Fifth Circuit Holds SEC Proceeding Brought in Agency's In-House Court Unconstitutional

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Key Points:

- A recent Fifth Circuit decision in *Jarkesy v. SEC* held that an SEC administrative proceeding violated the U.S. Constitution in three distinct respects:
  - The administrative proceeding deprived the target of the enforcement action of its right to a jury;
  - By giving the SEC discretion to choose to file actions administratively or in federal district court without an "intelligible principle" to guide the agency, Congress violated the nondelegation doctrine; and
  - Tenure protection afforded to administrative law judges unconstitutionally interferes with the president's ability to remove a judge.
- *Jarkesy* is the latest in a series of cases challenging the constitutionality of administrative proceedings, two of which have been recently taken up by the U.S. Supreme Court.

On May 18, 2022, in *Jarkesy v. SEC*, No. 20-61007 (5th Cir. May 18, 2022), a split panel of the U.S. Court of Appeals for the Fifth Circuit identified three independent constitutional flaws in the administrative adjudication system of the Securities and Exchange Commission (SEC). The case arose from the SEC's enforcement action brought against the manager of two hedge funds and the funds' unregistered investment adviser (the petitioners) before the agency's in-house administrative law judge. The Fifth Circuit's conclusions may significantly constrain the SEC's — and perhaps other agencies' — future ability to litigate certain enforcement actions before administrative tribunals.

First, the Fifth Circuit ruled that the SEC's adjudication procedure violated Seventh Amendment rights to jury trial. It reasoned that the action against the petitioners resembled a traditional common law claim — such as a civil action for fraud — and was not uniquely suited for adjudication within an agency. Indeed, the panel noted that the SEC has the option to bring enforcement actions in federal courts. The Fifth Circuit held that the Seventh Amendment applies to proceedings where the SEC is seeking to obtain civil penalties, and although the SEC also sought such equitable remedies as disgorgement of ill-gotten gains and a securities industry bar, the court reasoned that all the remedies stemmed from the same facts. The petitioners therefore had a right to jury trial for the liability-determination portion of the case.

Second, the Fifth Circuit held that Congress unconstitutionally delegated to the SEC legislative power when it empowered the agency to decide whether to bring an enforcement action in an administrative tribunal or in federal court. In particular, the court noted that Congress gave the SEC extensive powers to decide not only whether and in what venue to bring enforcement actions, but also whether the respondent has access to "certain legal processes" afforded in district court actions or is denied those rights in an administrative proceeding. To delegate authority to an agency, Congress must articulate an "intelligible principle" to guide the authority's exercise, and the panel reasoned that Congress overstepped by granting the SEC unfettered discretion in forum selection. Although the nondelegation doctrine has scarcely been used by courts to strike down federal statutes since the New Deal, the Fifth Circuit's ruling may be the latest sign of judicial interest in reviving it.

Third, the Fifth Circuit held that administrative law judges who preside over the SEC's administrative tribunals enjoy an unconstitutional degree of tenure protection, which hinders the president's ability to remove them under the Take Care Clause of Article II

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of the Constitution. In general, federal officials whose authority is significant enough to qualify them as "inferior officers" must face a prospect of removal by the president and therefore cannot be protected by two or more layers of "for cause" protection for removal. The panel reasoned that administrative law judges are sufficiently powerful to trigger these requirements, but they can only be removed from office for good cause — and then only with the participation of SEC commissioners and members of the Merit Systems Protection Board, who are themselves only removable for cause.

The Fifth Circuit's decision is the latest in a wave of constitutional litigation concerning administrative proceedings — and it is arguably a decision that will have the most far-reaching consequences for the SEC's use of administrative proceedings in litigated enforcement actions. In 2018, the Supreme Court held that administrative law judges are subject to the Appointments Clause of the Constitution and that their hiring process violated that clause. Following that decision, the SEC pulled back sharply from filing cases administratively and tended to use its administrative forum only for settled actions, in which respondents agree to waive constitutional arguments, and for the small minority of cases that could not be filed in federal district court, such as disciplinary proceedings. More recently — just two days before the Fifth Circuit issued its decision in *Jarkesy* — the U.S. Supreme Court agreed to review another decision by the Fifth Circuit, *SEC v. Cochran*, along with another appeal involving another federal agency, *Axon Enterprise Inc. v. FTC*, that both challenge the constitutionality of administrative law judges' tenure protection under the Take Care Clause.

Given the overlap of issues and introduction of other constitutional issues that now cast a darker cloud on administrative forums, the agency may seek further review of the decision from the full Fifth Circuit or from the Supreme Court. In the meantime, the SEC will surely stay the course and continue to file most litigated actions in federal district court. Because much of the Fifth Circuit's ruling hinged on the nature of the specific claims brought by the SEC in the challenged administrative proceeding, the applicability of this decision to administrative proceedings instituted by other agencies is uncertain.

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