[Securities Regulation Daily Wrap Up, ENFORCEMENT—5th Cir.: SEC requests rehearing en banc of decision that struck down SEC decision, (Jul. 12, 2022)]

Securities Regulation Daily Wrap Up

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By Sara Cracau, J.D.

SEC requests rehearing *en banc* of decision that struck down the SEC decision finding that a principal and his advisory firm in violation of securities laws and imposed on him civil monetary penalties.

The SEC has petitioned the Fifth Circuit for a rehearing *en banc* of a decision that had vacated and remanded a Commission decision, finding it to be unconstitutional. The petition challenged the court's decision which found that: (1) the proceeding brought against the principal and his advisory firm violated the principal's right to a jury trial; (2) that the SEC's choice to initiate an administrative proceeding rather than a judicial action was an exercise of legislative authority in violation of the non-delegation doctrine; and (3) that the removal restrictions for the ALJ violated the separation of powers (*Jarkesy v. SEC*, July 1, 2022, *per curiam).*

The SEC had initiated an administrative action against a principal and his advisory firm that had launched two hedge funds that attracted about 120 investors and held about $24 million in assets under management. As a result of the adjudication, the SEC found that the principal had violated the securities laws by making many misrepresentations about how the funds were managed, audited, and valued and ordered him to cease and desist from committing future violations. In addition, it ordered him to pay a civil monetary penalty of $300,000, to disgorge $684,935.38 in ill-gotten gains, and to comply with the SEC's other equitable relief. On judicial review, the principal did not contest the SEC's factual findings. The court vacated and remanded the SEC's decision, finding it to be unconstitutional. Judge Davis dissented, disagreeing with all three of the majority's holdings.

Right to a jury trial. In its petition, the SEC points out that the majority recognized that the Seventh Amendment right to a jury trial applies to claims at common law but does not apply to "public rights" that Congress may create. However, it concluded that violations of securities laws arise at "common law" under the Seventh Amendment because fraud prosecutions were regularly brought at common law in the English courts. It did not find violations of securities laws to constitute "public rights." The dissenting judge explained that securities laws are public rights because they are designed both to protect investors and to guarantee fair markets and disagreed with the majority that it was sufficient that violations of the securities laws might "reflect" common law fraud claims. The SEC argued that the majority's holding conflicted with Supreme Court and Fifth Circuit precedent, noting that the Supreme Court has explained that penalty schemes are constitutional because Congress is permitted to provide an administrative enforcement scheme without jury intervention.

Furthermore, it argued that precedent recognizes that Congress may formulate causes of action that are closely analogous to common-law claims and provide for their adjudication in a non-jury forum. Although the common law requires proof that a misrepresentation was relied on by a party and resulted in harm, the SEC is not required to prove that an investor actually relied on a party's misrepresentation and was injured as a result. The federal securities laws are a "prophylaxis" prohibit not just common law fraud but also conduct that tempts fraud.

Violation of non-delegation doctrine. The SEC's petition points out that the majority concluded that the SEC's choice to bring an enforcement action in the form of an administrative proceeding rather than a district court suit violated the non-delegation doctrine because Congress did not provide an intelligible principle for choosing between these enforcement options. However, it determined that the institution of an administrative proceeding was an exercise of legislative power because it had the "purpose and effect of altering the legal rights, duties, and relations of persons." The dissenting judge opined that the SEC's enforcement action was an exercise of executive rather than legislative authority, pointing out that the majority's interpretation would lead to the conclusion that any SEC decision that affected a person's legal rights would be considered legislative action. The SEC contended that the majority's holding also conflicts with Supreme Court precedent by applying the non-delegation doctrine to executive action. Although precedent found that action by Congress is legislative, it did not suggest that enforcement of laws by the executive branch raised concerns as being "legislative" in nature.

Violation of separation of powers. Thirdly, the SEC points out in its petition that the majority held that the federal statutory restrictions for removing ALJs for "good cause established and determined by the Merit Systems Protection Board" violated the separation of powers doctrine. The majority agreed with the principal of the advisory firm that ALJs were insulated from the president by at least two layers of for-cause protection from removal which was unconstitutional. Instead of proposing a remedy for this constitutional infirmity, the majority vacated the SEC's decision.

The dissenting judge opined that the ALJ removal restrictions were constitutional because ALJs perform an adjudicative function and pointed out that the majority failed to explain how the ALJs' tenure protections interfere with the president's ability to execute laws. The SEC argued that any concerns regarding the MSPB's involvement in the process of ALJ removal should be addressed by construing the MSPB's role in determining "good cause" rather than second guessing the agency's determination that removal was necessary. It also pointed out that in cases involving separation-of-powers violations, the usual practice is to sever the violative portion of the statute but that was not done in this instance.

The court requested the principal to respond to the SEC's petition requesting a rehearing.

The case is No.: 20-61007.

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