The Texas Lawbook

SEC in Constitutional Danger Zone Following Several Recent Decisions

JUNE 8, 2022 SCOTT MASCIANICA, RICH PHILLIPS & DANNY ATHENOUR

The constitutional spotlight is shining on the U.S. Securities and Exchange Commission (SEC). In the last several weeks, the U.S. Supreme Court agreed to hear a case seeking broader federal jurisdiction for constitutional challenges, the U.S. Court of Appeals for the Fifth Circuit found multiple constitutional infirmities in SEC practice and procedures, and a petition for certiorari was filed seeking to end the SEC's longstanding "gag order" requirement for settlements.

Cochran: SCOTUS Agrees to Consider Jurisdiction for Constitutional Challenges to SEC Procedure

On May 16, 2022, the U.S. Supreme Court granted certiorari in *SEC v. Cochran*, a case that questions whether district courts have jurisdiction to consider claims challenging the constitutionality of the SEC's administrative proceedings.

This case began with an SEC administrative action against a CPA, Michelle Cochran, for allegedly failing to comply with Public Company Accounting Oversight Board auditing standards. The SEC's Administrative Law Judge (ALJ) ultimately imposed fines and banned Cochran from practicing before the SEC for five years. Cochran objected to the Commission's adoption of the ALJ's decision.

Before the Commission ruled on Cochran's objection, the Supreme Court issued its opinion in *Lucia v. SEC*, which held that SEC ALJs are officers of the U.S. under the Appointments Clause, which requires that they be appointed by the President, a court of law or a department head. In response to *Lucia*, the SEC remanded all pending administrative proceedings for new hearings before constitutionally appointed ALJs. Cochran's case was thus sent back for a rerun before a new ALJ.

At that point, Cochran filed collateral litigation in federal district court to enjoin the SEC's administrative enforcement proceedings against her. Cochran argued the inverse of *Lucia*. She asserted that because SEC ALJs enjoy multiple layers of "for-cause" removal protection, they are unconstitutionally insulated from the President's Article II *removal* power. The district court dismissed Cochran's claim for lack of subject-

matter jurisdiction, observing that, under 15 U.S.C. Section 78y, "a person aggrieved by a final SEC order may obtain review of it in the federal court of appeals." That statutory scheme, the district court reasoned, "implicitly divest[ed]" federal district courts of jurisdiction to hear any challenges to SEC proceedings. Cochran appealed to the Fifth Circuit.

The SEC advanced two primary arguments: 1) in Section 78y, Congress implicitly stripped district courts of jurisdiction to hear constitutional claims; and 2) Cochran's claims were not ripe. The Fifth Circuit, sitting en banc, was not swayed and held that the district court had subject-matter jurisdiction over respondent's removal-power claim. The court observed that Cochran's removal-power claim fell outside of Section 78y, reasoning that the statute

provides that *only* "person[s] aggrieved by a final order of the Commission" may petition in the relevant court of appeals to review that final order. The statute says nothing about people, like Cochran, who have not yet received a final order of the Commission. Nor does it say anything about people, again like Cochran, who have claims that have nothing to do with any final order that the Commission might one day issue. Cochran's removal power claim challenges the *constitution* of the tribunal, not the legality or illegality of its final order. Her injury has absolutely nothing whatsoever to do with a final order, and therefore her claim falls outside of § 78y.

The Fifth Circuit remanded for further proceedings. The Supreme Court granted the SEC's petition for certiorari. The date for argument has not been set.

***Jarkesy*: Fifth Circuit Finds Three Constitutional Violations in SEC Procedure**

Only two days after *Cochran*, the Fifth Circuit handed down an opinion that *held* SEC ALJs were unconstitutionally insulated from presidential removal, among other constitutional infirmities. In *Jarkesy v. SEC*, the SEC sued Petitioners Jarkesy and Patriot 28 in an administrative proceeding. The ALJ ruled against Jarkesy, and the Commission affirmed the ALJ's decision. Following the Commission's review, the SEC ordered the Petitioners to pay a civil penalty of $300,000 and disgorge $685,000 in ill-gotten gains, and they were banned from various securities-industry activities. With a final SEC order in hand, the Petitioners did not face the jurisdictional issue in *Cochran* and appealed directly to the Fifth Circuit.

The Fifth Circuit held the SEC's action against the Petitioners suffered from three independent constitutional infirmities: 1) the proceedings violated Petitioners' Seventh Amendment right to a jury trial; 2) Congress had unconstitutionally delegated legislative power to the SEC by granting it full discretion to choose the forum for enforcement actions without appropriate guidance; and 3) the statutory removal restrictions on SEC ALJs violated the President's removal power.

In analyzing whether the administrative proceedings violated Petitioners' Seventh Amendment right to a jury trial, the court used a two-prong test, first analyzing whether similar claims arose "at common law" and, if so, whether they were nonetheless "public

rights" such that agency adjudication was appropriate. Applying the first prong, the court held that the SEC's claims were essentially a fraud action, which was typical in English courts at the time of the founding and therefore arose "at common law." The court found that this conclusion was further enforced by the fact that the SEC was also seeking penalties. Applying the second prong, the court held that the "public rights" doctrine did not apply because common-law fraud claims were "quintessentially about the redress of private harm," regardless of whether the government was bringing the suit.

But the Fifth Circuit did not stop at the Seventh Amendment. The panel next analyzed whether Congress had unconstitutionally delegated legislative power to the SEC in allowing the SEC to choose whether to bring enforcement actions in federal courts or as administrative proceedings within the agency. The "non-delegation" doctrine is a separation of powers principle that prevents Congress from passing the legislative buck to the Executive Branch absent an "intelligible principle" to guide the Executive Branch's decision-making. The Fifth Circuit first held that, unlike prosecutorial discretion, the statute's delegation was legislative in nature because it allowed the SEC to decide "which defendants should receive *certain legal processes* … a power that Congress uniquely possesses." And although the "intelligible principle" doctrine poses only a minimal barrier to congressional delegation, the Fifth Circuit nonetheless held that the statute failed to clear it because Congress had provided essentially "no guidance whatsoever" as to how the SEC was to choose between in-house or federal court adjudication.

The Fifth Circuit's final constitutional blow dealt with the removability of ALJs – the underlying, unreached issue in *Cochran*. The court observed that the Supreme Court has long viewed the Article II mandate for the President to "take care that the laws be faithfully executed" as including a requirement the President have adequate power over officers' removal. More recently, the Supreme Court held that multiple layers of for-cause insulation of officers unconstitutionally restricts the President's removal power. Relying on this authority, the Fifth Circuit held that because the ALJs were only removable for-cause by the SEC Commissioners and members of the Merit Systems Protection Board, and the SEC Commissioners were only removable for-cause by the President, ALJs were unconstitutionally insulated from the President's removal discretion. In other words, "the President lacks the control necessary to ensure that the laws are faithfully executed."

***Romeril*: Cert Petition Urges Court to Consider SEC's "Gag Order" Policy for Settlements**

Finally, a recent petition for certiorari filed in the Supreme Court questions the constitutionality of the SEC's longstanding "no admit, no deny" requirement for settling with the agency. Although the SEC has permitted defendants (in district court actions) and respondents (in administrative proceedings) to settle without admitting the allegations, such settlements also require that a defendant agree not to "deny the allegations in the complaint or order for proceedings."

In 2003, Barry Romeril settled with the SEC over allegations of securities laws violations. As part of that consent agreement, Romeril agreed not to deny any allegation in the complaint or "creat[e] the impression that the complaint is without factual basis." But in 2019, almost 16 years after the settlement agreement, Romeril filed a motion seeking relief from the judgment on the grounds that it violated the First Amendment or due process. The district court denied Romeril's motion. On appeal, the U.S. Court of Appeals for the Second Circuit affirmed, finding that parties can waive certain rights in resolving legal proceedings, including First Amendment rights.

Romeril filed a petition for certiorari, emphasizing the high percentage of SEC cases – some 98 percent – that end in settlement with the SEC. Romeril argues the "no-deny" policy violates the First Amendment because it places unconstitutional prior restraints on a defendant's right to speak candidly about their experience with the SEC. The policy, Romeril argues, is also an unconstitutional content- and viewpoint-based restriction on free speech that "ensures the agency not only the *first* public word … but also gives the government the final and *only* word in nearly all SEC cases." Romeril also makes due-process arguments as to the adequacy and fairness of the process surrounding the consent agreement.

Amici curiae present other compelling arguments. They highlight the "Hobson's choice" that defendants face in settling with the SEC and cite a study that found "the average cost for companies to respond to an SEC formal investigation – prior to the filing of any litigation – was more than $4 million." They further argue that "the SEC's requirement of transparency and full disclosure for the benefit of market participants has one glaring exception highlighted by the Petitioner's case." In short, they claim that the "gag order" policy denies the market the benefits of full transparency and disclosure.

Takeaways: What Comes Next?

Cochran, *Jarkesy* and *Romeril* represent three unique challenges to SEC practices. *Cochran* raises a statutory, jurisdictional question for the Supreme Court and potentially opens the door to greater collateral attacks against SEC procedures. *Jarkesy* stands as a strong rebuke to agency power, but the case is likely to face additional review from an en bancFifth Circuitpanel and the Supreme Court itself. And *Romeril* raises an important challenge to a longstanding settlement policy of the agency. Here are some takeaways on what to look for next:

- **Limited Impact on Ongoing SEC Enforcement Approach:** Since the Supreme Court's decision in *Lucia,* the agency has generally refrained from filing any litigated administrative proceedings. As a result, the impact of *Jarkesy* and *Cochran* on the Division of Enforcement's approach will be far less than it would have been pre-*Lucia*. Although we can expect challenges to prior rulings from litigated administrative proceedings, such cases comprise a significant minority of the SEC's litigated actions in recent years.

- **Impact on Prior (and Future) SEC Settlements?**: Historically, a significant majority of SEC administrative proceedings have been resolved via settlement. However, in light of this ruling, we should expect to see the argument – likely in the Fifth Circuit – that a prior SEC settlement should be voided because it was entered into as part of an unconstitutional proceeding.

Going forward, it will bear watching whether the Division of Enforcement seeks to modify its standard offer and order language in administrative proceedings to include certain waivers, such as right to a jury trial. As the Second Circuit found in *Romeril,* "[i]n the course of resolving legal proceedings, parties can, of course, waive their rights, including such basic rights as the right to trial and the right to confront witnesses." Such language may be of limited impact if the entire proceeding is held unconstitutional, but it may be one measure the Division Enforcement staff takes in the interim to limit constitutionality risks.

- **How Will the SEC Handle Certain Administrative-Only Proceedings?**: The Seventh Amendment holding from *Jarkesy* hinged on matters where the SEC is seeking a civil penalty in fraud actions. In other words, for matters where the SEC isn't alleging fraud or seeking a penalty, that aspect of the ruling likely won't have much, if any, impact. Additionally, it's unclear if the non-delegation holding would impact proceedings – such as 12(j), 102(e), or "causing" violations – where the SEC does not have an alternative in district court. But, even if those aspects of *Jarkesy* do not present hurdles for future administrative proceedings, the open question of whether the multiple layers of for-cause removal protection for ALJs renders administrative proceedings unconstitutional still presents risks for the SEC where it has no alternative in district court.

- **Will *Jarkesy* End Up in the Supreme Court?** With *Cochran* already before the Supreme Court and a cert petition on file in *Romeril*, the question is what the government will do in *Jarkesy*. The government may seek an en banc review, although en banc reviews are generally not favored unless 1) they are necessary to secure or maintain uniformity of court decisions; or 2) the proceeding involves a question of exceptional importance. If the government does not believe an en banc review will yield a different result – which could be informed by the Fifth Circuit's en banc opinion in *Cochran* – it may forgo en banc review and petition directly to the Supreme Court (en banc review is not a prerequisite for a cert petition). Given the broad implications of *Jarkesy* to not only the SEC, but all administrative agencies that have administrative proceedings before ALJs, the question is not "if" there will be a cert petition, but "when" it will be filed.

One interesting aspect of any cert petition will be the finding concerning the Seventh Amendment right to a jury trial. As the dissent noted, another circuit reached a contrary holding in an unpublished opinion concerning the Seventh Amendment right to a jury trial in an SEC administrative proceeding. The Eleventh Circuit, relying on similar Supreme Court authority as the Fifth Circuit majority, rejected a similar Seventh Amendment challenge, holding that "it is well established that the Seventh Amendment does not require a jury trial in administrative proceedings designed to adjudicate statutory 'public rights.'" Although the Eleventh Circuit opinionis unpublished, the contrary holding increases the chance the Supreme Court will grant cert to resolve the split.

- **Broad Impact Across Federal Agencies**: Noting the significance of the *Cochran* decision, Columbia Law Professor John C. Coffee predicted the grant of cert was "expediting a government-wide determination of whether ALJs should be removable at will by the president." Any federal agency that has similar removal protections for ALJs is susceptible to the same attacks that prevailed in *Jarkesy*. Indeed, in January 2022, the Supreme Court granted certiorari in *Axon Enterprise v. Federal Trade Commission* to decide the same jurisdictional question raised in *Cochran* with respect to Federal Trade Commission (FTC) administrative proceedings and, on June 1, 2022, granted the Solicitor General's motion to consolidate briefing in both cases. As with the SEC, *Axon Enterprise* could clear the path for additional constitutional attacks on FTC practice. More broadly, the Supreme Court's docket seemingly signals an appetite for administrative-law issues with wide-ranging implications for federal agencies.

- **Future of No Admit, No Deny**: The critical subtext of the *Romeril* petition is that the Second Circuit denied Romeril's Rule 60(b)(4) motion based largely on the factors for finding a judgment "void" as opposed to "erroneous." But, as noted above, the court's reasoning was based on its views that certain constitutional rights (including First Amendment rights) can be waived and that Romeril's due-process arguments lacked merit.

Essentially, the SEC is willing to settle charges without parties admitting liability, but it will not allow the parties to deny the charges. And this is not the first time the SEC has faced constitutional challenges in connection with this language, and the Fifth Circuit is currently mulling a similar challenge in a case captioned *SEC v. Novinger*. But if the Supreme Court were to grant cert and ultimately find that such language violated Romeril's constitutional rights, the impact to the SEC's Enforcement program would arguably outstrip any impact from *Cochran* or *Jarkesy*, as the SEC includes this settlement language in most of its settlements in both district court and administrative proceedings. The SEC has utilized "no admit, no deny" language in consent agreements for 50 years, and it's an important feature to facilitate settlements without extracting

admissions that could expose parties to collateral risk (such as criminal exposure and increased private litigation risk).

Scott Mascianica *is a Dallas partner in Holland & Knight's White Collar Defense and Investigations and Securities Enforcement teams. He is a former assistant regional director in the SEC's Division of Enforcement.*

Rich Phillips *is an appellate partner at Holland & Knight in Dallas.*

Danny Athenour *is a Dallas associate and member of the firm's Litigation and Dispute Resolution practice.*

Brandon Len King*, a litigation associate in Austin, also contributed to this article.*