

Fifth Circuit Holds SEC's In-House Courts and Judges Unconstitutional

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In [*Jarkesy v. Securities and Exchange Commission*](#), the Court of Appeals for the Fifth Circuit issued a remarkable opinion holding numerous aspects of the SEC's administrative enforcement regime are unconstitutional. The May 18, 2022 ruling stands to eliminate the SEC's ability to adjudicate enforcement actions seeking penalties using ALJs, rather than bringing suit in federal district court. It also could tee up further argument at the Supreme Court to resolve the scope of the SEC's – and, perhaps, other administrative bodies' – adjudicatory powers.

Factual Background

The SEC brought an enforcement action against George Jarkesy and Patriot28, the investment adviser to two hedge funds, in an administrative proceeding, charging them with various violations under the federal securities laws for fraud. After the respondents' attempt to enjoin the proceedings by filing suit in the District Court for the District of Columbia failed, the SEC ALJ held an evidentiary hearing and found that Jarkesy and Patriot28 committed securities fraud. The Commission affirmed, rejecting the respondents' arguments that the proceeding violated their constitutional rights and ordering the respondents to cease and desist from further violations and to pay a civil penalty of \$300,000. The SEC also ordered Patriot 28 to disgorge nearly \$685,000 and barred Jarkesy from participating in various securities industry activities.

Jarkesy and Patriot28 sought review of the Commission's decision. The Fifth Circuit, in a 2-1 opinion written by Judge Jennifer Walker Elrod, agreed that the SEC's proceedings were unconstitutional, and vacated the SEC's decision.

The Fifth Circuit's Decision

The majority opinion held the SEC's actions involved three independent constitutional violations: (1) adjudication by the SEC's in-house enforcement body violated a defendant's constitutional right to a jury; (2) Congress's delegation of authority to the SEC to decide whether its cases should be heard in federal district court or in-house was unconstitutional; and (3) the removal restrictions on SEC ALJs violated Article II.

Right to a Jury Trial

The Fifth Circuit used a two-step test to determine whether Jarkesy and Patriot²⁸ (referred to as the petitioners in the Fifth Circuit's opinion) were deprived of their Seventh Amendment right to a jury trial: first, whether the SEC's claims against them arose "at common law," and, if so, whether they solely involved "public rights" that were appropriate for agency resolution without the aid of a jury.

The court based its first step on the Seventh Amendment's requirement that "[s]uits at common law" must be tried by a jury. The majority looked to Supreme Court precedent, which interpreted "Suits at common law" to include all actions akin to those brought at common law when the Seventh Amendment was adopted, as well as suits brought under a post-founding statute seeking remedies like those that were available under common law. In the majority's view, the SEC's claims boiled down to assertions of fraud, which were regularly brought in English courts. It also held that actions seeking civil penalties are akin to certain traditionally legal claims, and the equitable remedies also sought by the SEC (which are traditionally outside the bounds of the Seventh Amendment) did not invalidate the right to a jury trial on the fraud claims. Therefore, the Court held the SEC's claims were subject to the Seventh Amendment.

In the second step of the inquiry, the Court determined the securities fraud claims did not involve purely “public rights,” and were thereby not exempt from the right to a jury trial. In the majority’s view, statutes creating “public rights” are different from laws serving a public purpose, and public rights are only those created by statute without any basis in common law. Because the federal securities laws under which the SEC charged the defendants reflected traditional fraud claims, the majority reasoned they were not “public rights.” Judge Eugene Davis, in his dissent, disagreed; in his view, the public purpose of the federal securities laws and the fact that the SEC, a government entity, brought those claims, meant the case involved public rights. The majority balked at that analysis, arguing the dissent would mean that any action brought by the government would not require a trial by jury. And although the majority acknowledged the federal securities laws created some new causes of action and that certain remedies that were distinctly public in nature, the securities fraud claims against the defendants were quintessentially about the redress of private harms.

Congressional Delegation of Authority

The next constitutional violation found by the Fifth Circuit involved Congress’s delegation of authority to the SEC to decide whether to bring an action in-house or in federal court. The petitioners’ argument rested on Supreme Court precedent that Congress may only grant legislative or regulatory power to another entity – such as the SEC – if it also provides an “intelligible principle” by which the entity should exercise that power. Thus, the Court’s analysis involved another two-part inquiry: whether Congress delegated legislative power to the SEC, and if so, whether Congress provided an intelligible principle to guide the SEC in making its decisions.

As to the first prong, the Court held that, by giving the SEC the ability to determine which subjects of its enforcement actions were entitled to a jury trial in an Article III court and which were not, Congress had delegated its legislative power. The majority distinguished this grant of authority from the exercise of prosecutorial discretion, or, as the dissent put it, the proper delegation to the executive branch to make a forum choice for an SEC enforcement action. In the majority’s view, the SEC’s grant of authority was not merely to decide on a forum, but rather allowed it to choose which defendants should receive certain legal processes in an Article III court (such as a trial by jury).

The majority summarily dealt with the second prong of its test: because Congress's grant of authority to the SEC was entirely open ended without any instruction, it had not provided any intelligible principle by which to guide the SEC in making these decisions. This lack of guidance rendered the SEC's decision-making authority an unconstitutional legislative act by an agency. The dissent, however, disagreed that Congress had granted any legislative authority to the SEC, but rather viewed it as having properly delegated the power to make forum choices for enforcement actions to an executive agency. Accordingly, it did not see any violation of the nondelegation doctrine.

Removal Provisions for SEC ALJs

Finally, the Court held the removal procedures for SEC ALJs unconstitutional under Article II of the Constitution, which provides that the President has the ability to ensure all laws are faithfully executed. SEC ALJs, as "inferior officers" of an executive agency exercising important discretion, must be subject to a certain degree of control by the President. However, they have two levels of protection from removal by the President, as both ALJs and SEC Commissioners may only be removed for good cause. In the majority's view, these two for-cause termination requirements sufficiently insulated SEC ALJs from removal such that the President was impeded from ensuring that laws are faithfully executed. Here, too, the dissent disagreed with the majority's premise, arguing that SEC ALJs solely perform an adjudicative function and therefore do not interfere with the President's executive authority.

Implications

Should the *Jarksey* opinion stand, the SEC may find itself unable to adjudicate most actions seeking penalties in administrative proceedings (at least as to respondents located within the Fifth Circuit). Some cases could remain within the purview of the SEC's administrative courts, however, such as those seeking only equitable relief or cases based on provisions of the federal securities laws that do not have a common-law corollary; as admitted in the majority's opinion, neither such category of cases is subject to the Seventh Amendment's right to a jury trial. But the majority of the SEC's contested cases, and certainly those seeking civil penalties for securities fraud, fit squarely within the *Jarksey* decision.

That said, it is unclear if this portion of the decision, standing alone, would have a significant impact on the SEC's enforcement scheme. As the majority pointed out, the SEC regularly brings securities-fraud actions in Article III courts and adjudicates them through jury trials. But being forced to seek redress only in federal court could change the SEC's calculus while conducting an investigation; it could potentially result in more concessions by the SEC in order to successfully settle a matter that, prior to *Jarksey*, the agency would have adjudicated administratively.

It is also unclear what effect this opinion could have on the government's administrative authority in general. *Jarksey*'s discussion of the unconstitutionality of ALJ termination policies is not, by its clear terms, limited to SEC ALJs. Unless the federal government alters the for-cause removal requirements for all ALJs and/or the commissioners above them, the federal government could lose thousands of ALJs who adjudicate all types of legal disputes pursuant to federal statutes. Removing the ability for ALJs to hear administrative disputes could also clog the federal court system with many more disputes than it is used to, thereby slowing the process for criminal and civil trials.

The *Jarksey* opinion will almost undoubtedly be subject to further review. It presents novel interpretations of Supreme Court precedent that, as the dissent points out, had appeared to be well-settled prior to the *Jarksey* case. And the Supreme Court already granted *certiorari* in another Fifth Circuit case, *Cochran v. SEC*, that also challenges the SEC's in-house administrative tribunals. Although that case is slightly narrower than *Jarksey*, the SEC's adjudicatory ability could hang in the balance of both decisions.

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