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Fifth Circuit Holds SEC Administrative Proceedings Unconstitutional

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In a decision with potentially wide-sweeping implications for the securities enforcement arena and a host of other federal government administrative proceedings, on May 18, 2022, the United States Court of Appeals for the Fifth Circuit held that Securities and Exchange Commission ("SEC") administrative enforcement proceedings are unconstitutional. The decision not only embraces, but intensifies, the skepticism toward the federal administrative agencies adopted by the Supreme Court in *Free Enterprise Fund v. Public Company Accounting Oversight Board*,[1] *Lucia v. SEC*,[2] *Seila Law LLC v. Consumer Financial Protection Bureau*,[3] and other recent cases.

In a 2-1 ruling, the panel in *Jarkesy v. SEC*, No. 20-61007, 2022 U.S. App. LEXIS 13460 (5th Cir. May 18, 2022), concluded that administrative enforcement proceedings before administrative law judges ("ALJs") "suffer[] from three independent constitutional defects."[4] First, they deprive the accused of the Seventh Amendment right to a jury trial in an Article III court. Second, they constitute an improper delegation of legislative power in violation of Article I's vesting clause. Third, they are adjudicated by inferior officers who are statutorily insulated from executive removal in violation of Article II's Take Care clause. Accordingly, the panel vacated the SEC's decision and remanded the case for further proceedings.

This Alert summarizes the key elements of the court's analysis and the implications of its decision. If you have any questions, please do not hesitate to contact one of the authors or your usual Ropes & Gray advisor.

Background

In 2013, the SEC brought an administrative action for securities fraud against hedge fund manager George R. Jarkesy, Jr. and his investment advisor, Patriot28 (together, the "Petitioners").[5] The agency alleged that the Petitioners overvalued their investment fund's assets and misrepresented their fund's safeguards in order to raise the fees they could charge investors.[6] In response to the enforcement action, the Petitioners filed suit in federal district court to enjoin the proceedings, but the district court for the District of Columbia, and ultimately the U.S. Court of Appeals for the D.C. Circuit, allowed the agency's proceedings to continue.[7]

At the conclusion of the administrative proceedings, the ALJ found that the Petitioners indeed committed securities fraud.[8] On review, the SEC affirmed and assessed monetary penalties against the Petitioners, ordered them to cease and desist from their fraudulent practices, and barred Jarkesy from certain securities industry activities such as associating with brokers or serving as an officer of an advisory board.[9]

The Commission also rejected the Petitioners' various constitutional challenges. Among other arguments, the Petitioners had contended (1) that the proceedings violated their Seventh Amendment right to jury trial, (2) that the SEC's authority to choose arbitrarily to bring the case before its own ALJs, rather than before an Article III court, was an unconstitutional delegation of legislative power, and (3) that the structure of the SEC—specifically, the multiple layers of protection insulating the ALJ from removal by the President—violated Article II's Take Care clause.[10]

The Petitioners then sought direct review of the Commission's decision in the Fifth Circuit Court of Appeals.

The Panel's Opinion

On appeal, the Fifth Circuit sided with Petitioners on all three arguments.

First, the court determined that the SEC's agency-adjudicated enforcement action violates the Seventh Amendment's guarantee of the right to trial by jury.[11] According to the panel, because they seek civil penalties, SEC enforcement actions are akin to common law fraud suits, to which the jury trial right generally applies, and do not concern mere "public rights," to which the Seventh Amendment generally does not apply. Because fraud is not a cause of action "unknown to the common law" and because jury trials would neither "dismantle the statutory scheme" nor "impede swift resolution" of fraud

enforcement actions, said the panel, the Petitioners were entitled to a jury trial.[12] The SEC had contended that the proceedings concerned public, not private, rights on the basis that the securities statutes at issue were designed to protect the general public. To the panel, however, such an argument lacked any limiting principle, and would allow for claims under virtually any federal statute to be adjudicated by a non-Article III tribunal without Seventh Amendment protection.[13] Therefore, the panel concluded that the Petitioners had the right to a jury to adjudicate the fraud liability that would support penalties against them.

Second, the panel held in the alternative that Congress unconstitutionally delegated its Article I powers by providing the SEC with unfettered discretion to choose the forum in which to bring enforcement actions.[14] Under long-standing precedent cited by the panel, Congress may not assign legislative powers to an administrative agency without supplying an "intelligible principle" to guide the agency's exercise of that legislative authority.[15] According to the panel, the discretion afforded the SEC in choosing whether to bring an enforcement proceeding in an Article III court or in an administrative forum was not only a legislative power, but one lacking any intelligible principle. In the first place, the panel reasoned that, by deciding which parties would be entitled to Article III proceedings with a right to trial by jury, the SEC was effectively "altering the legal rights, duties and relations of persons . . . outside the legislative branch" and was thus exercising legislative authority.[16] And such legislative authority, the panel continued, was unbounded by any intelligible principle since "Congress has said *nothing at all* indicating how the SEC should make that call in any given case."[17] Although the panel acknowledged that the Supreme Court has not "in the past several decades" held that Congress failed to supply a requisite intelligible principle when delegating its legislative authority, the panel emphasized that neither had the Court in those decades "considered the issue when Congress offered no guidance whatsoever."[18]

Third, the panel agreed with Petitioners that the statutory restrictions on the President's ability to remove SEC ALJs contravene Article II's Take Care clause.[19] Under Supreme Court precedent in *Free Enterprise Fund v. Public Co. Accounting Oversight Board*, having two layers of "for cause" protection from removal for executive officers violates Article II by depriving the President of his authority to oversee executive branch activity.[20] The court explained that such double-layered insulation exists with respect to SEC ALJs because, by statute, (1) they can only be removed by SEC Commissioners through a proceeding before the Merit Systems Protection Board ("MSPB") based on a finding of good cause, and (2) in turn, the President can only remove SEC Commissioners and MSPB members for good cause.[21] Moreover, the panel stated, given the Supreme Court's holding in *Lucia v. SEC* that SEC ALJs are "inferior officers" for purposes of Article II's Appointments Clause, and in light of their "considerable power" in adjudicating SEC enforcement actions, SEC ALJs are "sufficiently important to executing the laws that the Constitution requires that the President be able to exercise authority over their functions."[22] But because the panel vacated the SEC's decision on the first two constitutional grounds, it did not decide whether vacating would be the appropriate remedy based on this Take Care clause violation alone.[23]

The Dissent

Judge W. Eugene Davis rejected the majority's conclusions on each of the three alleged constitutional defects.

First, the dissent rejected the majority's analogy to common law fraud, instead agreeing with the SEC that its enforcement proceedings entail only "public rights" to which the Seventh Amendment jury trial right does not attach. As Judge Davis explained, such proceedings concern only "matters 'which arise between the Government and persons subject to its authority in connection with the performance of the constitutional functions of the executive or legislative departments.'"[24] Second, in likening the SEC's forum discretion to the well-established discretion of prosecutors to choose which charges to pursue in a criminal case, the dissent argued that Congress supplied enough of an "intelligible principle" by limiting SEC's choice to two possible fora.[25] And finally, the dissent took issue with the majority's Article II analysis and argued that both *Free Enterprise Fund* and *Lucia* are inapposite because, respectively, (1) SEC ALJs perform an adjudicatory, not policymaking, function and have merely "recommendatory" powers, and (2) even if ALJs are inferior officers for Appointments Clause purposes, it does not therefore follow that "ALJs' tenure protections interfere with the President's ability to execute the law."[26]

Implications of the Panel's Decision

If the decision stands, *Jarkesy* would deal another blow to SEC administrative proceedings, whose use by the SEC has dwindled since *Lucia*. Moreover, its constitutional holdings, far broader and less flexible than *Lucia* and the Supreme Court's

other recent administrative law decisions, could trigger similar challenges to dozens of other federal administrative bodies that deploy ALJs, such as the Federal Trade Commission, Social Security Administration, Department of Labor, Consumer Financial Protection Bureau, International Trade Commission, and Environmental Protection Agency, among others.[27] At present, the Fifth Circuit's decision is only binding on federal courts in Texas, Louisiana, and Mississippi. Moreover, the panel's decision could possibly be overturned by the Fifth Circuit *en banc* or the Supreme Court, should the government choose to seek further review.[28] While it is thus difficult at this point to gauge fully either its immediate or long-term impact, *Jarkesy* is a powerful example of the increasingly aggressive stance of some federal courts toward the independence and authority of administrative agencies—and a clear demonstration of such courts' willingness to cut back dramatically on those agencies' ability to enforce their statutory authorities. Parties who are being subjected to agency enforcement action should consider asserting similar challenges in order to preserve these arguments in the event they gain further traction in other courts or the Supreme Court.

1. 561 U.S. 477 (2010) (holding that statute insulating Public Company Accounting Oversight Board members from Presidential removal with two levels of "for cause" protection violated Article II's Take Care clause).
2. 138 S. Ct. 2044 (2018) (holding that SEC administrative law judges are "inferior officers" for purposes of Article II's Appointments Clause and must therefore be appointed by the President or other delegated officer).
3. 140 S. Ct. 2183 (2020) (holding that the structure of the Consumer Financial Protection Bureau, with a single director who could only be removed from office "for cause," violated Article II's Take Care clause).
4. 2022 U.S. App. LEXIS 13460, at *5.
5. *Id.* at *2–3.
6. *Id.*
7. *Id.* at *3. In this initial federal proceeding, the Petitioners alleged that the SEC violated their constitutional rights to due process and equal protection. *Jarkesy v. SEC*, 48 F. Supp. 3d 32, 38 (D.D.C. 2014), *aff'd*, 803 F.3d 9, 12 (D.C. Cir. 2015). The district court, affirmed by the court of appeals, avoided the constitutional issue and instead ruled that it lacked subject matter jurisdiction over the dispute until the ALJ issued a ruling.
8. *Id.*
9. *Id.* at *3–4.
10. *Id.* at *5.
11. [1] *Id.* at *6–24.
12. *Id.* at *14–17.
13. *Id.* at *19.
14. *Id.* at *24–32.
15. *Mistretta v. United States*, 488 U.S. 361, 372 (1989) (*quoting J.W. Hampton, Jr., & Co. v. United States*, 276 U.S. 394, 409 (1928)).
16. *Jarkesy*, 2022 U.S. App. LEXIS 13460 at *28–29 (*quoting INS v. Chadha*, 462 U.S. 919, 952 (1983)).
17. *Id*. at *31 (emphasis added).
18. *Id*. at *30.
19. *Id.* at *32–37.
20. 561 U.S. 477 (2010).
21. *Jarkesy*, 2022 U.S. App. LEXIS 13460 at *34.
22. *Id.* at *35.
23. *Id.* at *38.
24. [1] *Id.* at *42 (*quoting Crowell v. Benson*, 285 U.S. 22, 50 (1932)).
25. *Id.* at *54.
26. *Id.* at *59–62.
27. *See Agency Services: Administrative Law Judges*, United States Office of Personnel Management, https://www.opm.gov/services-for-agencies/administrative-law-judges/#url=ALJs-by-Agency.
28. Indeed, two cases pending before the Supreme Court next term raise similar issues concerning district court jurisdiction over constitutional challenges to agency structure. In *SEC v. Cochran*, 2022 U.S. LEXIS 2425, No. 21–1239, the Court will consider the Fifth Circuit's *en banc* decision holding that a plaintiff may bring a collateral suit in federal district court alleging that SEC ALJs are improperly insulated from removal, without first pressing the claim and obtaining a final determination in the administrative proceeding. In *Axon Enterprise v. FTC*, 2022 U.S. LEXIS 2355, No. 21–86, the Court will similarly consider the Ninth Circuit's holding that a plaintiff may not bring constitutional claims in district court challenging the FTC's structure or its ALJs' insulation from removal before the FTC proceedings have concluded.