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SEC ENFORCEMENT

Jarkesy, Cochran and the Attack on ALJs

By Michael D. Birnbaum, Haimavathi V. Marlier, Gerardo Gomez Galvis, and Justin A. Young

On May 18, 2022, the US Court of Appeals for the Fifth Circuit in *Jarkesy v. SEC* issued a scathing rebuke of the Securities and Exchange Commission's (SEC) use of administrative law judges (ALJ).¹ Considered in tandem with the US Supreme Court's May 16, 2022 grant of *certiorari* in *SEC v. Cochran*,² which examines district courts' jurisdiction to consider actions to enjoin ongoing SEC administrative actions, *Jarkesy* may have profound implications for the SEC's and other federal agencies' use of ALJs in a wide array of matters.

In *Jarkesy*, Judge Jennifer Walker Elrod, writing for a 2-1 majority, held that: (1) the SEC's use of ALJs deprived the petitioners of their Seventh Amendment rights to a jury trial; (2) Congress unconstitutionally delegated legislative power to the SEC by failing to provide an intelligible principle by which to exercise the delegated power; and (3) statutory removal restrictions for SEC ALJs violate Article II of the US Constitution.

Should the *Jarkesy* majority's holding be adopted by other Circuits, or affirmed by the Supreme Court if appealed by the SEC, then the SEC will be forced to reexamine significant aspects of its enforcement program, including determining which cases previously litigated before ALJs still make sense to pursue in the costlier and often less SEC-friendly federal court system.³ Other agencies and those facing administrative actions before them will surely be watching, as similar judges serve across numerous

other federal agencies—most notably the nearly 1,700 ALJs that adjudicate social security disputes.

Background

The Fifth Circuit also recently decided *SEC v. Cochran*, which presents a separate—albeit related—obstacle for the SEC's use of its in-house court system. The *Cochran* court held that an accountant could challenge the constitutionality of an *ongoing* administrative enforcement action on the basis that the ALJ assigned to the in-house proceeding was unconstitutionally insulated from removal by the President in violation of Article II of the Constitution.

Historically, the Securities Exchange Act has been interpreted to require respondents to wait until after the issuance of an adverse order from the SEC to challenge that order—including any potential constitutional infirmities—in federal court, and even then only in a Court of Appeals. Under *Cochran*, a federal district court would have jurisdiction to hear challenges to the SEC's authority, or that of its ALJs, before the SEC ever issues an adverse order.

How the Supreme Court decides *Cochran* may thus have wide-ranging implications. Although the appellee's challenge in *Cochran* is focused specifically on the removal issue described above, even if the SEC ultimately prevails or finds a way to address that particular issue, one can easily imagine a whole host of objections that other respondents might wish to pursue in SEC proceedings before awaiting any decision on the merits. Permitting them to do so before waiting for a decision from the SEC would have the potential to radically change the SEC's calculus in determining whether, or when, to proceed with administrative cases.

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Until the issues raised in *Jarkesy* and *Cochran* are finally resolved, litigants opposite the SEC and agencies with similarly appointed ALJs would be well-served to preserve the rights the Fifth Circuit has now recognized, both as to the agencies' use of ALJs in general and the right to pursue injunctive relief earlier than might previously have been deemed possible.

The Fifth Circuit's *Jarkesy* and *Cochran* Decisions

Petitioner George Jarkesy established two hedge funds and selected Petitioner Patriot28 as the investment adviser for the funds. The SEC pursued in-house proceedings against Jarkesy and Patriot28 alleging fraud, and an ALJ found that the "Petitioners committed various forms of securities fraud" and ordered them to pay a penalty of \$300,000 in addition to other relief.⁴ Petitioners challenged the constitutionality of the proceedings, and after the Commission rejected their arguments (while otherwise affirming the ALJ's order), Jarkesy and Patriot28 filed a petition for review in the Fifth Circuit, which accepted several of their arguments and vacated the SEC's judgment.

The Fifth Circuit found the SEC's use of ALJs in *Jarkesy* was unconstitutional for three reasons.

1. The court determined that the administrative proceedings violated the Petitioners' Seventh Amendment rights to a jury trial. Although the Seventh Amendment does not prevent Congress from assigning actions to administrative adjudications where the government sues to enforce "public rights," the Fifth Circuit held that the SEC's claims against Jarkesy and Patriot28 were not to enforce public rights; rather, they arose from common law fraud claims for which Petitioners had a right to jury trial. The majority further noted that courts have historically ruled on fraud and securities fraud claims, which "are quintessentially about the redress of private harms." In a dissenting opinion, Judge Eugene Davis reasoned that SEC administrative proceedings involve public rights because they are examples of "the Government sue[ing] in its sovereign capacity to enforce public rights created by statutes," and the broad congressional purpose of securities laws is to "protect investors." The majority rejected this argument and criticized the dissent for treating the government's involvement as a sufficient condition, not merely a necessary condition, for determining whether a suit vindicates public rights.
2. The court held that Congress unconstitutionally delegated legislative power by giving the SEC unfettered authority to choose whether to bring enforcement actions in federal courts or within the agency. As explained by the Fifth Circuit, this long-dormant doctrine holds that Congress may only grant regulatory authority to another entity when it provides an "intelligible principle" guiding how to exercise that authority, but here, "Congress offered *no guidance* whatsoever." In so holding, the court rejected Judge Davis's dissenting contention that Congress lawfully delegated the ability for the SEC to choose whether to bring an action internally or in federal court, because—similar to how a criminal prosecutor has discretion to determine under which statute to charge a defendant—"the SEC's forumselection authority is part and parcel of its prosecutorial authority."
3. The court found the statutory removal restrictions for the SEC ALJs to be unconstitutional. Currently, SEC ALJs can be removed only with a showing of good cause by the Merits Systems Protection Board (MSPB). Members of the MSPB can only be removed by the President for limited reasons. SEC ALJs are therefore "insulated from the President by at least two layers of for-cause protection from removal," which the Court found unconstitutional because ALJs "perform substantial executive functions" that require the President to have sufficient control over the performance of their functions.

In dissent, Judge Davis argued that the removal restrictions for the SEC ALJs do not

violate the Constitution's Take Care Clause because SEC ALJs perform an adjudicative, rather than executive, function, and ALJ powers are merely recommendations because the Commission can review their findings *de novo*.

Given the decision's programmatic importance, the SEC surely will at least consider an appeal. At the very least, one should expect additional litigation as to what *Jarkesy* means, including in cases that do not sound in fraud or do not pursue penalties from SEC respondents.

Meanwhile, the Supreme Court will adjudicate when, and before what court, litigants facing SEC administrative proceedings may challenge ALJs' authority to decide their fate. In an opinion joined by the two judges who formed the *Jarkesy* majority, the Fifth Circuit, sitting *en banc*, created a circuit split when it held that a federal district court has jurisdiction to hear a challenge to the constitutionality of an ongoing SEC administrative enforcement action.

Indeed, the *Cochran* majority acknowledged that their decision contradicted precedent from five other circuits holding that the Securities Exchange Act implicitly divests federal courts from jurisdiction to hear constitutional challenges to ongoing SEC administrative proceedings, though the Court stated "the other circuits are not as unanimous as they appear, as their decisions have drawn powerful dissents that largely support our position" and "the consensus view is not always correct."

In a signal of the importance of *Cochran*'s potential impact beyond the SEC context, Solicitor General Elizabeth Prelogar asked the Supreme Court on May 19, 2022, to coordinate the briefing schedules (though not the arguments) of *Cochran* and *Axon Enterprise, Inc. v. Federal Trade Commission*—a case presenting similar questions about federal district courts' jurisdiction over challenges to the FTC's structure.⁵ Indeed, these cases and *Jarkesy* alike will have a profound impact on the extent to which many government agencies can utilize ALJs and

the ways future litigants can challenge those ALJs' authority.

Conclusion

The practical impact of *Jarkesy* and *Cochran* is to leave the SEC and numerous other federal agencies facing serious questions about the continued viability of their in-house courts. Until these issues are resolved by the Supreme Court or Congress, litigants will undoubtedly continue to challenge the ability of the SEC and other government agencies to even bring such cases before such tribunals.

Notes

1. *Jarkesy v. SEC*, No. 20-61007, 2022 WL 1563613 (5th Cir. May 18, 2022).
2. *Cochran v. SEC*, 20 F.4th 194 (5th Cir. 2021), cert. granted sub nom., 2022 WL 1528373; *see also* *SEC v. Cochran*, No. 21-1239, 2022 WL 1528373 (U.S. May 16, 2022).
3. Although the SEC's in-house courts are meant to be impartial venues, critics have argued that ALJs are institutionally biased in favor of the SEC's enforcement division. The SEC recently reported a breach related to the separation of its enforcement and adjudicatory functions whereby enforcement staff improperly accessed ALJ materials for pending cases, including in *both* the *Cochran* and *Jarkesy* cases. *See* SEC, Commission Statement Relating to Certain Administrative Adjudications, (Apr. 5, 2022), <https://www.sec.gov/news/statement/commission-statement-relating-certain-administrative-adjudications>.
4. As the *Jarkesy* court noted, following the Supreme Court's 2018 holding in *Lucia v. SEC*, 138 S. Ct. 2044, 2054-55 (2018), because SEC ALJs are subject to the Constitution's appointments clause and were not properly appointed under the Constitution, Petitioners were entitled to a new hearing before a properly appointed ALJ. The Petitioners, however, bypassed the second in-house trial under a properly appointed ALJ and proceeded with their original petition to the SEC's five Commissioners.
5. Letter of Securities and Exchange Commission, et al., *SEC v. Cochran*, No. 21-1239 (U.S. May 19, 2022).