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Supreme Court and Fifth Circuit Cases Could Impact SEC's Use of Administrative Forum

The Supreme Court Agrees to Take a Case Concerning the Constitutionality of SEC Administrative Law Judges and the Fifth Circuit Invalidates Aspects of SEC Administrative Proceedings

SUMMARY

Two cases—one recently accepted for review by the Supreme Court, and another recently decided by the Court of Appeals for the Fifth Circuit—could change the manner in which the SEC brings enforcement actions against those accused of violating federal securities laws.

The Supreme Court Accepts *Cochran v. SEC*

Congress has empowered the SEC to bring civil enforcement actions seeking a variety of sanctions, including monetary penalties, in either a federal court or in agency proceedings before administrative law judges (ALJs) at the SEC. On May 16, 2022, the Supreme Court agreed to hear a case about when and where the subjects of SEC administrative proceedings can challenge the constitutionality of those proceedings.

In *Cochran v. SEC*, an accountant accused by the SEC of failing to comply with federal auditing requirements raised a constitutional challenge in federal court to the SEC's charging her in an administrative proceeding.¹ Cochran argued that SEC ALJs are unconstitutionally insulated from the President's removal power. This challenge follows from the Supreme Court's decision in *Lucia v. SEC*, which held that SEC ALJs must be *appointed* by someone under Presidential control but left unresolved the constitutionality of the ALJs' removal protections.²

In taking the case, the Supreme Court did not agree to decide the merits of Cochran's constitutional challenge but will instead decide only whether Cochran can raise her claim now in federal court or must first raise that challenge as part of the administrative proceeding. Given that it can take several years at significant financial cost to make one's way through the agency review process, and that many defendants settle in the meantime, this case could have a meaningful impact on the ability of the subjects of agency enforcement proceedings to raise constitutional challenges to actions brought not only by the SEC but by other agencies as well.

The Fifth Circuit Issues its Decision in *Jarkesy v. SEC*

Meanwhile, on May 18, 2022, the Fifth Circuit issued a decision with serious implications for the future of administrative enforcement actions—at least in the Fifth Circuit. In *Jarkesy v. SEC*, the Commission charged hedge fund founder George Jarkesy and Patriot28, the funds' investment advisor, with securities fraud in an administrative action.³ After an evidentiary hearing before an ALJ, Jarkesy and Patriot28 were ordered to pay a \$300,000 civil penalty and were barred from certain securities industry activities, among other penalties.

In a 2-1 decision, however, the Fifth Circuit vacated the penalties imposed against Jarkesy and Patriot28, and in doing so invalidated major aspects of the agency's administrative enforcement proceedings. First, the Fifth Circuit held that any action brought by the SEC before an ALJ seeking civil penalties for alleged securities fraud is unconstitutional because it violates the accused's right to a jury trial. If this result stands, within the Fifth Circuit, which covers Texas, Louisiana, and Mississippi, the SEC will no longer be able to bring enforcement actions seeking civil penalties for fraud in agency proceedings, and must instead bring those claims in federal court.

Second, the Fifth Circuit held that the SEC's authority under the Dodd-Frank Act to bring enforcement actions either in federal court or within the agency is an unconstitutional delegation of legislative power. The Fifth Circuit reasoned that because Congress has not given the SEC any guidance as to how to decide between pursuing an action in federal court or alternatively in agency proceedings, and because that decision is legislative in nature, the grant of authority violates Article I of the Constitution, which provides that "all legislative powers" are vested in Congress, rather than an agency.⁴

Finally, the Fifth Circuit found that SEC proceedings suffer from a third deficiency, namely that the statutory removal restrictions for SEC ALJs are unconstitutional (the same claim that Cochran seeks to raise in the case recently accepted by the Supreme Court). SEC ALJs can only be "removed" by the SEC Commissioners if good cause is found by a separate civil service review board. Those SEC Commissioners, in turn, can only be removed by the President for good cause. According to the Fifth Circuit, this structure prevents the President from exercising his constitutional duty to "take care" that the laws are faithfully executed because ALJs are insufficiently subject to his control. This aspect of the

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decision could serve to invalidate any proceeding before SEC ALJs within the Fifth Circuit until the removal protections are altered.

The Fifth Circuit's decision may have broad implications for other agencies beyond the SEC such as the Federal Trade Commission, the Consumer Financial Protection Bureau, and the Federal Energy Regulatory Commission, which often bring enforcement actions in administrative proceedings overseen by ALJs. The decision is unlikely to be the last word, however, as the SEC may well seek review by the Supreme Court, which could hear the case alongside *Cochran* next term.

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ENDNOTES

- ¹ The Government's petition for certiorari requesting that the Supreme Court take up the case is available [here](#).
- ² 138 S. Ct. 2044.
- ³ *Jarkesy v. SEC*, 2022 WL 156313 (5th Cir. May 18, 2022). The decision is available [here](#).
- ⁴ U.S. Const. art. I, § 1.

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