

Fifth Circuit Holds That SEC's Use of In-House Courts to Adjudicate Enforcement Actions Is Unconstitutional

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Historically, if the Securities and Exchange Commission (SEC) wanted to obtain monetary relief against a defendant for violations of the federal securities laws, it needed to sue that defendant in federal court. However, when Congress passed the Sarbanes-Oxley Act in 2002, it gave the SEC the option of seeking such relief from its own administrative law judges, instead. The SEC's resulting ability to pick its forum has been heavily criticized on a variety of grounds in the ensuing 20 years.^[1] On May 18, 2022, the Fifth Circuit issued an opinion in *Jarkesy, et al. v. Securities and Exchange Commission*, No. 20-61007, 2022 WL 1563613 (5th Cir. May 18, 2022) that, if upheld, would not only eliminate this option entirely but would also require a redesign of the oversight and removal process for administrative law judges at not just the SEC but other independent agencies, as well.

The *Jarkesy* opinion arose from the SEC's investigation of the investment activities of hedge fund managers George R. Jarkesy, Jr. and Patriot28. The SEC accused Jarkesy and Patriot28 of inflating the valuations of their funds, but, rather than suing them in federal district court, filed an administrative action against them seeking civil monetary penalties and other relief. After an evidentiary hearing, an SEC administrative law judge ruled against Jarkesy and Patriot28 and found that they had committed securities fraud. The Commission affirmed the ALJ's decision and ordered (1) the parties to pay a \$300,000 civil penalty, (2) Patriot28 to pay nearly \$685,000 in disgorgement plus interest, and (3) Jarkesy be barred from various activities in the securities industry.

Jarkesy and Patriot28 then petitioned for review from the Fifth Circuit. In a 2-1 decision, that Court vacated the SEC's judgment on multiple constitutional grounds. Specifically, the Court held that (1) the SEC's in-house adjudication of Petitioners' case violated Petitioners' Seventh Amendment right to a jury trial; (2) Congress unconstitutionally delegated legislative power to the SEC by failing to provide an intelligible principle by which the SEC would exercise the delegated power; and (3) statutory removal restrictions on SEC administrative law judges (ALJs) violate the Take Care Clause of Article II of the Constitution.

TAKEAWAYS

- **The Fifth Circuit's opinion is unlikely to be the last word.** In light of the significance of the Fifth Circuit's opinion, it is highly likely that the SEC will seek further review, either en banc from the full Fifth Circuit or by the Supreme Court. Assuming an en banc panel of the Fifth Circuit does not reverse the panel's decision, the Supreme Court is likely to take the case, in light of its significance and its constitutional underpinnings. On the other hand, if the

Supreme Court does not grant cert., other defendants are certain to cite the Fifth Circuit’s opinion in raising similar challenges to SEC administrative actions in other Circuits. All of this will take some time to play out and, in the meantime, the legitimacy of SEC in-house adjudications will remain unsettled.

- **The Fifth Circuit’s ruling does not entirely prohibit the SEC from bringing enforcement actions before ALJs.** Although the Court held that defendants have a Seventh Amendment right to a jury trial in actions that seek to impose civil penalties, it was careful to distinguish cases where the SEC seeks only equitable remedies, such as a bar from participation in the securities industry or disgorgement of ill-gotten gains, where no such jury trial right would attach.²² Therefore, this procedural tool remains available to the SEC, although the panel’s third holding – that the removal provisions are unconstitutional – casts a separate cloud over the ability of such ALJs to serve in any capacity unless that holding is reversed or Congress passes legislation to establish a different removal system.
- **The requirement that penalty actions be litigated in federal court will eliminate whatever “home court advantage” the SEC may have had, but is unlikely to affect the number of enforcement actions that the agency brings.** The Fifth Circuit’s holding changes the forum in which the SEC can bring enforcement actions but does not bar any of those enforcement actions or change the substantive legal standards applicable to them. In that regard, as the Fifth Circuit itself noted, there is nothing about securities fraud enforcement actions that makes them uniquely suited for agency adjudication and, indeed, the very fact that the SEC always had the option of proceeding in federal court in such cases illustrates the point that the removal of the ALJ option will not preclude the SEC from bringing charges when it wants to do so.
- **The Fifth Circuit’s reasoning that the removal restrictions on the SEC’s ALJ’s violate the Take Care Clause would apply to ALJ’s of other independent agencies, as well.** The reasoning underlying the panel’s opinion that the statutory removal provisions for SEC ALJs is unconstitutional is not unique to that agency. Accordingly, defendants in administrative actions before other ALJs of other independent agencies with similar removal provisions are certain to raise identical challenges in those cases, too. As a result, the Fifth Circuit’s decision has created uncertainty about the legitimacy of actions before ALJs in independent agencies generally.

²² See, e.g., Todd Phillips, et al., *Debates Over Agency Judges Should Focus on Functions, Not Job Titles*, Brookings (Nov. 17, 2020); see also, e.g., Ilya Shapiro, et al., *Administrative Law Judges Are Unconstitutional*, CATO Institute (May 2, 2016) <https://www.cato.org/blog/administrative-law-judges-are-unconstitutional>; Thomas Hanusik, *What’s Missing from The SEC’s Forum Selection Guidance*, LAW360 (May 21, 2015) <https://www.law360.com/banking/articles/658532>.

²³ See *Jarkesy*, No. 20-61007, 2022 WL 1563613 at *5.

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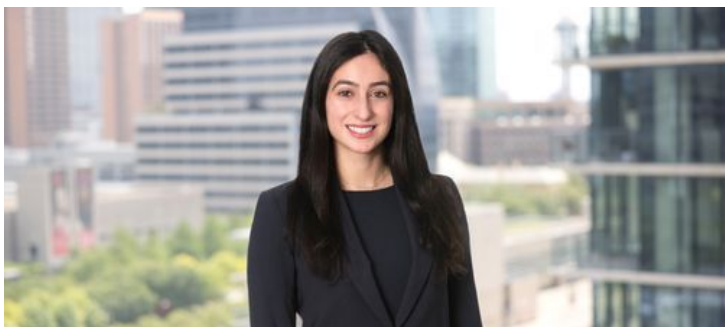
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