

Attacks on the SEC Administrative Citadel

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For decades, the SEC Enforcement Division has opted to use the SEC's in-house administrative law judges (ALJs) when the case involved a registered entity, which was the jurisdictional base for in-house administrative proceedings. This in-house ALJ process was instituted in the late 1960s. Arguably, the in-house expertise concerning the securities markets and the securities industry provided a more favorable forum where sophisticated securities law issues could be litigated by those in the know. It was a worthy idea.

The SEC enforcement staff increasingly began to "forum shop" when the case would not warrant or support a federal district court proceeding and the staff wanted to ensure a favorable resolution. A former chief ALJ even admonished her fellow ALJs when they failed to support the SEC enforcement staff. And one ALJ has ruled in favor of the enforcement staff 99% of the time.

The first crack in the SEC citadel appeared in 2018 when the U.S. Supreme Court ruled in *Lucia v. SEC* that the ALJ process violated the appointments clause of the U.S. Constitution, which provides that all "inferior" officers must be appointed by the president with the advice and consent of the Senate. Because SEC ALJs essentially function like trial judges, they are "inferior officers" under the appointments clause. Since they were not appointed in the constitutionally required manner, the ALJ process had a structural error. Pending cases had to be reheard. Recent cases have broadened this attack on the ALJ process.

Michelle Cochran fell prey to this system in 2016 when she was charged with aiding and abetting her former employer's alleged failure to complete certain auditing functions under SEC standards. She represented herself pro se, and the ALJ before whom she appeared warned her that he never had ruled against the SEC enforcement staff. In 2017, she lost her case and was banned from practicing as an accountant before the SEC for five years and ordered to pay a civil penalty of \$300,000.

After the *Lucia* decision in 2018, which required many then-pending cases to be heard over again, Cochran was assigned another ALJ to rehear her case. Rather than going through such a preordained ALJ rehearing, she filed suit in federal court, seeking an injunction against the SEC. She

alleged a violation of the president's removal powers under Article II of the Constitution, due to the multiple layers of tenure protection that the SEC afforded to its ALJs. But the federal district court dismissed her case, citing Section 25(a) of the Securities Exchange Act of 1934. According to the court, Section 25(a) implicitly stripped it of jurisdiction until Cochran had exhausted the SEC's internal appellate review process. On appeal, the Fifth Circuit initially agreed with the district court. But an en banc panel changed its mind and held that she could go directly to federal district court when the in-house ALJ process is structurally unconstitutional. On May 16, 2022, the U.S. Supreme Court granted a petition for certiorari on that point and consolidated it with a similar case brought by the Federal Trade Commission under the FTC Act.

Two days later, on May 18, the Fifth Circuit ruled in *Jarkesy v. SEC* that the SEC in-house ALJ process has three additional constitutional problems. First, it violates the right to a jury trial, which the Seventh Amendment provides for in "all suits at common law." Fraud cases were traditionally handled in the courts of England at common law. Nor can Congress or the SEC circumvent the Seventh Amendment by claiming it is bringing its administrative proceedings to adjudicate so-called public rights (i.e., when the government sues as sovereign under a statute to enforce a public right). Congress cannot assign adjudication of such rights to an administrative agency. Moreover, a jury trial would not dismantle the statutory scheme and would not impede a swift resolution of such claims. Further, when the SEC seeks a civil penalty, which it usually does, the Seventh Amendment right to a jury trial must remain sacrosanct.

Second, the Fifth Circuit found that the statutory scheme provided no "intelligible principle" for determining when the SEC can prefer the ALJ process to federal district court. True, Congress can delegate its power. But there must be an "intelligible principle" by which the delegated entity performs its functions. Accordingly, the court concluded that the unfettered discretion exercised by the SEC constitutes an unconstitutional delegation of authority that provides an opportunity for forum shopping by the SEC.

Third, the statutory restrictions on removing SEC ALJs from their positions violate the take care clause of Article II. The president must "take care" that all laws are faithfully executed and enforced. He cannot fulfill that executive duty if he cannot choose and remove puisne judges if they misbehave. At least two levels of protection against removal are given to the ALJs: they can be removed by the SEC commissioners only if good cause is found by the Merit Systems Protection Board (MSPB), and SEC commissioners and MSPB members can be removed by the president for cause. Therefore, apart from the appointments clause violation found in *Lucia*, the court concluded that these removal restrictions result in a violation of the take care clause of Article II.

A final Fifth Circuit case to consider is *SEC v. Novinger*. When settling an enforcement action, the SEC requires that respondents agree not to openly contradict any of the SEC's allegations, even if they settled without admitting or denying the charges. It is essentially an administrative "gag order."

But that gag order arguably violates the First Amendment for a host of reasons, e.g., it is a forbidden prior restraint, content restriction, and grant of unbridled enforcement discretion to the SEC. Novinger went to federal court to seek relief from such a consent judgment. But this time, the Fifth Circuit ruled in favor of the SEC, finding that the respondent's First Amendment claims did not rise to the level of a due process violation needed to set aside a final judgment under Federal Rule of Civil Procedure 64. In a similar case, the Second Circuit had earlier refused to grant a former Xerox executive similar relief in *SEC v. Romeril*, and the Supreme Court denied Romeril's petition for cert.

We await the Supreme Court's next term to see if other doors to the SEC citadel will be unlocked.

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