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# Recent Decisions Cast Shadow Over SEC's In-House Adjudication System


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Two recent judicial developments create questions about the constitutionality of the SEC's in-house judicial system. First, on May 16, the Supreme Court agreed to hear the case of Michelle Cochran, an accountant facing disciplinary proceedings before an SEC administrative law judge (ALJ). Cochran challenged the constitutionality of how the SEC's ALJs are appointed and protected from removal. The Fifth Circuit Court of Appeals ruled en banc in December 2021 that Cochran could challenge the constitutionality of the SEC's ALJs.[1] The Supreme Court may combine the review of Cochran's case with an already pending case, challenging the appointments process for Federal Trade Commission (FTC) ALJs. The government has asked that the Court coordinate the briefing for the two cases but hold separate oral arguments. The Court has not yet indicated how the two cases will proceed.

A few days after the Supreme Court's order, the Fifth Circuit dealt another blow to the SEC's administrative enforcement system with a 2-1 panel ruling that (1) the SEC had violated the petitioners' Seventh Amendment right to a jury trial when an ALJ found the petitioners liable for securities fraud; (2) that Congress had unconstitutionally delegated legislative discretion to the SEC to determine which matters should be subject to ALJ adjudication; and (3) that the statutory removal restrictions on SEC ALJs violated the take care clause of Article II of the Constitution.[2]

These recent decisions by the Fifth Circuit signal increasing judicial scrutiny of the SEC's in-house adjudication system and demonstrate significant skepticism of the SEC's power to bring enforcement actions against alleged violators of the federal securities laws without going before a U.S. district court.

On May 18, only two days after the Supreme Court's order granting review of the decision in *Cochran,* the Fifth Circuit ruled the SEC's administrative adjudication system was unconstitutional for three reasons, agreeing with George Jarkesy and his investment advisor Patriot28 LLC who challenged the SEC's in-house adjudication after the agency imposed a $300,000 civil penalty, $685,000 disgorgement order, and a ban on Jarkesy's involvement in the securities industry.[3] First, the court found that the adjudication via ALJ violated the petitioners' Seventh Amendment right to a trial by jury because securities fraud is an action arising at common law, and thus could not be delegated to an administrative tribunal.[4] Examining securities fraud actions, the court found that these claims "are not the sort that are uniquely suited for agency adjudication" and that adjudication via ALJ rather than the district court did not serve to further protect any public right.[5] Second, the court found that Congress unconstitutionally delegated legislative power to the SEC by allowing the agency "unfettered authority to choose whether to bring enforcement action in Article III courts or administratively within the agency."[6] The SEC argued that this decision was nothing more than an exercise of prosecutorial discretion, but the court disagreed, finding that the decision effectively gave the SEC the discretion to decide as to which legal processes litigants should receive protection — a decision Congress improperly delegated.[7] Third, the court found that the statutory removal restrictions for SEC ALJs were unconstitutional because ALJs “perform substantial executive functions,” and the president as a result “must have sufficient control over the performance of their functions, and, by implication, he must be able to choose who holds the positions.”[8] Relying on the Supreme Court’s decision in *Lucia v. SEC*, which held that SEC ALJs are inferior officers under the appointments clause, the Fifth Circuit found that the statutory limit of SEC ALJs’ removal — which can occur only after a determination of good cause by the Merit Systems Protection Board — violated the take care clause because with such limited removal power, “the President lacks the control necessary to ensure that the laws are faithfully executed.”[9]

The Fifth Circuit’s final enumeration of error in *Jarkesy* mirrors its earlier decision in *Cochran* that the Supreme Court agreed to review. In *Cochran*, the Fifth Circuit found that the petitioner’s challenge to the existence of SEC ALJs was precluded from judicial review by the enabling statute because “[t]he nature of [the] challenge is structural — it does not depend on the validity of any substantive aspect of the Exchange Act, nor of any SEC Rule, regulation or order” and because Cochran’s challenge to the removal protections for SEC ALJs was outside the agency’s expertise.[10] Cochran had argued the same position the Fifth Circuit vindicated in *Jarkesy* — that the removal protections for SEC ALJs unconstitutionally insulated them from the president’s Article II removal power. The SEC had argued in response that because Cochran’s enforcement action before the SEC ALJ was still ongoing, Cochran was required to raise her constitutional claims before the ALJ, and the district court lacked jurisdiction. The Fifth Circuit ruled en banc in favor of Cochran, reversing a panel ruling that sided with the SEC.

The Fifth Circuit’s decision in *Jarkesy* may be a preview of a later Supreme Court decision in *Cochran*, determining whether ALJs across all agencies are subject to unfettered removal by the president. Several commentators have theorized that the Supreme Court’s decision to review *Cochran* and the FTC challenge in tandem indicates such a broad decision is likely. The Fifth Circuit’s decision last week could be an early preview of what such a decision may look like if the Supreme Court agrees that ALJs are unconstitutionally insulated from the president’s removal power. While currently confined to the SEC’s ALJ system and the Fifth Circuit, the Supreme Court’s ruling could undercut ALJ adjudication systems across the executive branch. In the meantime, the decisions deal a serious blow to the SEC’s in-house adjudication process and signal intense skepticism — at least in the Fifth Circuit — about the ability of the SEC to effectively prosecute and adjudicate securities violations through an administrative proceeding. While it remains to be seen how the Supreme Court or other circuits will address the issue, these recent developments cast a shadow over the future of the SEC’s in-house adjudication system and give defendants before SEC ALJs enticing arguments for potential appeals.

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[1] *See Cochran v. SEC*, 20 F.4th 194 (5th Cir. 2021).

[2] *Jarkesy v. SEC*, __ F.4th __, 2022 U.S. App. LEXIS 13460 (5th Cir. May 18, 2022).

[3] *Id.* at *4-5.

[4] *Id.* at *10-12.

[5] *Id.* at *17-18.

[6] *Id.* at *24.

[7] *Id.* at *29-30.

[8] *Id.* at *32.

[9] *Id.* at *35-36.

[10] *Cochran*, 20 F.4th at 207-08.

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