

Securities Litigation and Enforcement

Fifth Circuit Holds SEC's In-House Forum is Unconstitutional

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When Congress passed the Dodd-Frank Act, it expanded the SEC's power to use its in-house administrative forum to bring enforcement actions. Supporters said this change promoted investor protection by giving the SEC a more efficient avenue in an expanded set of cases. Almost a decade after Dodd-Frank was passed, however, this benefit has not materialized. Instead, the SEC's in-house forum has been subject to repeated constitutional attacks and has been criticized for failing to serve as a fair forum to litigate cases to final judgment more quickly.

Most recently, a divided panel of the Fifth Circuit in *Jarkesy v. Securities and Exchange Commission*, No. 20-61007 (5th Cir. May 18, 2022), found that the use of in-house administrative law judges (ALJs) by the SEC is unconstitutional because it violates the Seventh Amendment's right to a jury trial, reflects an impermissible delegation of authority to the agency, and features adjudicators that are improperly insulated from removal. Each of these holdings is interesting in its own right and may provide fodder for other litigants seeking to cast doubt on the actions of ALJs used by the SEC and perhaps other federal agencies. This article describes the issues at play in the case and discusses how the continuing uncertainty of the constitutionality of the SEC's in-house forum may impact the agency going forward.

Constitutional Issues Raised by Jarkesy

In *Jarkesy*, an investment adviser and its principal (Petitioners) challenged the constitutionality of the SEC in-house forum. Agreeing with the challengers, the majority of the panel (Judges Elrod and Oldham) found three independent defects in the SEC's use of an ALJ to adjudicate Petitioners' case.

First, the Fifth Circuit held that the proceedings deprived the Petitioners of their right to a jury trial under the Seventh Amendment. The Court found that the SEC's enforcement action arose "at common law" under the Seventh Amendment. *Jarkesy*, slip op. at 9. Relying heavily on *Tull v. United States*, 481 U.S. 412, the Fifth Circuit explained that because the SEC sought civil penalties—a "common-law-like" legal remedy—the action was firmly within the common law. See *Jarkesy*, slip op. at 7. While the SEC ordered equitable remedies in conjunction with the civil penalties, the Court found that the civil penalty was sufficient to trigger the Seventh Amendment's protections. *Jarkesy*, slip op. at 10.

In so holding, the panel rejected the SEC's argument that it was vindicating "public rights" and, therefore, the Seventh Amendment did not apply to its action. The panel wrote that just because the suit would "discourage and remedy fraudulent behavior" did not "mean such suits concern public rights at their core." *Jarkesy*, slip op. at 14–15. The Fifth Circuit explained that the securities statutes did not create a separate public right but, instead, reflected common law fraud actions. *Jarkesy*, slip op. at 11, 14. Additionally, in the Fifth Circuit's view, requiring jury trials would not dismantle or impede the statutory scheme, especially because Congress gave the SEC authority to bring suit either within the agency structure or before an Article III court. *Jarkesy*, slip op. at 11. For these reasons, the Court held that the Petitioners were entitled to a jury trial.

Second, the Fifth Circuit held that Congress delegated an inherently legislative power without a corresponding "intelligible principle" when it allowed the SEC to determine the forum in which to bring suit. The Court found that determining which cases would be heard by Article III judges and which would be heard by ALJs was "a power that Congress uniquely possesses." *Jarkesy*, slip op. at 24. The Fifth Circuit rejected the SEC's argument that Congress delegated only prosecutorial discretion, an

executive power, and instead reasoned that Congress, “gave the SEC power to decide which defendants should receive *certain legal processes*,” a uniquely legislative power. *Jarkesy*, slip op. at 24 (emphasis in original).

Addressing the non-delegation doctrine, the Court also found that when delegating this legislative power, Congress failed to provide an intelligible principle to guide the exercise of the power. Specifically, the Court found that “Congress has said nothing at all indicating” how the SEC should determine which cases should be adjudicated in administrative tribunals and which should go to Article III courts. *Jarkesy*, slip op. at 25. This “total absence of guidance” was an impermissible delegation of legislative authority under the Constitution. *Jarkesy*, slip op. at 25.

While the Fifth Circuit thought these first two defects were independently sufficient to vacate and remand the SEC’s decision, it also found a third defect. Relying on *Lucia v. SEC*, 138 S. Ct. 2044 (2018), the court found that SEC ALJs are inferior officers who “perform substantial executive functions” and, therefore, the Constitution requires that the President “be able to exercise authority over their functions.” *Jarkesy*, slip op. at 25, 28. As the Fifth Circuit explained, however, SEC ALJs may only be removed for cause by members of the Merit Systems Protection Board, who in turn may also only be removed for cause. *Jarkesy*, slip op. at 27. Citing *Free Enterprise Fund v. Public Company Accounting Oversight Board*, 561 U.S. 477 (2010), the panel thus held that these two layers of protection impermissibly kept the President from removing ALJs based on the exercise of their discretion.

Judge W. Eugene Davis dissented. In his view, the SEC’s enforcement action was a “public right” and, therefore, the Petitioners were not entitled to Seventh Amendment protections. *Jarkesy*, slip op. at 37 (Davis, J., dissenting). He also viewed the SEC’s “forum-selection authority” to be “part and parcel of its prosecutorial authority,” and therefore (under *United States v. Batchelder*, 442 U.S. 114 (1979)) the delegation of such authority did not violate the nondelegation doctrine. *Jarkesy*, slip op. at 45–46. Finally, the dissent reasoned that because SEC ALJs “perform an adjudicative function,” their layers of protection from firing do not inhibit the President’s ability to exercise effective oversight. *Jarkesy*, slip op. at 48.

Next Steps and Potential Implications

The Fifth Circuit’s decision is the latest word in a long-running conversation about the contours of administrative agencies’ constitutionally acceptable powers—a topic the US Supreme Court has recently addressed in *Lucia*, *Seila Law LLC v. Consumer Financial Protection Bureau*, 140 S. Ct. 2183 (2020), *United States v. Arthrex, Inc.*, 141 S. Ct. 1970 (2021), and *Free Enterprise Fund*. Because of the impact of the Fifth Circuit’s decision, the SEC could choose to seek *en banc* review (although success may not be seen as particularly likely given the full court’s composition and its decisions in other cases). The SEC also may ask the US Supreme Court to weigh in. Indeed, the views expressed by the dissent lay the groundwork for such further appeals.

Beyond the next steps in court, these continued attacks on the agency’s in-house forum have practical implications. The SEC would prefer to keep the focus of litigated cases on the merits of the underlying cases rather than on the constitutionality of their in-house forum. As a practical matter, while this uncertainty remains, the SEC may opt to bring more contested cases in federal court where it can steer clear of these constitutional challenges, even if it would otherwise prefer to litigate in the friendly confines of its own home court. And when the SEC does choose to pursue cases through its in-house forum, it will need to accept and address the attendant uncertainty. Meanwhile, litigants before that in-house forum (and other similar forums in other federal agencies) would be wise to monitor developments and preserve all possible arguments related to administrative agency powers and the use of ALJs by the SEC and other administrative agencies. And the SEC will need to keep its eye on *SEC v. Cochran*, in which the US Supreme Court will decide whether the *en banc* Fifth Circuit was correct in concluding that district courts have jurisdiction to hear a suit in which the respondent in an ongoing SEC administrative proceeding seeks to enjoin that proceeding.

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