

Fifth Circuit holds the SEC's administrative adjudications to be unconstitutional

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On May 18, the U.S. Court of Appeals for the Fifth Circuit ruled that the SEC's administrative proceedings are unconstitutional on three independent grounds. The decision could potentially have a significant impact on the constitutionality of administrative adjudications by other federal agencies as well.

Background

In 2013, the Securities and Exchange Commission (SEC) brought an enforcement action in its internal tribunal against George Jarkesy, Jr. and Patriot28, an investment adviser, alleging various violations of the federal securities laws. Jarkesy managed two hedge funds that attracted over 100 investors and held about \$24 million in assets. The U.S. Court of Appeals for the D.C. Circuit rejected the defendants' efforts to enjoin the SEC's proceedings, citing lack of jurisdiction. An administrative law judge (ALJ) concluded that the defendants had committed securities fraud, and the Commission affirmed the decision. The defendants then filed a petition for review in the Fifth Circuit.

Fifth Circuit holding

On May 18, 2022, the Fifth Circuit ruled in *Jarkesy v. SEC* that SEC administrative proceedings are unconstitutional on three independent bases.

- Judge Elrod, writing for the court in a 2–1 decision, first held that the SEC's proceedings violate the Seventh Amendment right to a civil jury. The court reasoned that actions for monetary penalties under the federal securities laws are sufficiently similar to common law fraud actions and sufficiently involve private rights—as opposed to public rights—that the targets of such actions are entitled to have a jury trial.
- Second, the Fifth Circuit ruled that Congress unconstitutionally delegated legislative power to the SEC by failing to provide the SEC with an “intelligible principle” to guide its decisions whether to file cases as federal court actions or internal administrative proceedings. The court reasoned that the “mode of determining” which cases are assigned to administrative tribunals is within the control of Congress, not the executive branch, and the relevant statutes underpinning the SEC's authority do not provide any guidance on how to make that determination.
- Finally, the court held that statutory removal restrictions for SEC ALJs are also unconstitutional. The opinion extended the reasoning of two U.S. Supreme Court cases: *Lucia v. SEC*, which held that SEC ALJs are inferior executive officers, and *Free Enterprise Fund v. PCAOB*, which held that two layers of for-cause protection from the President's power to remove inferior executive officers were unconstitutional. The *Jarkesy* majority similarly held that ALJs cannot be doubly insulated from the President's removal power, even if the ALJs are functionally exercising adjudicatory rather than executive power. As a result, the Fifth Circuit vacated the SEC ALJ's decision that George Jarkesy Jr. and investment adviser Patriot 28 LLC committed securities fraud.

Prior challenges to SEC administrative adjudications

Jarkesy follows a line of notable decisions that have upheld challenges to the SEC's administrative adjudications. Most notably, in 2018 the Supreme Court held in *Lucia v. SEC* that SEC ALJs are inferior executive officers and are therefore subject to the Appointments Clause of the U.S. Constitution, entitling Lucia and other similarly situated respondents to a new hearing before new, constitutionally-appointed ALJs. Anticipating the Supreme Court's decision, the SEC had also issued an order to ratify the prior appointment of its ALJs. Nonetheless, the Supreme Court left open the question of whether ALJs could survive a constitutional challenge to their *removal* protections, a question that the Fifth Circuit answered last week in the negative.

Years before *Lucia*, Judge Rakoff reached a similar conclusion in a 2011 Southern District of New York case, *Gupta v. SEC*. Gupta, a respondent to an SEC administrative proceeding that sought civil penalties, argued that the SEC's failure to file in federal court violated his Seventh Amendment right to a jury trial. Judge Rakoff denied the SEC's motion to dismiss Gupta's challenge to the administrative proceeding, calling the SEC's decision to initiate an administrative proceeding a "seeming exercise in forum-shopping." Following that decision, the parties stipulated to relitigating the underlying insider trading action in federal court.

In the wake of *Lucia* and as challenges have been pending regarding the process for removing ALJs, the SEC has opted to bring most contested cases in federal court instead of in administrative proceedings. Thus, the practical impact of *Jarkesy* on the SEC is likely limited, though it is possible that the SEC will seek a rehearing en banc from the Fifth Circuit's decision.

Pending Supreme Court case

The Supreme Court is poised to decide a related issue in *SEC v. Cochran*. Having granted the petition for certiorari on May 16, the Court will address whether respondents may bypass the statutory review scheme for challenging a final decision in an SEC adjudication by suing in district court to enjoin an ongoing ALJ proceeding.

The underlying constitutional challenge that the *Cochran* respondents are attempting to assert in district court is the same as that in *Jarkesy*—that the SEC ALJ removal statutes are unconstitutional. But while *Cochran* is an issue of district court jurisdiction to hear that challenge, *Jarkesy* ruled on the challenge itself. An SEC ALJ had already rendered a final order in *Jarkesy*, and the jurisdiction of the Fifth Circuit to review that final order was not in dispute.

If the Supreme Court rules against the SEC in *Cochran*, it will make it easier for SEC respondents to bring claims for head-on constitutional challenges against the agency, like in *Jarkesy*. The Fifth Circuit's decision serves as a preview of the constitutional disputes to come.

The Supreme Court granted a similar petition for certiorari in *Axon Enterprise v. Federal Trade Commission* in January 2022. *Axon* will address whether respondents of FTC proceedings can similarly challenge FTC ALJ removal statutes in district court notwithstanding an ongoing administrative proceeding. Last week, the Office of the Solicitor General filed a letter asking the Supreme Court to coordinate briefing schedules between *Cochran* and *Axon* because "the two cases substantially overlap" despite "differences in the relevant statutory texts."

Oral arguments have not yet been scheduled for *SEC v. Cochran* and *Axon Enterprise v. FTC*, but we can expect arguments and decisions in both cases in the upcoming October 2022 term.

Key takeaways

The impact and final status of the Fifth Circuit's decision remain uncertain. Practically speaking, the immediate impact on the SEC is likely limited. First, it is unclear whether other circuits will follow the Fifth Circuit's decision. Second, the SEC has filed most contested cases in recent years in federal district court. Finally, the ruling is limited to the SEC's power to conduct administrative adjudications and does not impact SEC rulemaking.

While challenges to ALJ appointments and removal have been working through the courts for several years, the Fifth Circuit's holdings that the proceedings violate the Seventh Amendment right to a civil jury and nondelegation are more novel. These holdings could have broader implications, including on other agencies' administrative adjudications.

Another consideration is whether *Jarkesy* will spur challenges to state agencies' administrative procedure. Although the Seventh Amendment provides a right to a jury trial only in federal courts, parties challenging state administrative adjudications could use *Jarkesy* as a litigation roadmap, as nearly every state constitution provides a right to civil jury trials and has nondelegation limitations.

The Fifth Circuit's decision in *Jarkesy v. SEC* is available [here](#), and the petition for a writ of certiorari in *SEC v. Cochran* is available [here](#).

A prior Davis Polk client update discussing the *Lucia* case is available [here](#).

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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