5th Circ. Ruling Signals Judicial Shift On SEC Admin Process

By Benjamin Daniels and Trevor Bradley (June 27, 2022)

Financial institutions, directors and officers have long been at the mercy of the U.S. Securities and Exchange Commission's administrative process. Critics complain that the SEC's administrative proceedings are unfair and give the agency an inherent advantage.


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That process is now under attack in a series of decisions coming out of the U.S. Court of Appeals for the Fifth Circuit.

The latest, Jarkesy v. SEC, declared the entire process unconstitutional under several different theories.[1] The U.S. Supreme Court is sure to review that decision, as it would transform how securities are regulated in the U.S.

Those facing SEC enforcement actions should preserve all constitutional challenges, and expect the SEC to shift toward bringing such actions in federal court.

Background

Through the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress gave the SEC the power to choose between two forums when filing an enforcement action.[2]

The first option is federal court, where defendants have a right to a jury, access to ordinary discovery processes and the protections of the Federal Rules of Evidence. The second option is an administrative proceeding before an administrative law judge, which does not involve a jury, has limited discovery and uses looser evidentiary standards.[3]

Since the passage of Dodd-Frank, the SEC has made it a priority to use administrative proceedings to expedite its enforcement actions.

The appeal in Jarkesy involved one such administrative proceeding, initially brought against a hedge fund founder and his investment adviser Patriot28 LLC, and eventually finding its way to the Fifth Circuit on a petition for review.

The founder and the investment adviser, or the petitioners, set up two hedge funds, secured 100 investors and managed $24 million in assets. Irregularities surfaced, however, spurring the SEC to investigate and commence an administrative enforcement action on the ground that the petitioners had committed securities fraud.

An administrative law judge conducted an evidentiary hearing and eventually concluded that the petitioners had violated securities laws. The petitioners then sought review of the administrative law judge's ruling from the full SEC, which then affirmed, rejecting the petitioners' constitutional challenges.

The SEC ordered that the petitioners cease and desist from committing further violations, pay disgorgement and civil penalties, and refrain from several industry activities. The petitioners then filed a petition for review of the full SEC decision with the Fifth Circuit.

The Fifth Circuit

The Fifth Circuit struck down the administrative decision as unconstitutional on three grounds, remanding the case for further proceedings.

Right to a Jury Trial

First, the court held that the administrative hearings violated the petitioners' right to a jury trial under the Seventh Amendment because the SEC's enforcement proceedings are similar to common law actions that traditionally require a jury trial.

Courts have held that matters of private rights must be tried by a jury, but not public rights. Securities fraud, the Jarkesy court reasoned, involved a private right because fraud is "quintessentially about the redress of private harms."

The mere fact that securities fraud is codified in statute did not transform it into a public right.

Improper Delegation of Power

Second, the court found that Congress had improperly delegated its legislative power to the SEC. The nondelegation doctrine holds that Article I of the U.S. Constitution gives Congress, and only Congress, the power to create laws. If Congress delegates that power, it must provide intelligible principles to guide that delegation.

Even though the doctrine is rarely used, the Fifth Circuit held that Congress did not provide the SEC with intelligible principles to determine which enforcement actions required presentation to a jury as opposed to an administrative hearing. Indeed, Congress was silent on the issue.

Unconstitutional Protections of Administrative Law Judges

Finally, the court found that the protections afforded to administrative law judges were unconstitutional. Administrative law judges in SEC enforcement actions can only be removed for good cause by a board, whose members, in turn, can only be removed for cause by the president.

The Jarkesy court held that this two-layer protection prevented the president from fulling his obligation to take care that the laws of the U.S. were faithfully executed under Article II, Section 3 of the Constitution.

Takeaways

Critiques have surfaced about the unfairness of the process and lack of procedural protections ever since the SEC's announced intent to expand its use of administrative enforcement proceedings.

Among other things, critics have cited the rapid process, loose evidentiary standards, the lack of juries, and the fact that administrative law judges and the SEC's enforcement division are on the same payroll.

Jarkesy shows that these critiques are not falling on deaf ears. The Supreme Court has decided to wade into the fray, agreeing to hear another case about the SEC's administrative enforcement proceedings, SEC v. Cochran.[4]

Cochran involves a procedural issue — whether constitutional challenges can be brought midprocess rather than wait for the entire process to conclude — but signals a growing discomfort in the judiciary with the SEC's actions.

The Supreme Court likely will review the decision because it casts doubt on the actions of some 30 agencies that use administrative law judges for administrative enforcement. Many federal agencies use similar processes, including the U.S. Environmental Protection Agency, the U.S. Commodity Futures Exchange Commission, the Consumer Financial Protection Bureau, the Federal Trade Commission and the National Labor Relations Board.

Should the decision stand, there will likely be dozens of lawsuits challenging the administrative actions of these other agencies to follow.

Those facing SEC enforcement actions should take affirmative steps to preserve rights enumerated in Jarkesy. While the decision itself is limited to the Fifth Circuit, those facing enforcement actions should bring their constitutional challenges early and often to preserve any constitutional claims as the case proceeds.

Targets of these actions should also expect to see a shift in SEC enforcement priorities, with the SEC opting to go to federal court rather than risk invalidation of an administrative proceeding. As the courts work through these issues, targets should expect longer enforcement actions but with more procedural and evidentiary protections.

Those facing administrative enforcement actions from other agencies should also consider the constitutional arguments raised in Jarkesy. After all, there is no appreciable difference between the different agencies' use of administrative law judges, and all of them have similar for-cause protection before they can be removed from office.

Those working their way through other agency proceedings would be well advised to consider incorporating constitutional challenges into the process.

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[1] Jarkesy v. SEC, 34 F.4th 446 (2022).

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010).

[3] See 15 U.S.C. § 78u-2(a).

[4] SEC v. Cochran, No. 21-1239, 2022 WL 1764758 (May 16, 2022).