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SEC Enforcement Matters

A Jury of Your Peers: Fifth Circuit Ruling in *Jarkesy v.* SEC Broadly Expands the Right to a Jury Trial for SEC Actions

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In May 2022, the U.S. Court of Appeals for the Fifth Circuit (Court or Fifth Circuit) decided *Jarkesy v.* SEC. The Court's decision has deep ramifications for the SEC that build off of other recent decisions reasserting constitutional limitations on the SEC's authority. Specifically, the Fifth Circuit declared that SEC enforcement proceedings before an administrative law judge (ALJ) violate the Seventh Amendment's jury-trial guarantee, that Congress unconstitutionally delegated legislative authority to the SEC when it authorized the SEC to pursue administrative enforcement proceedings and that statutory restrictions on the removal of SEC ALJs violated the Constitution.

The ruling in *Jarkesy* is significant – it could reshape the SEC's enforcement priorities and opens the door to a number of additional strategic considerations for defendants targeted by the SEC. This article summarizes the case, identifies the key takeaways for fund managers and forecasts the decision's impact on future SEC enforcement efforts against fund managers.

For more on *Jarkesy*, see "Fifth Circuit Decision Could Hamstring SEC Enforcement Abilities" (Jun. 9, 2022). See also our two-part series "Present and Former SEC Officials Discuss Enforcement": Part One (Jun. 2, 2022); and Part Two (Jun. 9, 2022).

Jarkesy's Challenges to SEC Administrative Proceedings' Constitutionality

Proceedings Before the SEC

Under the Dodd-Frank Act, the SEC has discretion to initiate enforcement proceedings in one of two venues. The SEC can institute administrative enforcement proceedings before the Commission, or the SEC can file a civil lawsuit in federal court.

Administrative proceedings are heard by an ALJ – an SEC employee who presides over the proceeding. In an administrative proceeding, the ALJ holds a hearing in which both sides present witnesses and evidence. The ALJ then prepares an initial decision with findings of law and fact that can be appealed to the Commission. Judicial review is available by filing a petition for review in the appropriate court of appeals.

By contrast, an Article III federal district judge presides over a civil lawsuit, whose judgment is directly appealable to the courts of appeals. In a civil action, the SEC files a complaint against the defendant, and the case proceeds like any other civil lawsuit in federal court. SEC administrative proceedings can move very quickly, while the trial court process can take much longer.

Allegations Against Jarkesy

In 2013, the SEC initiated enforcement proceedings against George Jarkesy, Jr., alleging violations of the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. The SEC opted to bring those proceedings in the administrative forum before an ALJ. Following an evidentiary hearing, the ALJ concluded that Jarkesy had violated the securities laws, ordering a civil penalty of $300,000 and disgorgement of $685,000.

Jarkesy's Appeal

Jarkesy appealed to the Commission, challenging the constitutionality of the administrative enforcement proceedings. He argued that the proceedings violated his Seventh Amendment right to a jury trial because an ALJ decided his case instead of a jury. Jarkesy also argued that Congress unconstitutionally delegated legislative authority to the SEC by endowing it with unfettered discretion to choose whether to initiate enforcement proceedings in an administrative forum or in federal court. Finally, Jarkesy maintained that for-cause removal requirements for ALJs ran afoul of the Constitution.

The Commission rejected Jarkesy's constitutional arguments on the merits and affirmed the ALJ's ruling.

The Fifth Circuit's Ruling

After the Commission affirmed the ALJ's decision, Jarkesy filed a petition for review in the Fifth Circuit. In a path-marking decision, a divided panel of the Fifth Circuit held that the SEC's administrative enforcement proceedings violated Jarkesy's right to a jury trial. It also concluded that Congress had unconstitutionally delegated legislative authority to the SEC and that the process for removing SEC ALJs violated the Constitution.

See "SEC Use of Administrative Proceedings and Whistleblower Incentives, and Provides Guidance for Fund Managers Facing an Examination (Part Two of Two)" (Jan. 19, 2017).

Right to a Jury Trial

The Seventh Amendment guarantees a right to a jury trial in "suits at common law" in which the amount in controversy exceeds $20. In *Tull v. United States*, the U.S. Supreme Court held that the Seventh Amendment's jury trial guarantee applies to all cases in which a claimant would have had a right to a jury trial at the time the Seventh Amendment was ratified. Generally speaking, the jury-trial right extends to suits asserting common-law causes of action. It also extends to suits asserting statutory rights, provided the statute affords remedies similar to those at common law (*e.g.*, monetary damages).

The right to a jury trial, however, does not extend to cases involving "public rights" – *i.e.*, cases in which the government sues under its sovereign power to enforce statutes designed to protect public interests. Cases involving public rights need not be tried by a jury and may proceed before an administrative agency (*e.g.*, the SEC) or some other non-jury adjudicator.

The Fifth Circuit concluded that Jarkesy was entitled to a jury trial and that the SEC's administrative proceedings violated the Seventh Amendment. Significantly, the Court considered both the substantive cause of action (*i.e.*, securities fraud) and the remedies sought by the SEC (*i.e.*, a civil penalty, among others).

The substantive cause of action entitled Jarkesy to a jury trial, the Court reasoned, because securities fraud was not so different from fraud – a common-law cause of action that would have been tried before a jury at the time of the Seventh Amendment.

The remedy sought by the SEC also entitled Jarkesy to a jury trial. Civil penalties, the Fifth Circuit explained, were not so different from monetary damages, claims for which have historically been tried before a jury. The Court acknowledged the SEC had pursued not only civil penalties but also disgorgement and an injunction – equitable remedies that are not traditionally tried before a jury. The existence of those equitable remedies, however, did not matter because the SEC sought at least one legal remedy (*i.e.*, civil penalties).

The Fifth Circuit majority also rejected the SEC's argument that the case involved public rights. When deciding whether a case involves public rights, courts consider:

- whether Congress created a new cause of action and new remedies to address a "manifest public problem" that traditional remedies could not adequately address; and
- whether the use of jury trials would dismantle that statutory scheme or impede swift resolution of the claims.

Those considerations, the Fifth Circuit concluded, weighed against application of the public-rights doctrine. The fraud claims the SEC brought against Jarkesy were similar to private fraud claims brought at common law in that they lacked unique or complicated regulatory issues best suited for agency enforcement.

Notably, in a dissenting opinion, Judge W. Eugene Davis concluded that an enforcement action by the government (*e.g.*, an SEC enforcement action) is a vindication of a public right that Congress can appropriately assign to an administrative agency for adjudication.

The Non-Delegation Doctrine

The failure to provide a jury trial was not the only constitutional defect in the proceedings against Jarkesy. The Fifth Circuit also concluded that Congress unconstitutionally delegated legislative authority to the SEC when it endowed the Commission with unrestrained discretion to decide whether enforcement proceedings should occur in an administrative forum or in a civil lawsuit in federal court.

The Constitution assigns legislative authority to Congress as the representatives of the people. No other branch of government can constitutionally exercise legislative authority, nor can Congress delegate or assign that responsibility to the judicial or executive branches. Thus, when Congress intends for a court or executive agency to exercise authority with the purpose and effect of altering legal rights and duties, Congress must provide some "intelligible principle" to guide the exercise of that authority. The absence of that guidance would allow the court or executive-branch agency to impermissibly exercise legislative power.

The Fifth Circuit concluded that Congress improperly delegated legislative power to the SEC. The authority to decide which defendants receive the legal processes associated with proceedings in federal court, and which defendants do not, is a power unique to Congress. The Fifth Circuit majority rejected the SEC's argument that such a decision was akin to prosecutorial discretion — a power falling within the executive realm.

Moreover, the Court found that Congress failed to provide any guiding intelligible principle about which cases should be brought in federal court and which should be adjudicated before the Commission. Indeed, Congress provided no guidance at all, vesting the SEC with unrestrained authority to make that decision.

Again, Judge Davis disagreed. He analogized the SEC's authority to choose the appropriate forum to prosecutorial discretion – precisely the sort of authority that members of the executive branch may exercise.

Removal

A third and final constitutional defect infected the SEC proceedings against Jarkesy. The Appointments Clause vests the President with the authority to appoint Officers of the U.S. Ancillary to that authority, the Supreme Court has held, is the authority to remove Officers. Without that authority, the President cannot control executive branch officers and cannot fulfill his constitutional responsibility to ensure laws are faithfully executed.

Although the President holds the removal authority, Congress can place restraints on the exercise of that authority. For example, Congress can mandate that certain Officers be removed only for cause. Congressional authority to impose limits on the President's ability to remove federal Officers, however, is itself limited by the Constitution. If the President's removal authority is too severely restrained, federal Officers will no longer be accountable to the President and, by extension, to the people who elect the President.

For that reason, in *Free Enterprise Fund v. Public Company Accounting Oversight Board*, the Supreme Court determined that Congress violated the Appointments Clause by shielding federal officers behind two layers of for-cause removal. *Free Enterprise Fund* involved Commissioners of the Public Company Accounting Oversight Board (PCAOB) who were removable by the SEC for cause. SEC Commissioners, in turn, were removable by the President for cause. In *Free Enterprise Fund*, the Supreme Court concluded that members of the PCAOB were too insulated from removal by the President and therefore insufficiently responsive to elected representatives.

In *Jarkesy*, the Fifth Circuit found that the procedures governing removal of SEC ALJs ran afoul of *Free Enterprise Fund*. As the Supreme Court held in *Lucia v. SEC*, SEC ALJs are Officers. And, as in *Free Enterprise Fund*, ALJs were protected by two layers of for-cause removal:

- SEC ALJs are removable by the SEC only for cause; and
- Commissioners of the SEC are removable only by the President for cause.

Therefore, the President was unconstitutionally restricted from removing them, violating the President's ability to faithfully execute the laws.

See "Despite Headwinds, Enforcement Remains Strong, Notes Co-Director of SEC Enforcement Division" (Sep. 27, 2018).

As with the other rulings in *Jarkesy*, Judge Davis disagreed. He concluded that *Free Enterprise Fund* did not apply because SEC ALJs only perform adjudicative functions, with only recommendatory powers. *Free Enterprise Fund* expressly stated that its holding did not apply to government employees with adjudicative functions.

Significance and Implications of *Jarkesy*

Poised for a Broad Impact

On its face, the Fifth Circuit's ruling in *Jarkesy* is sweeping and significant. The decision was the first to conclude that SEC administrative proceedings violate the Seventh Amendment. That ruling has wide-ranging implications, as it will entitle targets of SEC enforcement actions to a jury trial – and, therefore, to federal court proceedings – in a wide range of cases that, previously, could have been litigated before an ALJ in administrative proceedings.

Conflict With *Kokesh*

The implications of *Jarkesy*'s Seventh Amendment ruling could extend even further when considered alongside the Supreme Court's ruling in *Kokesh v. SEC*. In *Kokesh*, the Supreme Court concluded that disgorgement – a traditionally equitable remedy for which no jury trial was afforded – qualified as a civil penalty for purposes of computing the then-applicable statute-of-limitations period. *Jarkesy*, in turn, concluded that civil penalties were a type of remedy that traditionally could only be enforced in courts of law and required a jury trial. Thus, *Kokesh* provides some support for the argument that even some actions for disgorgement might require a jury trial. At the same time, *Kokesh* interpreted the meaning of the terms "disgorgement" and "civil penalty" in the context of a specific statute. *Kokesh* did not, however, consider how courts viewed those terms at the time the Seventh Amendment was adopted.

See "The SEC's New Disgorgement Powers: Questions and Consequences" (Apr. 8, 2021).

In fact, some of the analysis in *Kokesh* could suggest that *Jarkesy*'s reasoning is vulnerable if other courts of appeals take up the question or if the issue reaches the Supreme Court. For example, in concluding that disgorgement qualified as a civil penalty under the then-applicable statute of limitations, *Kokesh* explained that securities laws are "public laws" and that violations of the securities laws are "committed against the United States rather than an aggrieved individual." SEC enforcement actions, *Kokesh* continued, are brought in "the public interest" and "remedy harm to the public at large." That reasoning tends to suggest that, contrary to *Jarkesy*'s conclusions, SEC enforcement proceedings do involve public rights that may be assigned to an agency adjudicator. *Jarkesy* did not address *Kokesh*, however.

Implications of the Non-Delegation Ruling

The Fifth Circuit's non-delegation ruling also has broad implications – not just for the SEC but for other administrative agencies as well. Citing Section 929P(a) of the Dodd-Frank Act, the Fifth Circuit found it an impermissible delegation of legislative authority to grant the SEC the "power to bring securities fraud actions for monetary penalties within the agency instead of in an Article III court." Thus, *Jarkesy* appears to suggest the initiation of any administrative enforcement proceeding would violate the Constitution. That conclusion, moreover, would apply not just to the SEC but to the many other agencies authorized to initiate both administrative proceedings and civil enforcement actions.

A closer reading, however, suggests that *Jarkesy* may not sweep so broadly. For one, the Fifth Circuit did not explicitly describe the remedy for the non-delegation violation. It simply remanded to the SEC for further proceedings consistent with the court's opinion. The Fifth Circuit thus did not say whether the Dodd-Frank Act's authorization to initiate administrative enforcement proceedings was facially invalid in its entirety, whether some portion of the statute could be saved through severance or whether the statute was invalid as applied in this particular case.

See our two-part series on a decade of Dodd-Frank: "Why and How the Regulations Brought Private Funds Into Compliance" (Dec. 3, 2020); and "SEC Enforcement, the Volcker Rule and a Report Card on Its Efficacy in Hindsight" (Dec. 17, 2020).

Jarkesy's analysis, however, tied the non-delegation violation tightly to the jury trial right, objecting to Congress giving the "SEC the ability to determine which subjects of its enforcement actions are entitled to Article III proceedings with a jury trial, and which are not." Thus, even after *Jarkesy*, the

SEC may retain the authority to institute administrative proceedings for those violations to which the jury-trial right does not attach.

Limited Removal Power Impact

Jarkesy's ruling concerning the removal power seems least consequential. Although the Fifth Circuit invalidated statutory removal restrictions on ALJs, that ruling simply affords the Commission greater flexibility and authority to remove ALJs. That conclusion seems unlikely to materially affect SEC ALJ proceedings going forward. Further, the Fifth Circuit in *Jarkesy* declined to decide whether that constitutional deficiency alone required vacatur of the SEC's decision.

Effect on SEC Enforcement Trends

The Fifth Circuit's opinion in *Jarkesy* will almost certainly affect how the SEC approaches enforcement going forward. As the decision only applies in the Fifth Circuit, the SEC might pursue administrative proceedings in other circuits whenever jurisdiction and venue rules allow.

More significantly, *Jarkesy* seems likely to exacerbate the recent trend of increasing the number of SEC enforcement actions brought in federal court. In 2021, for example, the SEC filed 434 new enforcement actions. Of those, more than 50 percent were civil actions in federal district court. In comparison, in 2018, the SEC initiated 611 enforcement actions with just over one-third filed in federal court.

See "Six Takeaways From the SEC's FY 2021 Enforcement Results" (Jan. 27, 2022).

Those statistics demonstrate another likely consequence of *Jarkesy*'s preference for federal court proceedings: a decrease in the number of enforcement actions brought by the SEC. As district court proceedings typically take longer and require more resources than internal agency proceedings, the SEC may initiate fewer enforcement actions. Indeed, as the number of federal court cases increased from 2018 to 2021, the total number of enforcement actions dropped.

In addition, *Jarkesy* could shift the SEC's enforcement priorities, prompting the SEC to forgo weaker claims involving fraud and similar actions that would entitle the defendant to a jury trial and instead focus on other claims – *e.g.*, reporting, registration, disclosure and accounting-control violations – that might not be subject to a jury-trial requirement and that could be initiated before an ALJ. Similarly, the SEC might choose to pursue equitable remedies – *e.g.*, injunctions or disgorgement – with more frequency and forgo claims for civil penalties. Thus, *Jarkesy* could change how the SEC charges cases, especially if other courts of appeals follow *Jarkesy*'s lead and reach similar conclusions.

Considerations for Targets of SEC Scrutiny

For targets of SEC investigations and enforcement proceedings, *Jarkesy* brings one critical question to the fore – does the target or defendant want a jury trial? In many cases, a jury trial could be preferable to adjudication by an ALJ.

Traditionally, defendants benefit from a jury trial if the case involves sympathetic mitigating factors or a story that could appeal to the ordinary citizen. By contrast, a defendant whose case involves inflammatory facts but strong legal defenses may prefer an administrative proceeding on the theory that an ALJ might be more likely to look past the inflammatory subject matter and decide the case by dispassionately applying the law.

Even if a defendant intends to negotiate a resolution to the charges, he or she may be able to leverage an advantage from *Jarkesy*'s holding. For example, that defendant might agree to resolve the SEC's investigation before an ALJ in exchange for less serious charges or remedies that do not trigger a jury-trial obligation.

And, without question, defendants in SEC enforcement proceedings – particularly, those outside the Fifth Circuit – should invoke *Jarkesy* to challenge the constitutionality of their own proceedings. At best, they may prevail and defeat the proceedings entirely. At worst, those defendants will have preserved the argument for appellate review.

Jarkesy Will Likely Not Be the Last Word

Ultimately, the issues decided in *Jarkesy* are complex, and the Fifth Circuit sits on the vanguard in addressing them. In the wake of *Jarkesy*, other courts of appeals are sure to address these issues and a "circuit split" – when two courts of appeals decide the same question differently – seems possible, if not likely. Even the Fifth Circuit may yet reverse itself, as the Fifth Circuit could grant a rehearing in light of Judge Davis' dissent in *Jarkesy*.

Ultimately, Supreme Court review seems likely. The issues strike at the core of the American judicial system and implicate the foundations of the administrative state. In short, the questions seem too important to address on an ad hoc basis through the courts of appeals.

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