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Fifth Circuit Holds that SEC Administrativre Proceedings are Unconstitutional

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On May 18, 2022, a split panel of the Fifth Circuit Court of Appeals held that Securities and Exchange Commission (SEC) administrative proceedings are unconstitutional. In *Jarkesy v. SEC,* the Fifth Circuit opined in a groundbreaking ruling that administrative law judge adjudication of antifraud claims seeking civil penalties violates the following constitutional rights of a respondent: (1) the Seventh Amendment right to a jury trial, (2) the judicially crafted nondelegation doctrine and (3) the Take Care Clause of Article II of the Constitution.[1] This decision limits SEC actions and relief in administrative proceedings moving forward.

Facts

The ruling arises out of an SEC administrative proceeding brought against George Jarkesy, who formed two hedge funds that raised around $24 million from over 100 investors, and the associated investment adviser, Patriot28 (collectively "respondents" or "petitioners"). The SEC charged both with securities fraud under the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. Further, the administrative action alleged misrepresentations regarding the funds' prime broker and auditor, the funds' safeguards and the value of the funds' assets. The respondents commenced a parallel action in the District Court for the District of Columbia in which they unsuccessfully sought to enjoin the SEC's administrative proceedings against them. However, the SEC's Administrative Law Judge (ALJ) held an evidentiary hearing and found that the respondents committed securities fraud.

On the initial appeal of the ALJ's findings, the Commission affirmed—predictably rejecting the respondents' argument that the administrative proceeding violated their constitutional rights. The Commission ordered respondents to cease and desist further violations and to pay a civil penalty of $300,000. Patriot28 was also ordered disgorgement of $685,000, while Jarkesy was barred from engaging in various securities industry activities.

Fifth Circuit Opinion

The Fifth Circuit appeal arose out of a review of the Commission's decision. There, Judge Elrod held that the SEC's administrative proceedings were unconstitutional. The court focused on three constitutional arguments. First, it held that the administrative process deprived the petitioners of their constitutional right to a jury trial. Second, the court found the SEC's administrative proceeding framework to result in an unconstitutional delegation of congress's legislative power to the Commission. Finally, it concluded that the statutory removal restrictions of the ALJ violated Article II of the Constitution. Ultimately, the Fifth Circuit vacated the SEC decision and remanded the case. The court's reasoning is discussed in further detail below.

First, the Fifth Circuit held that the SEC's administrative adjudication procedure violated the petitioners' Seventh Amendment right to a jury trial because the claim was analogous to a traditional common law claim for fraud. As such, this action was not suited for agency adjudication. The panel further reasoned that where the SEC is seeking to obtain civil penalties, the Seventh Amendment applies. While the SEC also sought equitable remedies such as disgorgement of ill-gotten gains and a bar from engaging in various securities industry activities, the court reasoned that the remedies all

[1] *Jarkesy v. SEC*, No. 20-61007 (5th Cir. May 18, 2022).

stemmed from the same facts, thus the Seventh Amendment still applies.

Second, the Fifth Circuit held that Congress unconstitutionally delegated its legislative power to the SEC when it instilled the agency with unfettered discretion to bring enforcement actions in either administrative tribunals or federal court. The court held that the SEC lacked any “intelligible principle” to guide its exercise of absolute discretion over whether to proceed in front of an ALJ or before an Article III court. Therefore, this amounted to congress unconstitutionally delegating its legislative power to the SEC.

Third, the Fifth Circuit held that the Take Care Clause of Article II of the Constitution was violated. The clause provides that the president has the power to ensure that all federal laws are faithfully executed. Since ALJs are not subject to removal at the direction of the president or senior officers that the president can readily remove, the court held that the executive authority to ensure that laws are faithfully executed is unconstitutionally restrained. Therefore, the statutory removal restrictions on ALJs is unconstitutional.

Conclusion

The SEC will almost certainly seek further review from an *en banc* Fifth Circuit panel or from the Supreme Court. Until then, it is likely that the SEC will proceed by continuing to file most litigated actions in federal district court. Overall, the Fifth Circuit opinion presents a novel interpretation of Supreme Court precedent that seemingly was previously well-settled. The case is significant as it breaks new ground. However, the opinion’s applicability to other agencies is unknown at this point, as is the question of its possible extension or adoption beyond the Fifth Circuit. But readers may expect further developments in this space in the near future.

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