

Full Scale of Constitutionality of SEC's Adjudication System Underway

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The Supreme Court's decision to hear CPA Michelle Cochran's appeal represents the latest challenge to the Security and Exchange Commission's in-house adjudicatory structure and could set the stage for a larger ruling on the constitutionality of agency administrative adjudication systems including those to which members of the institutional investing profession are subjected.

Ms. Cochran — seeking to challenge a currently pending SEC enforcement action against her before an administrative law judge or ALJ — is asking the court to allow her to challenge the constitutionality of the SEC's in-house adjudication system in a U.S. District Court before the conclusion of the agency adjudication.

In January 2019, Ms. Cochran filed suit in the Northern District of Texas, challenging the constitutionality of the SEC's ALJ system. Specifically, Ms. Cochran argued that SEC's ALJs are unconstitutionally insulated from removal in violation of the president's executive authority under Article II of the Constitution. The District Court dismissed her case for lack of subject matter jurisdiction, however, finding that Congress had implicitly divested district courts of jurisdiction over actions before SEC ALJs and that until Ms. Cochran had a final order from the ALJ, she had no avenue for appeal in federal court.

Ms. Cochran appealed her case to the Fifth Circuit Court of Appeals in New Orleans, where a three-judge panel affirmed the district court's dismissal. Ms. Cochran then petitioned the Fifth Circuit for en-banc hearing before all judges of the court, which the Fifth Circuit granted.

The full Fifth Circuit reversed the panel, however, finding that the district court had jurisdiction to hear Ms. Cochran's claims even though the administrative adjudicatory process had not concluded. The Fifth Circuit examined two arguments presented by the SEC — first, that Congress had implicitly stripped district courts of jurisdiction to hear collateral challenges to administrative adjudications, and second, that Ms. Cochran's claims were not yet ripe because she had not completed the administrative adjudicatory process. The Fifth Circuit rejected both arguments and, in its conclusion, and a concurring opinion, strongly criticized the agency's position and the general power of administrative agencies.

In May of this year, the Supreme Court granted certiorari to review the case, consolidating the *SEC vs. Cochran* with *Axon Enterprises Inc. vs. FTC*, a similar case involving an administrative proceeding before the FTC. The Supreme Court consolidated briefing on the two cases. While both Ms. Cochran and Axon Enterprises are

challenging the overall constitutionality of ALJ schemes, the current appeals focus only on the availability of preliminary review by a district court before the conclusion of the administrative adjudication.

Despite the narrow focus of the appeals, however, other recent developments suggest that a full-scale challenge to the constitutionality of the ALJ structure will follow shortly on the heels of any decision in *Cochran*. On May 18, 2022, the Fifth Circuit again ruled against the SEC in a suit challenging its ALJ system. In fact, just two days after the Supreme Court granted certiorari in *Cochran*, the Fifth Circuit found that the SEC's ALJ system was unconstitutional as a whole. The decision in *Jarkesy vs. SEC* found that the SEC's in-house adjudication of securities antifraud statutes violated the right to trial by jury, that Congress unconstitutionally delegated to the SEC the power to decide whether securities fraud cases were heard in Article III courts or before an ALJ, and that the removal protections given to SEC ALJs were unconstitutional. This last argument relating to removal protections is the same argument Ms. Cochran made in her underlying case.

Both Ms. Cochran and the plaintiff in *Jarkesy* argued that SEC ALJs were unconstitutionally insulated from the president's control, in violation of the "take care" clause of Article II. Implicit in this obligation to "take Care that the Laws be faithfully executed" is a removal power, the court reasoned, and the SEC's structure — which provided multiple layers of removal protection for ALJs — unconstitutionally limited this power. The court relied on the earlier Supreme Court decision in *Lucia vs. SEC* for the proposition that SEC ALJs are "inferior officers" under the appointments clause. Because ALJs are inferior officers serving an important executive function, the court reasoned, the president must have "the control necessary to ensure that the laws are faithfully executed." The removal protections built into the SEC's ALJ structure, therefore, were unconstitutional.

While the Fifth Circuit's decision in *Jarkesy* set the stage for a future challenge to the overall ALJ structure before the Supreme Court, even in the short term, a ruling in *Cochran* allowing immediate challenges in a district court could paralyze the ALJ system going forward. Ms. Cochran's administrative case has been on hold since her initial district court challenge. If every litigant before an ALJ has the right to an immediate collateral challenge in district court — which would pause the ALJ process — the ALJ process across agencies would grind to a halt until the underlying challenges are resolved. In this case, *Jarkesy* sets the stage for these future challenges. Of course, the ultimate result could be an upholding of the ALJ system. But given the Supreme Court's decision in *Lucia* and the Court's increasing skepticism of administrative agencies generally, these recent developments do not portend well for the ongoing viability of agency administrative adjudication structures.

This impact will be felt most heavily in industries currently subject to SEC regulation, such as financial advisers, investment companies, public companies and accountants. Historically, the SEC has used administrative adjudications more frequently in cases involving professionals in regulated industries. Any ruling that limits these adjudications — whether by allowing preliminary challenges that stay ALJ proceedings or ultimately overturning the ALJ structure — will severely hamper the SEC's use of ALJ adjudications against regulated entities and persons, and these parties will be the first to feel the impact of further developments.

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