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SEC Enforcement Matters

# Agency Power and Adjudication: The Government Seeks Supreme Court Review of *Jarkesy v. SEC*

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In May 2022, the U.S. Court of Appeals for the Fifth Circuit decided *Jarkesy v. SEC*, holding that SEC enforcement proceedings before an administrative law judge (ALJ) were unconstitutional on three separate grounds. *Jarkesy* therefore threatened a key avenue the SEC regularly pursues to enforce the securities laws. As a result, the SEC has petitioned the U.S. Supreme Court (Court) to reverse the Fifth Circuit's decision. If the Court takes the appeal and upholds the Fifth Circuit's decision, it could entirely reshape the SEC's enforcement priorities going forward.

This article summarizes the Fifth Circuit's decision, examines the SEC's pending petition before the Court and forecasts the decision's impact on future SEC enforcement efforts against private fund managers if the Court takes the case.

For additional commentary from MoloLamken attorneys, see "How Fund Managers Can Handle Insider Trading Risks After *U.S. v. Chow*" (Jun. 24, 2021).

## SEC Enforcement at a Glance

Today, the SEC has two routes by which it can enforce the federal securities laws. It can:

1. file a civil lawsuit in federal court; or
2. institute administrative enforcement proceedings before the Commission.

If the SEC chooses the first option, a federal district judge presides over the civil lawsuit. The case then proceeds like any civil case in federal court – the Federal Rules of Civil Procedure and the Federal Rules of Evidence apply; the defendant has a right to a jury trial; and the district court's final judgment is directly appealable to a court of appeals.

Administrative proceedings, on the other hand, are heard by an ALJ, who is an SEC employee. In such proceedings, the assigned ALJ first holds a hearing – governed by the SEC's Rules of Practice – in which both sides present witnesses and evidence. The ALJ then prepares an initial decision with findings of law and fact. That initial decision can be appealed to the full Commission, which renders a final order. Judicial review of the Commission's final order can then be obtained in the appropriate court of appeals.

The SEC has complete discretion in deciding whether to bring a civil lawsuit or commence an administrative proceeding. Currently, the SEC makes ample use of both paths.

## The Fifth Circuit's Decision in *Jarkesy*

### Background

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 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.

### The Fifth Circuit Panel's Ruling

After the full Commission affirmed the ALJ's decision, Jarkesy petitioned for review in the Fifth Circuit. A divided panel of the Fifth Circuit held that the administrative proceedings against Jarkesy were unconstitutional on three separate grounds:

1. those proceedings violated Jarkesy's Seventh Amendment right to a jury trial;
2. Congress unconstitutionally delegated legislative authority to the SEC by giving it unfettered discretion to choose whether to bring enforcement proceedings in federal court or an administrative forum; and
3. the statutory removal requirements for ALJs ran afoul of Article II of the U.S. Constitution.

For more on *Jarkesy*, see "A Jury of Your Peers: Fifth Circuit Ruling in *Jarkesy v.* SEC Broadly Expands the Right to a Jury Trial for SEC Actions" (Jul. 21, 2022); and "Fifth Circuit Decision Could Hamstring SEC Enforcement Abilities" (Jun. 9, 2022).

### Denial of Rehearing *En Banc*

After the Fifth Circuit's original panel decision, the SEC petitioned for rehearing *en banc* by the full Fifth Circuit. In October 2022, the Fifth Circuit denied the petition, with six judges voting in favor of rehearing and ten voting against it.

Writing for the six judges in favor of rehearing, Judge Catharina Haynes wrote a dissent from the denial. First, Haynes explained that SEC administrative proceedings do not violate the Seventh Amendment because those proceedings involve the vindication of public rights. Second, she concluded that the SEC's right to choose its enforcement venue does not violate the nondelegation doctrine, pointing to the other exercises of discretion by the executive branch (*e.g.*, prosecutorial discretion) that have never been deemed to infringe on Congress's legislative power. Finally, she reasoned that the for-cause removal procedures for SEC ALJs do not conflict with the prior Court decision in *Free Enterprise Fund* because ALJs' duties are "distinctly adjudicatory."

Haynes concluded her dissent by claiming that the original panel's decision "deviated from over eighty years of settled precedent." She further noted that, if the panel's decision were left in place, it would call into question all types of adjudication proceedings within the executive branch – not only those within the SEC.

# Government Petition for Court Review

On March 8, 2023, the U.S. Solicitor General filed a petition for writ of certiorari before the Court, asking it to review all three of the Fifth Circuit's holdings.

## Court Review Is Discretionary

All parties that lose in a trial court can seek appellate review in the courts of appeals. Further review in the Court, however, is not automatic. Rather, a party that loses in the court of appeals must request permission to appeal to the Court by filing a petition for writ of certiorari with it.

The Court is not obligated – and, in fact, comes nowhere close to hearing – every case in which a losing party seeks its review. If four justices vote to grant the petition, the Court will hear the case on the merits. Per the Court's own rules, petitions are granted "only for compelling reasons," such as when:

- the court of appeals decision conflicts with the decision of another court of appeals on an important question of federal law – known as a "circuit split";
- the court of appeals decision involves an important question of federal law that should be decided by the Court; or
- the court of appeals decided an important question of federal law "in a way that conflicts with relevant decisions" of the Court.

Many cases the Court ultimately decides to review are cases of critical importance with the potential for widespread effects, such as those that may affect large numbers of people outside of the case itself or those that have implications for the manner in which the government functions and exercises its powers under the Constitution.

## The Government's Reasons for Seeking Review

The government's petition asks the Court to consider three issues, including whether:

1. the statutes authorizing the SEC to pursue administrative enforcement proceedings seeking civil penalties violate the Seventh Amendment;
2. those statutes also violate the nondelegation doctrine; and
3. Congress violated Article II of the Constitution by granting for-cause removal protection to the SEC ALJs.

The Fifth Circuit's decision in *Jarkesy* was the first to consider those questions in the context of SEC administrative proceedings, so the government could not point to a circuit split to justify Court review. Instead, the government has urged the Court to accept the case by arguing that the Fifth Circuit's decision was incorrect and presents important constitutional questions. The petition asks the Court to reverse the Fifth Circuit on each of its holdings.

**Seventh Amendment**

In its petition, the government asserted that the Fifth Circuit erred in holding that the SEC's administrative enforcement proceedings seeking civil penalties violated the Seventh Amendment right to a jury trial. The government argued that longstanding Court precedent makes clear that such proceedings are matters involving public – not private – rights and further that Congress has the well-established power to assign the adjudication of such public rights to entities other than federal judicial courts, such as SEC administrative enforcement proceedings.

The government also took issue with the Fifth Circuit's reasoning on the Seventh Amendment issue. First, the government argued that it does not matter that, if the SEC had brought an enforcement action seeking monetary penalties in federal court, the Seventh Amendment jury trial right would, of course, attach. The government pointed out that, under Court precedent, Congress may assign the adjudication of public rights to an agency even if the Seventh Amendment would have required otherwise in a federal trial.

Second, the government's petition also rejects the Fifth Circuit's comparison of the federal securities statutes to historic, common-law fraud as irrelevant. In the government's view, "Congress's power to assign an enforcement proceeding to a non-Article III tribunal does not depend on the extent to which that proceeding resembles common-law actions."

Finally, the government contended that the Fifth Circuit placed improper weight on the fact that the governing statutory scheme permits the SEC to choose between bringing an enforcement action in its own administrative proceeding or going to federal court. Although the Fifth Circuit reasoned that this choice meant that securities fraud cases were "not the sort that are uniquely suited for agency adjudication," the government maintained that it has no bearing on the public-versus-private-right distinction or Congress's power to assign the adjudication of public rights to agencies.

**Nondelegation Doctrine**

The government also argued that the Fifth Circuit erred in holding that the statutory scheme violates the nondelegation doctrine. Although the government acknowledged that, under the Constitution, Congress may not delegate its legislative powers to an executive agency, it rejected the Fifth Circuit's characterization of the SEC's ability to choose between an administrative enforcement proceeding and an action in federal court as a legislative power in the first place. Instead, the government claimed that ability to choose is simply an exercise of enforcement discretion – "a classic executive power."

The government further argued that the Fifth Circuit erred in finding a violation of the nondelegation doctrine due to the lack of an "intelligible principle" from Congress to guide the agency's choice. According to the government, under Court precedent, that intelligible-principle standard has been applied "only in cases where Congress has authorized executive agencies to adopt general rules governing private conduct." It also argued that the fact that Congress did not give the SEC an intelligible principle in the statute to consider in exercising its enforcement discretion does not mean that Congress delegated its legislative powers. Rather, in the government's view, Congress exercised its legislative powers when it enacted securities fraud laws and created a statutory scheme allowing both the courts and the SEC to award certain "overlapping but not identical set[s] of remedies."

The government dismissed the Fifth Circuit's reliance on the fact that the SEC's ability to choose where to bring an enforcement action allowed the agency to "decide which defendants should receive certain legal processes (those accompanying Article III proceedings) and which should not." It argued that "case-specific Executive Branch enforcement choices often affect the procedural rights that particular defendants may assert" and that fact does not mean that the SEC exercises Congress's legislative power in making such choices.

### For-Cause Removal

Finally, the petition argues that the Fifth Circuit erred in holding that the two layers of tenure protection afforded to SEC ALJs violated Article II of the Constitution. In contrast to the Fifth Circuit's understanding of *Free Enterprise Fund*, the government argued that that case does not apply to "independent agency employees who serve as administrative law judges," including the SEC ALJs. The government contended that the SEC ALJs perform adjudicative – not enforcement or policymaking – functions, and, for that reason, the President's power to remove those ALJs is different from his power to remove other executive officers. Citing Court precedent, the government argued that Congress can limit the President's power to remove officials performing adjudicative functions.

The petition also seeks to distinguish the Court's decision in *Free Enterprise Fund* on the ground that the removal standard in that case was more stringent than that which applies to SEC ALJs. In the government's view, the *Free Enterprise Fund* standard meant the SEC could remove Public Company Accounting Oversight Board (Board) members only for "willful violations of the Act, Board rules, or the securities laws; willful abuse of authority; or unreasonable failure to enforce compliance." The government contrasted those limitations with the standards governing SEC ALJs, arguing that the agency can remove its ALJs for "good cause" after an opportunity for a hearing before the Merit Systems Protection Board, meaning the SEC can remove ALJs for a "broad range of reasons, including the failure to perform adequately or to follow agency policies."

### Future Proceedings

As the respondent, Jarkesy can oppose the government's petition and explain why the Fifth Circuit's decision does not warrant Court review. Jarkesy's brief in opposition was due on May 10, 2023, but a request for additional time was submitted on April 28, 2023.

On May 4, 2023, the extension request was granted in part, and the deadline was extended to May 23, 2023. The petition will then be distributed to the Justices on June 6, 2023, and considered by them at their June 22, 2023 conference, the last conference day of the term. The Court could issue an order on June 26, 2023, but it is also possible the decision on the petition will not be made until later in the summer or even the beginning of the October Term 2023.

## Implications If the Court Grants Review

If the Court grants the government's petition and takes *Jarkesy* up for review on the merits, the resulting decision could have far-reaching implications for administrative enforcement in the U.S., especially for those in heavily regulated fields, such as private fund managers.

### Shape of the Enforcement Landscape

If the Court takes up the case, its ultimate decision could potentially reshape the enforcement landscape. If the Court finds that the SEC's administrative enforcement proceedings to pursue civil penalties violates the Seventh Amendment right to a jury trial, that would disrupt the SEC's current enforcement scheme, causing the Commission to bring more enforcement actions in federal court. Although the SEC might still be able to pursue arguably more minor charges, such as reporting or registration violations, before an ALJ, a Court decision affirming the Fifth Circuit would prevent the SEC from channeling more serious securities fraud cases into its own administrative proceedings.

Indeed, the limited data available suggests that, in the wake of the Fifth Circuit's decision, the SEC has already started pursuing more actions through civil enforcement. In fiscal year 2022 – and prior to the Fifth Circuit's decision in *Jarkesy* – the SEC filed roughly 50% more administrative proceedings than civil lawsuits. After the decision, the ratio flipped, with the SEC preferring civil enforcement actions by 50%. A Court decision affirming the Fifth Circuit would reinforce this trend, while a reversal by the Court might cause the SEC to utilize administrative enforcement with renewed vigor.

See "Discussing 2022 Enforcement Results, SEC Enforcement Director Stresses Trust-Building Measures" (Jan. 5, 2023).

In addition, affirmance in the Court could result in the SEC's bringing fewer enforcement actions overall, as federal court proceedings generally take more time and resources than in-house administrative proceedings. The SEC might also alter its decision-making and enforcement priorities to focus on certain kinds of cases over others. For example, if required to bring certain enforcement actions in federal court, the Commission might establish new thresholds for prioritizing more serious cases, while foregoing enforcement actions that the Commission would have previously pursued in an administrative forum. The SEC might also alter its remedial choices, trending away from civil penalties and towards equitable remedies, such as injunctions or disgorgement, to allow it to bring cases in an administrative venue.

See "What Remedies and Relief Can Fund Managers Expect in SEC Enforcement Actions?" (Jan. 10, 2019).

A Court decision upholding the Fifth Circuit's *Jarkesy* decision might also prompt congressional action to alter the statutory framework for administrative enforcement. In recent years, Congress has responded quickly with legislation designed to "overrule" Court decisions. For example, after the Court decisions in *Kokesh v. SEC* and *Liu v. SEC* limited the Commission's ability to seek disgorgement, Congress quickly passed legislation that explicitly established disgorgement as an appropriate remedy for securities law violations and expressly set a statute of limitations applicable for that remedy.

See "*Liu* Is Dead, Long Live *Liu*: *Spartan* and Disgorgement After the NDAA" (Oct. 20, 2022); and "The SEC's New Disgorgement Powers: Questions and Consequences" (Apr. 8, 2021).

Congress might respond similarly here. For example, if the Court agrees with the Fifth Circuit that Congress violated the nondelegation doctrine, Congress might enact legislation prescribing standards to govern whether the SEC can pursue an enforcement action administratively or whether it must sue in court. Other legislation might attempt to cure the Seventh Amendment deficiency by creating a role for juries within administrative adjudications or by creating a mechanism for a jury to review administrative actions. Such legislation could significantly alter administrative enforcement authority and practice in cases involving private fund managers.

## Impact Beyond SEC Cases

A Court decision in *Jarkesy* would have implications for all administrative enforcement proceedings, not just the SEC's. Consequently, the decision could impact a wide array of enforcement proceedings relevant to private fund managers, including enforcement by the CFTC and other regulators. Moreover, if the Court were to adopt the Fifth Circuit's view of the nondelegation doctrine, it could severely curtail similar statutory schemes outside of those governing the SEC.

Finally, a Court ruling that results in at-will termination for ALJs could make them more responsive to political considerations. On the one hand, that could yield ALJs who more effectively implement prevailing policy preferences as reflected by electoral outcomes. On the other hand, ALJs may be seen as less independent and impartial decision-makers.

Even if the Court agrees with the government and reverses the Fifth Circuit on each of its three holdings, that decision would at least provide clarity and stability. Ultimately, the Fifth Circuit's decision in *Jarkesy* was significant. Court review of that decision could be more significant still. For that reason, private fund managers should continue to pay attention to *Jarkesy*'s path through the court system and prepare for the possible effects of a Court decision on the merits.

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