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Are SEC and FINRA Administrative Hearings Unconstitutional?

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There are multiple constitutional challenges pending in the federal courts that threaten to upend the administrative procedure for disciplinary actions before the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA).

In 1934, Congress created the SEC to regulate the securities industry. In 1938, the Maloney Act delegated some of the SEC's regulatory authority to self-regulatory organizations comprised of industry member firms (SROs). The Maloney Act created the National Association of Securities Dealers, which regulated its member firms until its merger with NYSE Regulation in 2007. That merger created FINRA. For the past eighty-five years, the securities industry has been regulated by the SEC and designated SROs under its supervision. But that system is changing.

'Lucia v. SEC'

The Supreme Court's landmark ruling in *Lucia v. SEC,* 138 S.Ct. 2044 (2018), prohibited the use of administrative law judges appointed by the SEC staff. The Supreme Court held in *Lucia* that administrative law judges appointed by the staff may not constitutionally adjudicate hearings because they are officers of the United States. The ALJ in *Lucia* was appointed by the SEC staff. But only the President, courts, or heads of departments may constitutionally appoint such officers. The court ordered a new hearing before a properly-appointed ALJ.

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Lucia was a technical constitutional challenge to the method of appointing an ALJ. But the Supreme Court is currently considering a constitutional challenge to the use of ALJs in

any SEC proceedings. That case could have implications for other administrative agencies as well.

'*Jarkesy*': The Right to Jury Trial

In *Jarkesy v. SEC*, the U.S. Court of Appeals for the Fifth Circuit ventured much further than the Supreme Court had gone in *Lucia*. *Jarkesy v. SEC*, 34 F.4th 446 (5th Cir. 2022). The Fifth Circuit didn't merely hold that the ALJ in that particular case was improperly appointed. Rather, the court held that the use of *any* ALJ in an SEC administrative hearing violated the respondent's Seventh Amendment right to a jury trial and is *per se* unconstitutional. Thus, under the Fifth Circuit ruling, any respondent in any SEC enforcement action would have the right to trial by jury.

In addition, the Fifth Circuit held that the SEC had arrogated to itself the congressional power to select a forum to adjudicate disciplinary cases. The Circuit found that the SEC proceeding also violated the constitutional separation of powers in that the SEC was exercising Article I power belonging to the Congress. The court wrote, "Congress has delegated to the SEC what would be legislative power absent a guiding intelligible principle." *Jarkesy*, 34 F. 4th at 461. The Supreme Court heard oral argument on *Jarkesy* on November 29, 2023. A decision is expected in June.

Are FINRA Hearings Unconstitutional?

Even more far-reaching is a pending case before the U.S. Court of Appeals for the D.C. Circuit entitled *Alpine Securities v. FINRA*, No. 23-5129, 2023 WL 4703307 (D.C. Cir. July 5, 2023). *Alpine* is an action to enjoin a FINRA regulatory prosecution, also on constitutional grounds. In July 2023, the D.C. Circuit enjoined FINRA from proceeding with a disciplinary proceeding against the plaintiff registrant.

The plaintiff in *Alpine* seeks to apply the principles from *Lucia* to enjoin a pending enforcement action brought by FINRA. Alpine Securities Corp. is a registered broker dealer and FINRA member firm. FINRA opened a regulatory enforcement investigation, seeking to bar the firm from the industry for violating a prior acceptance, waiver, and consent. Alpine sued in federal district court, claiming that FINRA, as a private SRO, is not a governmental agency. But only the executive branch may constitutionally enforce the federal securities laws.

While the district court denied the injunction, the Court of Appeals reversed. In granting the injunction, the D.C. Circuit determined that there was a likelihood of success on the petition. In a concurring opinion, Judge Justin Walker wrote that, "Alpine has raised a serious argument that FINRA impermissibly exercises significant executive power." *Alpine*, 2023 WL 47033007, at *2, Section I.

Judge Walker opined that the reasoning in *Lucia* would apply with equal force to FINRA hearing officers. He reasoned that the FINRA hearing officers, who "enforce securities laws and decide parties' rights, are mere carbon copies of ALJs." In other words, if the Constitution requires presidential oversight and appointment of an SEC ALJ, then the same logic should apply to a FINRA hearing officer. As Judge Walker wrote: "It would be odd if the Constitution prohibits Congress from vesting significant executive power in an unappointed and unremovable government administrator but allows Congress to vest such power in an unappointed and unremovable private hearing officer." *Alpine*, 2023 WL 47033007, at *3, Section I.

The *Alpine* concurrence is not a final adjudication on the merits. Nor is it even a majority opinion by the Court of Appeals. But

it does represent part of a trend to unravel 85 years of administrative precedent.

Exhaust Administrative Remedies?

Historically, courts have required litigants to exhaust their administrative remedies before resorting to judicial review. For example, unhappy FINRA respondents may appeal their sanctions to the SEC, and from there to a federal court of appeals. But that's not what happened in *Alpine*. Rather, the Court in *Alpine* endorsed the petitioner's immediate resort to the courts, concluding that it did not need to exhaust its administrative remedies. Rather, there was no need to wait for the "corporate death penalty" that would be imposed upon a final FINRA adjudication.

Immediate access to the federal courts was recently permitted in *Axon Enterprise v. FTC* and *SEC v. Michelle Cochran*, which held that a respondent in an administrative procedure had standing to seek an injunction in federal district court. *Axon Enterprise v. FTC; SEC v. Cochran*, 143 S.Ct. 890 (2023).

In that case, Michelle Cochran was an accountant being administratively prosecuted by the SEC. An initial adjudication by an ALJ was vacated after the Supreme Court handed down the *Lucia* case in 2018, which held that ALJs needed to be appointed as officers of the United States. When the SEC sought to retry her before a different and newly-appointed ALJ, "that was the last straw for Cochran." *Cochran*, 143 S.Ct. at 898. She sued in U.S. District Court, which dismissed her claim, reasoning that she needed to exhaust her administrative remedies. But the district court's ruling was reversed.

The Supreme Court ruled that the District Court indeed did have jurisdiction to hear constitutional challenges to an administrative prosecution. The Court found that there was potential validity to Cochran's challenge to the constitutionality of the administrative procedure. It determined that the constitutional claim was collateral to the SEC regulatory adjudication. In addition, the SEC has no particular expertise in separation of powers issues.

Conclusion

A regulatory system that has been in place for eighty-five years is now in substantial jeopardy. SCOTUS has ruled that SEC administrative law judges must be appointed by the President or the Commission itself. And the Fifth Circuit has ruled that any administrative proceeding before an ALJ, however appointed, unconstitutionally violates a respondent's Seventh Amendment right to trial by jury. An affirmance of *Jarkesy* could upend the entire system of administrative law judges for the SEC and, potentially, other agencies as well.

The DC Circuit has already suggested that the *Lucia* reasoning is likely to apply to SRO disciplinary proceedings. And if the same logic applies to FINRA hearing officers as SEC ALJs, then why wouldn't *Jarkesy* apply to FINRA as well?

Time will tell whether FINRA will continue to exist in its current format, or whether its Division of Enforcement will need to revise its toolkit.

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