Federal Court Calls Unconstitutional the U.S. Securities & Exchange Commission's In-House Administrative Proceedings for Securities Fraud Cases

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Key Takeaways

- The U.S. Supreme Court is poised to hear cases that may curtail the administrative powers of the SEC
- These rulings may portend greater limits on federal administrative agencies generally

In *Jarkesy v. Securities and Exchange Commission,* the U.S. Court of Appeals for the Fifth Circuit held the SEC violates the constitution when it brings civil securities fraud charges before its own Administrative Law Judges (ALJs). The Fifth Circuit decision will almost certainly be appealed to the U.S. Supreme Court. This seems especially likely since the Supreme Court recently agreed to decide whether a respondent in a pending SEC administrative case may sue the SEC in federal district court to challenge the constitutionality of the restrictions on removal of SEC ALJs. *See Securities and Exchange Commission v Cochran*, No. 21-1239. The *Cochran* appeal, and the likely appeal of *Jarkesy*, set up the prospect that the Supreme Court may curtail the SEC's administrative powers, and the powers of federal administrative agencies generally.

Petitioner in *Jarkesy* hired an investment adviser to help run two hedge funds. The SEC investigated the funds and charged Jarkesy and others with fraud under the Securities Exchange Act and the Investment Advisers Act, alleging they made misrepresentations to investors. The 2010 Dodd Frank Wall Street Reform and Consumer Protection Act gave the SEC the option to pursue civil penalties in federal court before judges appointed under Article III of the U.S. Constitution, or in SEC administrative proceedings decided by ALJs selected by the SEC.[1] In *Jarkesy,* the SEC exercised its option to bring an administrative action for fraud before the SEC's own ALJ. The ALJ found that Jarkesy and others had committed securities fraud, issued civil monetary penalties and ordered disgorgement of ill-gotten gains. The Commission affirmed the ALJ's ruling, and rejected Jarkesy's arguments that the SEC administrative proceeding was unconstitutional. Jarkesy asked the Fifth Circuit to review the SEC's decision. The Fifth Circuit found, in a 2-1 decision, that the SEC's in-house adjudication of securities fraud cases was unconstitutional on three grounds:

1. The proceedings violated Jarkesy's Seventh Amendment right to a jury trial;
2. Congress unconstitutionally delegated legislative power to the SEC in violation of Article I of the Constitution, and
3. The statutory restrictions on removal of ALJs and the SEC Commissioners that hire them violated Article II of the Constitution by depriving the President of the United States of sufficient control over the ALJ's "substantial executive functions."

The dissenting Judge in *Jarkesy* presented an analysis rebutting each of these holdings, and indicated he found the SEC's administrative hearings constitutional. Below is a summary of the three issues that will likely be finally decided by the U.S. Supreme Court on appeal.

Seventh Amendment Issue

The majority in *Jarkesy* held the Seventh Amendment protects the right to a civil jury for "Suits at common law," "as those actions were understood at the time of the Seventh Amendment's adoption." Citing *Tull v United States*, 481 U.S. 412, 417 (1987), the *Jarkesy* court reasoned that a Seventh Amendment right to a jury trial applies to suits seeking statutory civil penalties, but acknowledged that Congress could assign such an action to the SEC without a jury if the proceeding involved "public rights." Citing the Supreme Court decisions in *Atlas Roofing Co. v. OSHA* and *Granfinanciera, S.A. v. Nordberg*, the *Jarkesy* court said a matter does not involve public rights merely because a government agency like the SEC is prosecuting it. Rather, public rights arise "when Congress passes a statute under its constitutional authority that creates a right so closely integrated with a comprehensive regulatory scheme that the right is appropriate for agency resolution." (citing *Granfinanceria S.A.*, 492 U.S. 33, 54 (1989)). The *Jarkesy* court framed this public rights test as a two-stage analysis: 1) a court must decide whether the claims at issue arise "at common law" under the Seventh Amendment, and if so, 2) whether the Supreme Court's public rights cases permit Congress to assign those claims to agency adjudication without a jury.

As to the first factor, the *Jarkesy* court cited authority supporting its position that actions for fraud and civil penalties "were distinctly legal claims" to which juries were afforded at the time the Seventh Amendment was adopted. The *Jarkesy* court so held even though the SEC also brought equitable claims for disgorgement and injunctive relief, citing Supreme Court precedent holding that a jury must determine facts relating to legal claims even if those facts also relate to equitable claims being prosecuted in the same action. As to the second factor, the *Jarkesy* court interpreted *Granfinanciera* to mean that a fraud case doesn't become a "public rights" case just because a government agency is bringing the case. The court noted that Article III courts and juries have been deciding securities fraud claims for decades, and that those fraud claims have been brought both by the SEC and private parties. Thus, the *Jarkesy* court held that Jarkesy has the right to have a jury decide the facts that would support a civil penalty for securities fraud, even if those facts may also support equitable remedies sought by the SEC.

The dissenting judge in *Jarkesy* interpreted the Supreme Court decisions in *Atlas Roofing* and *Granfinanceria* to mean that a securities fraud case implicates public rights, and does not require a jury, "where the Government sues in its sovereign capacity to enforce a statutory right." The dissenting judge thus seems to assume that an administrative action by a federal government agency is an action by "the Federal Government in its sovereign capacity."

Unconstitutional Delegation of Legislative Power to the SEC

Article I of the Constitution requires that "all legislative Powers" in the Constitution be vested with Congress. According to *Jarkesy*, U.S. Supreme Court precedent allows Congress to grant legislative power to an agency if it provides an "intelligible principle" by which the agency can exercise that power. *Jarkesy* found that the SEC's authority under the Dodd Frank Act to determine whether to bring in action in an Article III federal court or within the SEC, in its sole discretion, was a delegation of legislative power to the SEC. The Court then found this delegation unconstitutional because "Congress did not provide the SEC with an intelligible principle by which to exercise that power." The Court found that Congress failed to provide any standard at all about when the SEC should exercise its discretion to decide whether to sue in an Article III court or within the agency, which abdicated Congress's legislative power in violation of Article I.

The dissenting judge disagreed, and said the power to determine where to file a lawsuit was akin to the traditional executive function of prosecutorial discretion. So Congress properly delegated that executive function to the SEC as part of Congress's enabling legislation.

Restrictions to Removing ALJs and the SEC Commissioners that Appoint Them Violate Article II Because They Deprive the President of the Ability to Ensure that SEC ALJs Faithfully Execute the Law

Article II requires the President of the United States to "take Care that the Laws be faithfully executed." The Supreme Court has said this means the President must have adequate power over an officer's appointment and removal. In 2018 the Supreme Court, in *Lucia v SEC*, held that SEC ALJs are "inferior officers" under the Appointments Clause because of the substantial authority they wielded in SEC enforcement actions. Relying principally on the Supreme Court's decision in *Free Enterprise Fund v Public Co. Accounting Oversight Board*, the *Jarkesy* court held that the two layers of for-cause protection for SEC ALJs deprived the President of the ability to take care that the laws are faithfully executed. Because ALJs are inferior officers under the Constitution, they can only be removed by SEC Commissioners if good cause is found by the Merits Systems Protection Board (MSPB). And SEC Commissioners and MSPB members can only be removed by the President for cause. Therefore, the court held that "SEC ALJs are insulated from the President by at least two layers of for-cause protection from removal, which is unconstitutional under *Free Enterprise Fund*."

The dissenting judge in *Jarkesy* disagreed that *Free Enterprise Fund* stood for the proposition that all two-level for cause protections for inferior officers are unconstitutional. Rather, he wrote that SEC ALJs were not addressed by *Free Enterprise Fund*, and that the PCAOB members at issue in that case had extensive powers to determine policy and enforce laws, while SEC ALJs "perform solely adjudicative functions." The dissenting judge says the Supreme Court requires a "functional analysis" of what duties the officer performs to determine whether they are important enough to make for-cause protection of the officer an unconstitutional deprivation of the President's power under Article II to ensure faithful execution of the law.

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It will be interesting to see how the recent changes to the members of the Supreme Court affect its rulings in *Cochran* and *Jarkesy*, and how these rulings will affect the growing general controversy over SEC administrative proceedings and SEC ALJs.

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[1] In 2018, the U.S. Supreme Court, in *Lucia v SEC*, held that SEC ALJs are not mere employees, but are "Officers of the United States" under the Appointments Clause of the U.S. Constitution. Consequently, the Court held that SEC ALJs must be appointed directly by the Commission itself, as opposed to the Commission delegating that function. *See*

Matthew P. Allen, *The Supreme Court Rules that SEC ALJs Were Unconstitutionally Appointed* (June 25, 2018)