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Fifth Circuit Declares SEC's Quasi-Judicial Process Unconstitutional

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On May 18, 2022, the Fifth Circuit issued its opinion in *Jarkesy v. SEC*, holding that:

> **(1) the Securities and Exchange Commission's (SEC's) in-house adjudication of Petitioners' case violated their Seventh Amendment right to a jury trial;**
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> **(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, in violation of Article I's vesting of "all" legislative power in Congress; and**
>
> **(3) statutory removal restrictions on SEC ALJs violate the Take Care Clause of Article II.**

If this holding stands, it could have far-reaching ramifications. The SEC is just one of many agencies within the Executive Branch that utilizes Administrative Law Judges (ALJs) to streamline the adjudication of their enforcement actions. While administrative adjudication is cost-effective for the government, proponents of small government and the defense bar alike have criticized the practice, as it places the roles of prosecutor, judge, and jury in the hands of the same agency. For the SEC, this has proven to be particularly effective, given that (according to the *Wall Street Journal*) it has prevailed in 90 percent of the cases brought in its own administrative courts. We examine the Fifth Circuit panel's ruling and some potential ramifications.

While the Biden Administration may decide to appeal the Fifth Circuit panel's ruling to the *en banc* court and/or to the Supreme Court, doing so would be risky since recent jurisprudence from the Supreme Court tends to lean anti-agency. For instance, in 2017, in *Lucia v. SEC*, the Supreme Court ruled that the SEC's procedures to appoint ALJs were unlawful. In addition, certiorari was accepted in *SEC v. Cochran*, 21-1239, 2022 WL 1528373 (U.S. May 16, 2022), which challenges the validity of the SEC's *Lucia* "fix" to its revised ALJ appointment procedures (i.e., while the SEC had fixed the appointment problem that *Lucia* addressed, it did not fix a problem with the removability of ALJs).

The Fifth Circuit's Ruling

First, in holding that Petitioners' Seventh Amendment right to a jury trial was violated by the SEC's in-house adjudication process, the majority opinion emphasized that trial by jury "remains one of our most vital barriers to governmental arbitrariness." Relying heavily on *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989), the panel established that "traditional legal claims" cannot by assigned to an administrative tribunal by an act of Congress. Such "traditional legal claims" include:

(a) actions seeking civil money penalties, which are "akin to special types of actions in debt" historically brought as "distinctly legal claims"; and

(b) securities fraud enforcement actions, which are "not uniquely suited for agency adjudication."

In vacating the judgment, the panel held that Petitioners had a Seventh Amendment right to a jury in the case against them, which sought penalties for securities fraud, and therefore it should be brought in open court, not internally before an ALJ.

Second, the panel issued an "alternative holding" for vacating the ALJ's judgment—that Congress's delegation of "unfettered authority to choose whether to bring enforcement actions in Article III courts or within the agency" was an unconstitutional delegation of legislative power. Specifically, Congress's delegation was "absent a guiding, intelligible principle" and exceeded mere prosecutorial discretion, citing the plurality opinion in *Gundy v. United States*, 139 S. Ct. 2116 (2019).

Third, the Fifth Circuit held that the statutory removal restrictions for the SEC ALJs are unconstitutional because they are insulated by the President "by at least two layers of for-cause protection from removal." The panel relied on *Free Enterprise Fund v. Public Co. Accounting Oversight Bd.*, 561 U.S. 477 (2010) in reaching its conclusion but stopped short of vacating the SEC's judgment on this issue alone.

Potential Ramifications

Many pundits and legal reporters have characterized the *Jarkesy* decision, if it stands, as a near-fatal blow to the SEC and its ALJ structure. Yet, it seems that the SEC has already scaled back the use of its quasi-judicial administrative law process in certain circumstances, including matters in which penalties are sought, in response to *Lucia*. Further, it would not be difficult for Congress to revise its delegation of power to the SEC to include "an intelligible principle" as outlined in the panel's second holding. Nonetheless, any change to its administrative system, whether voluntary or forced, could have far-reaching effects on the SEC's enforcement decisions, given that those subject to enforcement actions almost always choose to settle with the SEC rather than defend themselves in the administrative realm.

The government may also be concerned that the Fifth Circuit's decision could impact actions pending before numerous *other* federal agencies. Congress has delegated to many federal agencies the authority to address violations through an internal administrative law process, including the imposition of civil money penalties or other adjudication of "traditional legal claims," as characterized by the panel is *Jarkesy*. For example, the Commodity Futures Trading Commission enforcement division similarly investigates potential fraud violations and may choose to bring an administrative action internally or in federal court. Other agencies that can adjudicate "traditional legal claims" through internal administrative law processes include the Environmental Protection Agency, the Federal Trade Commission, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. As *Jarkesy* provides persuasive authority to challenge threatened civil money penalty actions before ALJs, it is important to carefully review the opinion and its potential applicability to an agency's claimed authority to bypass having the action heard in federal district court.

Takeaway

Because such agency actions can involve both legal and equitable relief, *Jarkesy*—if upheld—may require the agencies to file actions in federal district court to not run afoul of a party's Seventh Amendment right to have their defenses to "traditional legal claims" heard before a jury. This could impact the Department of Justice, which handles cases for the government in federal district court, and could seriously inhibit affected agencies' ability to pursue civil money penalties.

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