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Fifth Circuit's Constitutional Carve-Back of the SEC's ALJ Enforcement Proceedings Likely to Lead to More Federal Court Cases

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On May 18, 2022, the United States Court of Appeals for the Fifth Circuit (the "Fifth Circuit") dealt a major blow to the U.S. Securities and Exchange Commission's ("SEC") enforcement program. In *Jarkesy v. SEC*, the Fifth Circuit ruled that the SEC's in-house administrative enforcement proceedings are unconstitutional. The administrative process has historically provided the SEC with a significant home-court advantage; defendants are not allowed full discovery, there is limited application of the rules of evidence, and, most notably, the SEC wins more often than it does when in federal court. The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 gave the SEC the ability to seek monetary penalties against anyone in administrative proceedings, which up to then had been limited to securities firms and professionals. The constitutionality of the SEC's administrative proceedings has been the subject of prior cases and has led the SEC to pull back on its use of the forum. Until and unless overturned, the Fifth Circuit's decision in *Jarkesy* will have a stark effect on the SEC's enforcement program and may have broader implications for other federal agencies.

Background

On March 22, 2013, the Securities and Exchange Commission ("SEC") instituted an administrative proceeding against Petitioner George R. Jarkesy Jr. ("Jarkesy"), Petitioner Patriot28 LLC ("Patriot28") and other former co-parties, alleging that Petitioners committed fraud under the Securities Act, the Securities Exchange Act, and the Investment Advisers Act by (1) misrepresenting who served as the prime broker and as the auditor; (2) misrepresenting the funds' investment parameters and safeguards; and (3) overvaluing the funds' assets to increase the fees charged to investors. Petitioners initially sued the SEC in the United States District Court for the District of Columbia to enjoin the administrative proceeding, but that court and the U.S. Court of Appeals for the D.C. Circuit held that it would only have jurisdiction to review any constitutional challenges to the administrative proceeding after the Petitioners received an adverse final order. Thus, the administrative proceedings against the Petitioners went forward, and the administrative law judge ("ALJ") concluded that Petitioners committed securities fraud. Petitioners then sought review from the SEC, which affirmed the ALJ's ruling. The SEC ordered Petitioners to pay $300,000 in civil penalties, ordered Patriot28 to disgorge $685,000 in illegal profits, and barred Jarkesy from various securities industry activities. Petitioners then filed a petition for review in the Fifth Circuit.

Summary of the Opinion

In a 2-1 opinion, the Fifth Circuit held that the SEC's administrative enforcement proceedings "suffered from three independent constitutional defects." As a result of at least two of these defects, the Fifth Circuit vacated the SEC's decision and remanded the case for proceedings consistent with the opinion.

First, the Fifth Circuit held that the Petitioners were deprived of their constitutional right to a jury trial. After a lengthy discussion of the historical importance of juries in the United States, Judge Elrod, writing for the majority, concluded that the SEC's enforcement action is a suit "at common law" such that the Seventh Amendment's right to a jury trial applies unless the enforcement action centers on "public rights created by statutes within the power of Congress to enact." *Atlas Roofing Co. v. Occupational Safety & Health Rev. Comm'n*, 430 U.S. 442, 450 (1977). Applying the "public rights" test articulated in *Atlas Roofing* and refined by *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989), the Fifth Circuit first held that securities fraud actions are not "new" causes of action created by Congress because traditional rights and remedies were inadequate to cope with a manifest public problem. Instead, the Fifth Circuit found that such fraud actions have been heard by common-law courts "for centuries," noting that the statutes under which the SEC brought its enforcement action mirror the traditional elements of common-law fraud. The Fifth Circuit further found that requiring jury trials for SEC enforcement actions would not "dismantle the statutory scheme" or "impede swift resolution" of the statutory claims because the SEC has always been able to bring such actions in Article III courts and frequently chooses to do so. As a result, the Fifth Circuit concluded that the SEC enforcement proceedings in this case violated Petitioners' right to a jury trial under the Seventh Amendment, and therefore that the SEC's decision must be vacated.

Second, the Fifth Circuit held alternatively that the SEC's decision must be vacated because Congress delegated "legislative power" to the SEC without providing an "intelligible principle" by which the SEC would exercise such power, thus violating Article I's vesting of "all" legislative power in Congress. Specifically, Congress, through Dodd-Frank § 929P(a), gave the SEC unfettered discretion over whether to bring securities fraud actions for monetary penalties in Article III courts or in administrative enforcement proceedings within the SEC. Indeed, the Fifth Circuit notes that Congress offered no guidance whatsoever to the SEC as to when proceedings should be brought in front of an Article III judge or an ALJ. Such a total absence of guidance, the Fifth Circuit held, is impermissible under the Constitution.

Third, the Fifth Circuit held that the statutory removal restrictions on ALJs charged with hearing administrative enforcement actions brought by the SEC violated the requirement in Article II, Section 3 of the U.S. Constitution that the President must "take Care that the Laws be faithfully executed." Under the statute, ALJs may be removed only by SEC Commissioners if good cause is found by the Merits System Protection Board ("MSPB"), and SEC Commissioners and MSPB members in turn may only be removed by the President for cause. The Fifth Circuit found that such multi-layer insulation from presidential oversight rendered the statutory scheme for removal of ALJs unconstitutional by hindering the President's ability to take care that the laws are faithfully executed. However, the Fifth Circuit declined to find that this constitutional defect provided independent grounds under which the SEC's decision must be vacated.

Summary of the Dissent

In dissent, Judge Davis began by arguing that the SEC's enforcement action satisfies the definition of a "public right" as set forth in *Atlas Roofing* and its progeny because the action is a suit initiated by the government for violations of a federal statute or regulation. Because *Granfinanciera*'s analysis deals only with whether an action between two private parties is within the reach of *Atlas Roofing*'s "public rights" doctrine, the dissent argued that requirements for finding a "public right" discussed in *Granfinanciera* (and applied by the majority here) that go beyond those set forth in *Atlas Roofing*, such as whether the enforcement actions would "dismantle the statutory scheme" or "impede swift resolution" of the statutory claims, apply only to cases not involving the government. The dissent also disagreed with the alternative holding that Congress exceeded its power by granting the SEC discretion over the forum in which enforcement actions may be brought, claiming that this alternative holding runs counter to Supreme Court precedent. Finally, the dissent challenged the majority's contention that ALJs' enjoyment of at least two layers of for-cause protection is unconstitutional, contending that the cases the majority relies on support the dissent's position.

Ramifications of *Jarkesy*

Jarkesy is just the latest case aimed at SEC administrative proceedings. In its 2018 decision in *Lucia v. SEC,* the US Supreme Court held that the SEC's process to appoint its ALJs was unconstitutional. While the SEC tried to remedy the issue through re-appointments, the decision caused the Commission to scale back its use of administrative proceedings. More recently, the US Supreme Court has agreed to consider the Fifth Circuit's decision in *SEC v. Cochran* (along with a case involving the Federal Trade Commission) to consider whether the tenure protection of ALJs violates the Take Care Clause. Taken together, these cases will likely spur the SEC to continue the trend to rely less and less on administrative proceedings and to file even more of its cases in federal court.