matter jurisdiction to hear the case.<sup>20</sup> A split panel of the Fifth Circuit affirmed on appeal.<sup>21</sup> These initial opinions agreed that a provision of the Exchange Act, [15 U.S.C. § 78y](#),<sup>22</sup> implicitly strips federal district courts of jurisdiction to hear challenges brought by a defendant in an ongoing administrative proceeding, even if the challenge involves the constitutionality of the administrative proceeding itself. The district court expressed its sympathy for Cochran—stating it was “deeply concerned” with her saga, and that “if she is correct in her contentions, she again will be put to further proceedings, undoubtedly at considerable expense and stress, before another unconstitutionally appointed [ALJ]”—but it ultimately found that its hands were tied and “she must make her constitutional arguments, no matter how meritorious they are,

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<sup>18</sup> See *Cochran v. SEC*, 20 F.4th 194 (5th Cir. 2021).

<sup>19</sup> See *Bennett v. SEC*, 844 F.3d 174 (4th Cir. 2016); *Hill v. SEC*, 825 F.3d 1236 (11th Cir. 2016); *Tilton v. SEC*, 824 F.3d 276 (2d Cir. 2016), cert. denied, 137 S. Ct. 2187 (2017); *Jarkesy v. SEC*, 803 F.3d 9 (D.C. Cir. 2015); *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015).

<sup>20</sup> *Cochran v. SEC*, No. 419-CV-066-A, 2019 U.S. Dist. LEXIS 49751 (N.D. Tex. Mar. 25, 2019).

<sup>21</sup> *Cochran v. SEC*, 969 F.3d 507 (5th Cir. 2020).

<sup>22</sup> Section 25 of the Exchange Act provides in relevant part that: “A person aggrieved by a final order of the Commission entered pursuant to this chapter may obtain review of the order in the United States Court of Appeals for the circuit in which he resides or has his principal place of business, or for the District of Columbia Circuit, by filing in such court, within sixty days after the entry of the order, a written petition requesting that the order be modified or set aside in whole or in part.” 15 U.S.C. § 78y(a)(1). It also provides that: “On the filing of the petition, the court has jurisdiction, which becomes exclusive on the filing of the record, to affirm or modify and enforce or to set aside the order in whole or in part.” *Id.* § 78y(a)(3).

before the SEC and then before the applicable court of appeals.”<sup>23</sup> The Fifth Circuit panel agreed that “the statutory review scheme is the exclusive path for asserting a constitutional challenge to SEC proceedings,” and that Cochran could not “leapfrog” or “short-circuit” that path by going directly to federal court, even if a constitutional challenge were at issue.<sup>24</sup>

After agreeing to rehear Cochran’s appeal *en banc* the Fifth Circuit reversed, meaning Cochran had finally scored a victory and could get her day in federal court.<sup>25</sup> Among other things, the Fifth Circuit held that: (1) § 78y does not strip federal district courts of their 28 U.S.C. § 1331 jurisdiction, which covers “all civil actions arising under the Constitution”<sup>26</sup>; (2) the Supreme Court’s decision in *Free Enterprise Fund v. PCAOB*<sup>27</sup> is dispositive and “foreclose[s] any possibility that § 78y strips district courts of jurisdiction over structural constitutional challenges”<sup>28</sup>; and (3) “Cochran’s removal power claim is not the type of claim Congress intended to funnel through the Exchange Act’s statutory-review scheme” because it is “wholly collateral to the Exchange Act’s statutory-review scheme, is outside the SEC’s expertise, and might never receive judicial review if district court jurisdiction were precluded.”<sup>29</sup>

The government’s cert petition followed a few months later, and the Supreme Court has now agreed to hear the case as part of its 2022-2023 term.<sup>30</sup>

### **Next steps and implications**

Among the issues to watch for now that the Court has granted certiorari:

First, if the Court ultimately affirms the Fifth Circuit after merits briefing and oral arguments, the floodgates might open for defendants to bring constitutional challenges in federal court before the SEC has issued final orders in their cases. Even before then, the Court’s grant of certiorari might immediately embolden defendants to bring their challenges in federal court, particularly if there is a jurisdictional nexus to the Fifth Circuit or another circuit that has not yet decided the issue before the Supreme Court.

Second, while the cert petition was under consideration, the SEC made an unprecedented [disclosure](#) that it had “identified a control deficiency related to the separation of its enforcement and adjudicatory

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<sup>23</sup> *Cochran v. SEC*, No. 419-CV-066-A, 2019 U.S. Dist. LEXIS 49751, at \*4-5 (N.D. Tex. Mar. 25, 2019).

<sup>24</sup> *Cochran v. SEC*, 969 F.3d 507, 510, 515-16 (5th Cir. 2020).

<sup>25</sup> *Cochran v. SEC*, 20 F.4th 194 (5th Cir. 2021).

<sup>26</sup> *Id.* at 199 (emphasis in original, internal quotes omitted).

<sup>27</sup> *Free Enterprise Fund v. PCAOB*, 561 U.S. 477 (2010).

<sup>28</sup> *Cochran v. SEC*, 20 F.4th 194, 201-02 (5th Cir. 2021).

<sup>29</sup> *Id.* at 207, 212.

<sup>30</sup> The form and timing of merits briefing and oral arguments remains to be seen, as the Supreme Court has agreed to hear a similar appeal involving the powers of the Federal Trade Commission (FTC) in *Axon Enterprise, Inc. v. FTC*, and the government filed a [letter](#) requesting coordinated briefing in the two cases: “[T]hat (1) the parties in *Cochran* be realigned, so that the federal parties are treated as respondents and Cochran is treated as petitioner; (2) Cochran’s opening brief and joint appendix (or motion to dispense with the joint appendix) in that case be due June 30, 2022; (3) the federal parties’ brief in that case be due August 8, 2022; and (4) the federal parties be allowed, in lieu of filing separate briefs in *Cochran* and *Axon*, to file a single, consolidated brief of 20,000 words across both cases.” The government also wrote that “all parties agree that *Axon* and *Cochran* should be argued separately.” The Court has not yet responded.

functions,” and that Enforcement staff had access to ALJ records in an unspecified number of administrative proceedings including *Cochran* and *Jarkesy*. The SEC explained: “[F]or a period of time, certain databases maintained by the Commission’s Office of the Secretary were not configured to restrict access by Enforcement personnel to memoranda drafted by Adjudication staff. As a result, in a number of adjudicatory matters, administrative support personnel from Enforcement, who were responsible for maintaining Enforcement’s case files, accessed Adjudication memoranda via the Office of the Secretary’s databases.” This revelation confirmed some of defendants’ worst fears about the fairness of in-house adjudication. The government informed the Supreme Court of these issues in a [letter](#) in April, and it could be used as a factor to sway the Supreme Court’s decision.

Third, as part of the forthcoming briefing process, we expect amicus briefs to describe the real human toll that prolonged and potentially unconstitutional SEC proceedings have on defendants. The defendants in *Lucia* and *Jarkesy* have already filed such a [brief](#) supporting *Cochran* before the Supreme Court, [as did](#) entrepreneur Mark Cuban and other former SEC defendants before the Fifth Circuit.

## Conclusion

These developments could signal a coming sea change in the way contested SEC enforcement actions are resolved. The SEC is keenly aware that the Supreme Court has taken an interest in its administrative proceedings and will soon rule on how defendants can challenge them, just as the Fifth Circuit ruled they are unconstitutional. More uncertainty with administrative proceedings could translate into the SEC bringing even more contested cases in federal court, and that could ultimately lead to more favorable results for defendants. There is also a possibility that the SEC could proactively address real or perceived constitutional deficiencies in light of these developments, such as when the Commission [ratified](#) the prior appointment of several ALJs in 2017 while *Lucia* was still pending before the Supreme Court. In the meantime, defendants may still find themselves navigating their cases in a potentially unconstitutional system where they may have no immediate recourse in the federal courts.

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