Securities Regulation Daily Wrap Up, TOP STORY—5th Cir.: SEC ALJ proceedings ruled unconstitutional, (May 19, 2022)

Securities Regulation Daily Wrap Up

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By Anne Sherry, J.D.

In a decision that could reshape enforcement throughout the executive branch, the Fifth Circuit held that in-house SEC proceedings for securities fraud were unconstitutional for at least two independent reasons.

In a 2-1 opinion, a panel of the Fifth Circuit Court of Appeals vacated an SEC administrative decision imposing penalties and other sanctions for securities fraud. The appeals court held that the administrative proceedings violated the petitioners' Seventh Amendment right to a jury trial and that Congress unconstitutionally delegated to the SEC the power to decide which proceedings should be kept in-house and which should be brought in the courts. The court also ruled that the statutory removal restrictions for SEC administrative law judges are unconstitutional, without deciding whether vacating would be the appropriate remedy for this error alone (*Jarkesy v. SEC*, May 18, 2022).

The petitioners—an individual and the investment advisor he hired to advise two hedge funds—have been fighting this constitutional battle since 2014, when they sued in federal court to enjoin the SEC's administrative proceedings. The district court held that it lacked jurisdiction, the D.C. Circuit affirmed, and the proceedings resumed within the SEC's administrative tribunal. The Commission ultimately affirmed the ALJ's conclusion that the petitioners committed securities fraud and ordered penalties and disgorgement totaling around $1 million, along with injunctive relief. The in-agency proceedings having run their course, the petitioners were finally able to challenge the proceedings in federal court, as the D.C. Circuit had instructed.

The payoff: the Fifth Circuit held that the administrative proceedings suffered from three independent constitutional defects, the first two of which each provided a standalone basis for vacating the SEC's decision:

1. The petitioners were deprived of their constitutional right to a jury trial;
2. Congress unconstitutionally delegated legislative power to the SEC by failing to provide an intelligible principle to guide its exercise of that power; and
3. The statutory removal restrictions on SEC ALJs violate Article II by depriving the President of adequate control.

Seventh Amendment. In holding that the administrative proceedings violated the petitioners' right to a jury trial, the appeals court observed that the Seventh Amendment protects the right to a jury in "suits at common law," which has been held to include suits with a statutory basis that seek legal remedies with an analog in the common law. However, Congress may assign actions for administrative disposition if the proceedings center on "public rights." The considerations relevant to whether the case implicates public rights include (1) whether Congress created a new cause of action because traditional rights and remedies were inadequate to cope with a manifest public problem and (2) whether jury trials would "dismantle the statutory scheme" or "impede swift resolution" of the statutory claims.

The court reasoned that the rights here arise "at common law" because common-law fraud was regularly prosecuted in English courts, and the Supreme Court has likened actions seeking civil penalties to early types of actions in debt that were distinctly legal claims. The fact that the SEC also brought equitable claims did not invalidate the right to a jury trial, which attached because the action sought civil penalties.

Next, the action could not properly be assigned to the agency under the public-rights doctrine. Securities fraud was not a new cause of action unknown to the common law, and jury trials would not dismantle the statutory fraud scheme or impede swift resolution of the SEC's fraud prosecutions. The court observed that the statutory scheme itself lets the SEC decide whether to bring enforcement actions in-house or in Article III courts, and the SEC has brought many such actions to jury trial. The court also found no evidence that jury trials would impede swift resolution of claims, noting that the SEC took seven years to resolve the petitioners' case.

The SEC countered that the securities statutes are designed to protect the public, but the court reasoned that Congress cannot convert any action into a "public right" simply by finding a public purpose for it. Private securities fraud suits also serve a public purpose by discouraging and remedying fraud in the securities markets, but that does not make them about "public rights" at their core.

Importantly, the court's holding here applies to the specific claims at issue in the underlying administrative proceeding. The securities fraud claims were not new or foreign to Article III courts and juries. But the court allowed that "some actions provided for by the securities statutes may be new and not rooted in a common-law corollary."

Delegation of power. As another, independent basis for vacating the SEC's decision, the court held that Congress unconstitutionally delegated legislative power to the SEC by allowing it to choose to bring cases in Article III courts or in-house. Article I vests all legislative powers in Congress, and the Supreme Court has interpreted this to mean that Congress may grant regulatory power to another entity only if it provides an "intelligible principle" to guide the exercise of that power. The court thus had to answer whether Congress delegated a legislative power to the SEC and, if so, whether it provided an intelligible principle so that the SEC exercises only executive power.

The court first concluded that Congress did delegate a power that would be legislative absent an intelligible guiding principle. Determining which subjects of enforcement action get a jury trial and which do not amounts to a delegation of legislative power. The court rejected the SEC's counterargument that this is just prosecutorial discretion: Congress "effectively gave the SEC the power to decide which defendants should receive *certain legal processes* … a power that Congress uniquely possesses."

Over 80 years ago, when the Supreme Court last considered an open-ended delegation of legislative power with no Congressional guidance at all, it concluded that the delegation was unconstitutional (*Panama Refining Co. v. Ryan* (U.S. 1935)). Here, even the SEC agreed that Congress left it with absolute discretion. "If the intelligible principle standard means anything, it must mean that a total absence of guidance is impermissible under the Constitution," the appeals court concluded.

Two-layer removal protection. Finally, the court found a third constitutional defect in the statutory removal restrictions for SEC administrative law judges. Because the court vacated the SEC's judgment on other grounds, it did not decide whether the removal defect would be enough by itself.

Under Article II, the President must "take Care that the Laws be faithfully executed." Because SEC ALJs perform substantial executive functions, the President must retain adequate power over their appointment and removal. SEC ALJs can only be removed by the SEC Commissioners if the Merits System Protection Board finds good cause, and SEC Commissioners and MSPB members can only be removed by the President for cause. The court agreed with the petitioners that this is like the two-layer for-cause protection for PCAOB members that the Supreme Court held unconstitutional in *Free Enterprise Fund v. PCAOB* (U.S. 2010).

Dissent. Judge Davis dissented from each of the majority's three conclusions on constitutionality. The dissent reads *Atlas Roofing v. OSHA* (U.S. 1977) as laying down a still-viable definition of cases implicating "public rights": when the government sues in its sovereign capacity to enforce public rights created by statutes within Congress's power to enact. Other circuits routinely hold that an enforcement action by the Government for violation of a federal statute or regulation is a public right that can be assigned to an agency for in-house adjudication. Here, the SEC's action enforced securities laws with a broad purpose of protecting investors, satisfying the *Atlas Roofing* definition. Judge Davis disagreed with the majority that *Granfinanciera, S.A. v. Nordberg* (U.S. 1989), a bankruptcy case to which the Federal Government was not a party, abrogated *Atlas Roofing*.

Judge Davis also disagreed that Congress improperly delegated legislative authority to the SEC. In his view, Section 929P(a) of Dodd-Frank established that SEC enforcement actions can be brought in Article III courts or in administrative proceedings, fulfilling Congress's duty of control. The Supreme Court has validated Congress's allowing government prosecutors to choose between two criminal statutes that provide different penalties for the same conduct (*U.S. v. Batchelder* (U.S. 1979)). As the Supreme Court has analogized agency enforcement decisions to prosecutorial discretion exercised in criminal cases, it follows that the SEC's forum-selection authority is within its prosecutorial authority.

Finally, the dissent wrote that rather than support the majority's conclusion, *Free Enterprise Fund* and *Lucia v. SEC* (U.S. 2018) explain that the SEC ALJs' tenure protections are constitutional because ALJs perform an adjudicative function. The Court in *Free Enterprise* expressly declined to address ALJs, noting two potentially distinguishable characteristics: (1) it was (at the time) disputed whether ALJs are "Officers of the United States," and (2) unlike PCAOB members, many ALJs performed adjudicative functions or possess purely recommendatory powers. Even when the Court answered the first question in *Lucia*, it expressly declined to decide whether the multiple layers of insulation from removal violated Article II. Judge Davis agreed with dicta in *Free Enterprise* suggesting that an ALJ's adjudicative role may justify multiple layers of protection. For purposes of the Article II removal precedents, the ALJs' role is not central to the functioning of the Executive Branch, and invalidating the removal restrictions could undermine the adjudicatory role and ALJs' ability to exercise independent judgment.

The case is No. 20-61007.

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