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Fifth Circuit Declines to Rehear Sweeping Decision That Hamstrings SEC's Enforcement Program

Posted by by George S. Canellos, Tawfiq S. Rangwala, John J. Hughes III, Milbank, on Tuesday, November 22, 2022

Editor's note: George S. Canellos and Tawfiq S. Rangwala are Partners, and John J. Hughes III is Special Counsel at Milbank LLP. This post is based on a Milbank memorandum by Mr. Canellos, Mr. Rangwala, Mr. Hughes III, and Michael Dauber.

After a sweeping defeat in the Fifth Circuit, the Securities and Exchange Commission ("SEC" or "Commission") may be headed to the Supreme Court in an effort to salvage important tools in its enforcement arsenal. The SEC had asked the full Fifth Circuit to rehear a split 2-1 decision issued in May in *Jarkesy v. SEC*,[1] the latest in a series of judicial blows to the SEC's expansive, decade-long reliance on administrative proceedings to seek monetary penalties from a wide range of entities and individuals.[2]

The Fifth Circuit denied the SEC's *en banc* petition on October 21, 2022, leaving a certiorari petition as the only remaining avenue for the SEC to challenge a decision that threatens several important aspects of its enforcement powers. As the judges dissenting from denial of *en banc* review recognized, the decision "raises questions of exceptional importance."[3] If left standing, *Jarkesy* potentially could cripple the ability of the Commission to hold gatekeepers and supervisors responsible for negligent oversight of those who commit fraud, opens the door to constitutional challenges to some SEC actions filed in federal court, and raises questions about the appropriateness of administrative settlements that the SEC continues to ink every day.

In *Jarkesy*, the Fifth Circuit ruled that SEC administrative proceedings are unconstitutional for three independent reasons: (1) the SEC's pursuit of monetary penalties for securities fraud in an administrative forum violated the petitioner's Seventh Amendment right to a jury trial in federal court; (2) Congress violated the constitutional non-delegation doctrine by giving the SEC, as part of Dodd-Frank Act amendments to the securities laws, unfettered discretion to file certain enforcement actions in either district court or in an administrative forum; and (3) statutory restrictions on the removal of administrative law judges ("ALJs") from office violate Article II of the Constitution.

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[1] *Jarkesy v. Securities and Exchange Commission*, 34 F.4th 446 (5th Cir. 2022).

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in July 2010, broadly expanded the SEC's enforcement authority by allowing it to use administrative proceedings to obtain monetary penalties for violations of the securities law by non-registered entities and individuals. Prior to Dodd-Frank, the SEC could only seek monetary penalties in an administrative setting in actions against financial institutions, such as broker-dealers and investment advisers that are regulated by the SEC, and persons associated with such entities.

[3] *Jarkesy v. Securities and Exchange Commission*, No. 20-61007, 2022 WL 12338551, at *3 (5th Cir. Oct. 21, 2022).

Early commentary by legal scholars and practitioners has tended to emphasize that, while wide-ranging in its rebuke of the SEC's reliance on ALJs, *Jarkesy* may be of limited short-term significance because the SEC has largely ceased bringing contested cases administratively in the wake of the Supreme Court's decision in 2018 in *Lucia v. S.E.C.*[4] (which held that SEC ALJs are inferior executive officers who must be appointed by the President or the Commission, rather than by SEC staff) and other challenges to the constitutionality of the SEC's administrative process. But the decision raises a host of thorny legal and practical questions that should influence advocacy and strategy in defending against SEC enforcement actions now that the full Fifth Circuit has chosen to leave the *Jarkesy* panel's decision as the last word.

THE FIFTH CIRCUIT'S DECISION

Jarkesy involved an enforcement action for alleged misrepresentations against the founder and investment adviser of two hedge funds. After an evidentiary hearing, an ALJ found that defendants had engaged in securities fraud and imposed a civil penalty and disgorgement (among other remedies). The Commission adopted the ALJ's findings and recommended sanctions. On appeal, however, the Fifth Circuit vacated the Commission's enforcement order on the grounds that the Commission's internal adjudicative process suffered from multiple constitutional defects.

First, the Court found that the imposition of monetary penalties for securities fraud in an administrative tribunal violated defendants' Seventh Amendment right to a jury trial. It reasoned that securities fraud claims are essentially claims "at common law" that trigger a jury trial right.[5] Although the "public rights" exception to the Seventh Amendment allows federal agencies to resolve certain civil claims through internal agency adjudication, the Court concluded that statutory antifraud claims do not qualify. Taking a seemingly novel approach to distinguishing between public and private rights, the majority determined that courts should undertake a claim-by-claim analysis to assess whether a law enforced by a particular federal agency fits within the "public right" exception.[6] The Court held that securities fraud claims do not fit because they are analogues of traditional common law fraud claims and do not involve new causes of action uniquely suited for agency adjudication. The Court argued that adjudication of such claims before a jury would not "dismantle the statutory scheme" or "impede swift resolution of the SEC's fraud prosecutions."[7] As evidence, the Court pointed to the fact that the SEC frequently does enforce such claims in federal court and was required to do so prior to passage of the Dodd-Frank Act.[8]

It remains to be seen whether this holding will stand, as *Jarkesy*'s public rights analysis is in some tension with Supreme Court precedent suggesting that an action by the government—particularly one enforcing a statute enacted as part of a comprehensive regulatory scheme—is

[4] 138 S. Ct. 2044 (2018).

[5] *Jarkesy*, 34 F.4th at 451–59.

[6] *Id.* at 458 ("The question is not just whether the government is a party, but also whether the right being vindicated is public or private, and how it is being vindicated. . . . But again, if the right being vindicated is a private one, it is not enough that the government is doing the suing. That means we must consider whether the form of the action—whether brought by the government or by a private entity—is historically judicial, or if it reflects the sorts of issues which courts of law did not traditionally decide.").

[7] *Id.* at 453–56.

[8] *Id.*

sufficient to bring a case within the public rights exception regardless of how closely the claim may resemble a common law cause of action.[9]

Second, the Court held that Congress unconstitutionally delegated its legislative power by allowing the Commission to pick whether to bring enforcement actions before an ALJ or a federal court judge, without Congress supplying any "intelligible principle" governing the choice between the two.[10] The Court rejected the Commission's argument that decisions about whether and how to pursue individual cases are executive acts akin to the prosecutorial discretion afforded federal prosecutors, finding instead that the choice of forum is a "legislative" decision because it defines which legal processes (and protections) a defendant will or will not enjoy.[11] The Court focused particularly on the absence of any guidance on how the SEC should exercise its forum-selection discretion, noting that "if the intelligible principle standard means anything, it must mean that a total absence of guidance is impermissible under the Constitution."[12]

The delegation ruling is noteworthy because the Supreme Court has not struck down a statute as violating the non-delegation doctrine since 1935. And since then, the Supreme Court has upheld statutes that delegate legislative authority constrained only by vague, open-ended guidance—for instance, statutes that merely direct agencies to regulate in the "public interest."[13] It will be interesting to see whether *Jarkesy* is a harbinger of increased judicial efforts to curb the reach of the administrative state through more expansive application of the non-delegation doctrine—or whether it represents an outlier that is promptly overturned by the Supreme Court.

Finally, while acknowledging that it did not need to reach the issue in light of its other holdings, the Court nevertheless found that statutory restrictions on the removal of ALJs unconstitutionally infringe the President's responsibility to "take Care that the Laws be faithfully executed."[14] This determination, which was less surprising than the Court's other rulings, extended the holdings of two Supreme Court decisions—*Free Enterprise Fund v. PCAOB*, in which the Supreme Court held that Public Company Accounting Overnight Board ("PCAOB") members are inferior executive officers who cannot constitutionally be insulated by *two* levels of "for cause" removal protection, and *Lucia*, in which the Supreme Court ruled that SEC ALJs are "inferior officers,"

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[9] *See Atlas Roofing Co., Inc. v. Occupational Safety and Health Rev. Commn.*, 430 U.S. 442, 444 (1977) (holding that "[c]onsistent with the Seventh Amendment, Congress may create a new cause of action in the Government for civil penalties enforceable in an administrative agency where there is no jury trial"); *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 53 (1989) ("Congress may effectively supplant a common-law cause of action carrying with it a right to a jury trial with a statutory cause of action shorn of a jury trial right if that statutory cause of action inheres in, or lies against, the Federal Government in its sovereign capacity."); *Stern v. Marshall*, 564 U.S. 462, 490-91 (2011) ("[I]t is still the case that what makes a right 'public' rather than private is that the right is integrally related to particular Federal Government action."); *see also Imperato v. SEC*, 693 F. App'x 870, 876 (11th Cir. 2017) ("It is well-established that the Seventh Amendment does not require a jury trial in administrative proceedings designed to adjudicate statutory 'public rights.'"). The Supreme Court's opinion in *Atlas Roofing*—the landmark case on this issue—was unanimous with no concurrences or dissents, suggesting that the longstanding doctrine was not considered controversial prior to *Jarkesy*.

[10] *Jarkesy*, 34 F.4th at 461–63.

[11] *Id.*

[12] *Id.* at 462.

[13] In its history, the Supreme Court has "found the requisite 'intelligible principle' lacking in only two statutes, one of which provided literally no guidance for the exercise of discretion, and the other of which conferred authority to regulate the entire economy on the basis of no more precise a standard than stimulating the economy by assuring 'fair competition.'" Whitman v. Am. Trucking Associa-tions, 531 U.S. 457, 474 (2001). Meanwhile, the Supreme Court has upheld (1) a statute that al-lowed the SEC to modify holding company systems to ensure that they are not "unduly or unneces-sarily complicate[d]" and do not "unfairly or inequitably distribute voting power among security holders," (2) wartime delegations of authority to fix commodity prices at "fair and equitable" lev-els; and (3) "various statutes authorizing regulation in the 'public interest.'" Id. (internal quotation marks omitted) (quoting Am. Power & Light Co. v. SEC, 329 U.S. 90, 104 (1946)).

[14] U.S. Const. Art. II § 3.

even though they do not have final decision-making authority over their cases.[15] Because SEC ALJs are insulated from presidential control by at least two layers of "for cause" removal protection, the Fifth Circuit found the statutory restrictions on their removal to be unconstitutional.[16]

The SEC's petition for *en banc* review underscored the broad implications of the decision—noting that *Jarkesy* "leaves uncertain how the Commission can proceed on remand if it were to use an ALJ" and asserting that several aspects of the ruling are "incompatible" with Supreme Court precedent.[17] The response from Jarkesy argued that the majority "faithfully applied current Supreme Court precedent" and took a swipe at the overall fairness of SEC administrative proceedings by pointing out that the SEC wins a lot more when before a home-court tribunal, as opposed to when the Commission is forced to prove its case in federal court.[18]

Six judges on the Fifth Circuit voted in favor of rehearing the case *en banc* and ten voted against.[19] An opinion dissenting from the denial of *en banc* review (joined by five of the six dissenting judges) articulated the fault lines that the Supreme Court would have to grapple with if the SEC seeks further review. The dissenting judges argued that under Supreme Court precedent, "there is no question that the SEC's enforcement action . . . involves 'public rights,'" and thus no jury trial is required.[20] On the non-delegation point, the dissent asserted that the SEC does not exercise "legislative power" in deciding where to bring an enforcement action.[21] And on the question of removal of administrative law judges, they posited that (i) inferior officers need not be appointed by the President but can instead be appointed by the heads of departments or courts of law, so insulating administrative law judges from *presidential* removal is not necessarily problematic, and (ii) the functions of administrative law judges are "distinctly adjudicatory," not executive functions.[22]

The dissenters also took pains to emphasize that *Jarkesy* has "massive impacts" on the law governing the SEC, by nullifying provisions that Congress considered necessary to enforce the securities laws—and calls into question the use of administrative law judges more broadly (including those used by other independent agencies).[23] The dissent's emphasis on the importance of the case may be intended as a signal to the Supreme Court that it should seriously consider granting review.

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[15] *Free Enterprise Fund v. Public Co. Accounting Oversight Bd.*, 561 U.S. 477 (2010); *Lucia,*138 S. Ct. 2044 (2018).

[16] *Jarkesy*, 34 F.4th at 464–65. The Commission's ALJs are arguably insulated by three layers of removal protection because they can only be removed by the Commission if the Merit Systems Protection Board finds "good cause" after a hearing. 5 U.S.C. § 7521(a). Both members of that board and the SEC commissioners themselves can only be removed by the President for "inefficiency, neglect of duty, or malfeasance." 5 U.S.C. § 1202(d); *SEC v. Blinder, Robinson & Co.*, 855 F.2d 677, 681 (10th Cir. 1988).

[17] SEC Pet. Reh'g En Banc at 9, 17, *Jarkesy v. Securities and Exchange Commission*, No. 20-61007 (5th Cir. July 1, 2022) ("SEC Petition").

[18] Jarkesy Opp. Pet. Reh'g En Banc at 1, *Jarkesy v. Securities and Exchange Commission*, No. 20-61007 (5th Cir. July 18, 2022).

[19] *Jarkesy v. Securities and Exchange Commission*, No. 20-61007, 2022 WL 12338551 (5th Cir. Oct. 21, 2022).

[20] *Id.* at *1.

[21] *Id.* at *2.

[22] *Id.*

[23] *Id.* at *3.

IMPLICATIONS FOR THE SEC'S ENFORCEMENT PROGRAM

The constitutional infirmities identified by the Fifth Circuit present, individually and collectively, a thicket of issues that call into question the viability of SEC administrative proceedings, even for purposes of settling cases outside of federal court. Unlike the rather technical problem in *Lucia*—the impermissibility of SEC staff appointing ALJs—these infirmities cannot be overcome through a simple fix by the Commission.[24] If followed by other courts, *Jarkesy*'s most significant implication is that it would spell the end of the SEC's ability to bring fraud actions in an administrative forum, with consequences not just for *how* the SEC prosecutes fraud claims (*i.e.*, in district court or administratively) but *whether* the SEC has the practical ability to bring a range of ancillary charges that it *only* has statutory authority to bring administratively. *Jarkesy* also opens potential new avenues for defendants to challenge SEC enforcement actions, including those filed in district court, or to advocate that no action is appropriate. Several of the most consequential (and difficult) questions raised by *Jarkesy*—assuming it is not swiftly overturned—are discussed below.

What categories of claims that could previously be brought in administrative proceedings would need to be brought in federal court?

Under the Fifth Circuit's reasoning, a federal jury trial would be required for any claim seeking a monetary penalty that is akin to an action at common law as it existed at the time of the passage of the Seventh Amendment.[25] While the public rights exception may allow ALJs to adjudicate new types of violations that are part of a statutory scheme and uniquely suited for administrative resolution, the Fifth Circuit's analysis of what would qualify as vindicating a public right again focuses on whether the violation in question resembles a claim historically decided by the judiciary.[26] If it does, *Jarkesy* points to federal court.

Assessing whether individual securities laws are in some way rooted in common law will be tricky for litigants, the SEC, and courts. *Jarkesy* suggests a clear answer for antifraud claims, which are included in most SEC actions. But the implications of its Seventh Amendment holding are murkier for many modern statutory violations designed to police the capital markets. Are there, for example, common law analogs for violations such as conducting a deficient audit, failing to disclose a known trend or uncertainty under Regulation S-K, non-compliance with short-selling restrictions under Regulation SHO, or falsification of books and records?

Defendants seeking to avoid an administrative proceeding—assuming other constitutional defects with such proceedings can be overcome—likely will try to develop creative arguments for putting claims in the "common law-private right" box, thereby paring back what the SEC can pursue outside of federal court. The potential implications of such advocacy are most pronounced for claims the SEC is statutorily authorized to bring *only* administratively—for example, an action to

[24] In *Lucia*, the Supreme Court held that SEC ALJs were "Officers of the United States" and thus had to be appointed by the President, "Courts of Law" or "Heads of Departments" (i.e., the Commission) under the Appointments Clause of the Constitution. *See generally Lucia v. S.E.C.*, 138 S. Ct. 2044 (2018). In November 2017, anticipating the outcome in *Lucia*, the SEC issued an order ratifying appointment by the Commission of existing ALJs. *See* Press Release, SEC Ratifies Appointment of Administrative Law Judges (2017-215) (Nov. 30, 2017), https://www.sec.gov/news/press-release/2017-215.

[25] *Jarkesy*, 34 F.4th at 452.

[26] *Id.* at 452–59.

bar an accountant from signing audit reports based on a failure to comply with professional standards.[27] Because such a claim is only authorized to be brought administratively under the current statutory framework, a court ruling that a jury trial right attaches to the claim could entirely nullify the claim unless Congress takes action to amend the securities laws.

Are there certain types of enforcement actions the SEC may no longer be able to bring?

If left standing and adopted by other courts, the Court's Seventh Amendment ruling could present a serious roadblock to the SEC's ability to charge actors with secondary responsibility for violations of the securities laws in situations where an action for the primary violation must be pursued in federal court, but the secondary violation can only be pursued administratively. The implications are particularly significant for two powerful tools the SEC has used to hold secondary actors to account: (1) liability for "causing" securities law violations; and (2) liability for failures by persons associated with SEC-registered financial institutions, including broker-dealers and investment advisers, to reasonably supervise subordinates who commit fraud.

The Dodd Frank Act empowered the SEC to impose monetary penalties in administrative proceedings against any person who "causes" another to violate the securities laws. This little noticed statutory change vastly expanded the potential scope of secondary liability under the securities laws for two reasons: *first*, the Commission and the Court of Appeals for the D.C. Circuit had previously held that negligence is sufficient to support a "causing" charge if the underlying primary violation only requires proof of negligence (*e.g.*, you can negligently cause someone to engage in a negligent misstatement actionable under Section 17(a)(2) of the Securities Act);[28] and, *second*, this largely untested statutory language is arguably broad enough to sweep in failures of oversight and persons having only a peripheral connection to the underlying violation. The SEC can establish such a claim by proving "acts *or omissions*" of an individual or entity that it "knew or *should have known* would *contribute* to such violation."[29]

Before the enactment of Dodd Frank, the SEC was authorized in administrative proceedings to order a person who "caused" a violation of the securities laws to "cease and desist" from causing the violation and to disgorge ill-gotten gains but was not authorized to penalize the person for doing so. The SEC, however, rarely saw a point in bringing such a toothless action. If the SEC wanted a penalty, it had to bring an action against the person in district court for aiding and abetting the underlying violation, which requires proof both that the person "substantially assisted"

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[27] Disciplinary actions against professionals—typically accountants and attorneys—who practice before the Commission are authorized by SEC Rule 102(e) and Section 4C of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78d-3. These provisions do not confer the power to seek penalties, likely taking them outside the purview of the Seventh Amendment. But the SEC often simultaneously charges accounting professionals with causing issuers to violate the securities laws or with direct violations of, among other things, Rule 2-02(b)(1) of Regulation S-X or Section 10A of the Exchange Act, as a vehicle to obtaining penalties in professional discipline cases. And, as discussed below, the SEC was granted authority under the Sarbanes-Oxley Act to bring actions in district court seeking civil penalties for violations of PCAOB rules in situations where the PCAOB fails to act or the public interest so requires. If the SEC does seek penalties in an administrative case essentially grounded in professional misconduct, professionals may seek to compare the case to common law malpractice or negligence to argue that a jury trial right applies.

[28] *See Howard v. S.E.C.*, 376 F.3d 1136, 1141 (D.C. Cir. 2004); *KPMG Peat Marwick LLP,* SEC Release No. 1360, at *20 (S.E.C. Release No. Jan. 19, 2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002).

[29] 15 U.S.C. §§ 77h-1(a), 78u-3(a) (emphasis added) (adopted pursuant to Section 929P(a) of the Dodd Frank Act).

in the underlying violation and that the person did so with *scienter* (*i.e.*, intentionally or recklessly).[30]

The power conferred on the SEC to penalize in an administrative proceeding any person who "causes" a securities law violation complemented its preexisting authority to impose secondary liability in an administrative proceeding on persons associated with an SEC-registered financial institution for another form of negligent conduct—failing "reasonably" to supervise another person who commits a violation of the securities laws.[31]

Ever since these causes of action were established, they have been staples of the SEC's efforts to penalize "gatekeepers" (such as broker-dealers, auditors, and officers and directors of public companies), supervisors, and others whose negligence was perceived to have contributed to a violation of the antifraud provisions. Yet, if the door were closed on administrative actions against primary violators, the SEC could have little practical ability to pursue negligence-based claims against secondary actors.

Consider, for instance, a scenario in which SEC wishes to charge primary perpetrators of a fraud with violating the antifraud provisions of the securities laws and to hold one or more of their colleagues or supervisors secondarily liable for negligently enabling or allowing the fraud to be perpetrated. Under *Jarkesy,* the action against the primary violators likely would trigger the right to a jury trial in federal court. But causing or failure-to-supervise liability can be imposed *only* in an administrative forum. Thus, the primary violators and secondary actors could not be charged and tried in the same proceeding. In this circumstance, the SEC might be forced to commence parallel actions in which it has to prove the underlying primary violation twice—once against the primary violators in court to impose direct liability, and then a second time, in a separate administrative proceeding against the executive or supervisor to impose liability for causing the violation or failing to reasonably supervise the primary violators. The same dynamic is present every time the SEC wishes to charge an individual wrongdoer with a primary violation of the antifraud provisions of the securities laws alongside auditors, broker-dealers, or other so-called gatekeepers that the SEC perceives to be at fault for the violation.

Bifurcated actions of this type could result in inconsistent findings in the two actions (*i.e.*, where a jury and an ALJ come to different conclusions regarding whether the primary violation occurred) and require the same witnesses to appear in different proceedings governed by different evidentiary standards and discovery rights. Timing and staging may also be an issue. If, continuing with the above hypothetical, the SEC decides to get through a federal trial against the primary violators first and then decide whether to charge secondary actors with negligence, what happens if the secondary actors refuse to toll the statute of limitations? Would the SEC commence both actions at the same time and seek to stay the administrative proceeding (over the objection of those alleged to have secondary responsibility)? Would it try and prosecute both actions at the same time (a wholly unpalatable option)? In many such cases, absent settlements that eliminate the dilemma, the SEC may simply forego actions against the secondary actors in the interests of prioritizing its claims against the primary violators. And, with knowledge of the SEC's dilemma, the secondary actors would have little incentive to settle.

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[30] 15 U.S.C. § 78*o*(b)(4)(E); 15 U.S.C. § 80B-3(e)(6).
[31] 15 U.S.C. §§ 78*o*(b)(4)(E), (b)(6)(A).

Of course, all of this assumes that actions for causing a securities law violation or failing to supervise one who commits fraud would not themselves be deemed to be akin to common law claims that vindicate private rights and require a jury trial. For example, does “causing” resemble common law aiding and abetting, and does a “failure to supervise” resemble common law negligent supervision? If a court so concluded, the SEC would not be able to bring these claims at all since it has no authority to pursue causing or failure-to-supervise liability in federal court. The SEC could, of course, avoid this problem by charging the executive or supervisor in court with aiding and abetting the misstatement but, as noted above, this would require the SEC to satisfy a much higher burden of proof (including, in supervision cases, the much taller order of showing that the supervisor substantially assisted the violation, as opposed to simply having failed to prevent the violation from happening).

These strategic considerations have been at play in SEC enforcement practice ever since the Commission, out of concern for adverse judicial rulings, quietly ceased filing any contested administrative cases. But the threat that the SEC could resume bringing such cases was enough to persuade some parties to settle claims of secondary liability, rather than being exposed to uncertain liability. Unless resolved favorably for the SEC by the Supreme Court, however, the constitutional issues raised by *Jarkesy* may largely eliminate any threat that the SEC may resume bringing contested administrative proceedings and render both “causing” and “failure to supervise” liability under the securities laws a dead letter for the foreseeable future.

If it is unconstitutional for the SEC to exercise unfettered discretion to choose between an administrative forum and federal court, is any choice of forum valid?

The Fifth Circuit’s non-delegation holding, read literally and taken to its logical conclusion, implies that even some SEC enforcement actions brought in federal court might be unconstitutional. The Court ruled that the SEC’s power to choose between district court and an administrative proceeding is unconstitutional because Congress has offered no “intelligible principle” governing how that power should be exercised. It follows that where the SEC has no choice of forum, there is presumably no delegation concern. But where the SEC has discretion to bring an action either in federal court or administratively and makes a choice, *the act of making the choice itself* is seemingly unconstitutional and an action in *either* federal court or an administrative forum might be impermissible—at least until Congress amends the statute to provide an “intelligible principle” governing the SEC’s choice of forum.

Under the Court’s Seventh Amendment holding, securities fraud claims for monetary penalties require a jury trial and therefore must be filed in federal court. So the SEC arguably has no choice. And certain actions—like for a supervision failure—can only be brought in an administrative setting. Again, no choice. But there are many claims where the SEC does have a choice between pursuing the claim administratively or in court.

For example, the SEC may file actions seeking penalties for violations of issuer reporting obligations under Section 13(a) of the Securities Exchange Act and related rules in either federal

court or an administrative proceeding.[32] The same is true for violations of Regulation Best Interest ("Regulation BI"), which imposes a duty of care on broker-dealers in recommending investment products to customers.[33] Similarly, some equitable remedies such as injunctions or cease-and-desist orders, and officer-and-director bars, carry no jury trial right and may be obtained in court or before an ALJ (albeit subject to different procedural rules and legal standards).[34] And in any case brought by the SEC for violations of the securities laws, courts have authority to grant "any equitable relief that may be appropriate or necessary for the benefit of investors."[35] In light of this broad authority, defendants could argue that the SEC always has a "choice" of forum when exclusively seeking equitable relief.

Ironically, the potential impact of the Fifth Circuit's non-delegation holding is blunted by its Seventh Amendment holding. Because the Court held that the SEC has no option but to file securities fraud cases in federal court, the SEC has no choice in that broad category of cases. Indeed, under the Fifth Circuit's Seventh Amendment analysis, even Congress cannot authorize the SEC to bring fraud charges before an ALJ. But if the Fifth Circuit had ruled only on the non-delegation issue (*i.e.*, the Seventh Amendment was not in play) and the SEC thus retained the power to choose the forum in which it brings securities fraud claims, the SEC would once again have a real choice—and, paradoxically, no choice at all. At least, that is, until Congress acts to supply an intelligible principle.

The Fifth Circuit did not appear to consider the significant implications its non-delegation holding could have in future cases—and it is unclear whether the court really intended to kneecap a broad swath of the SEC's regulatory authority. But if courts read *Jarkesy*'s non-delegation holding strictly and conclude that only Congress can fix the issue—by supplying an intelligible principle to guide the SEC's choice of forum—the implications could be far-reaching.

If it is unconstitutional for the SEC to bring a case in an administrative proceeding, is it constitutional to settle that case by administrative order?

In the months following the *Jarkesy* decision, the SEC has continued its customary practice of settling cases—including securities fraud cases—through administrative cease and desist orders. But the ruling raises questions as to whether this is constitutionally permissible. A defendant can waive a jury trial right, addressing the Seventh Amendment issue (and it will be interesting to see whether the SEC modifies its template for administrative settlements to include an express waiver). But this does not address the delegation problem, which involves a structural defect relating to the separation of powers between the legislative and executive branches of government and not a personal right of a particular defendant.

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[32] *See* 15 U.S.C. § 78m; 15 U.S.C. § 78u(d) (authorizing suits in district court for any violation of the Exchange Act or rules issued thereunder); 15 U.S.C. § 78u-2(a)(1)(A) (authorizing administrative proceedings for the same); *see S.E.C. v. Espuelas*, 767 F. Supp. 2d 467, 469 (S.D.N.Y. 2011).

[33] *See* 17 CFR § 240.15l-1 (Regulation Best Interest); 15 U.S.C. § 78u(d); 15 U.S.C. § 78u-2(a)(1)(A).

[34] *See* 15 U.S.C. § 78u(d)(2); 15 U.S.C. § 78u–3(f). Federal courts may enjoin defendants serving as an officer or director of a public company if the SEC proves a likelihood that the defendant otherwise would engage in future misconduct. In administrative proceedings, the Commission may issue bar orders based on evidence that there is some "risk" of future misconduct. *Compare Sec. & Exch. Comm'n v. E-Smart Techs., Inc.*, 139 F. Supp. 3d 170, 181 (D.D.C. 2015), *with KPMG, LLP v. S.E.C.*, 289 F.3d 109, 124 (D.C. Cir. 2002).

[35] 15 U.S.C. § 78u(d)(5).

If it is unconstitutional for the SEC to have the option to bring a case before an ALJ rather than a district court judge, arguably it could be unconstitutional for the SEC to have the option to settle a case through an administrative proceeding rather than in federal court. This is especially so because the Firth's Circuit's delegation holding turned on the fact that the different forums implicated different legal processes (and the court viewed a choice between different legal processes as fundamentally a legislative decision). The same logic could extend to settlements. Administrative resolutions require only Commission approval, whereas settlements in federal court also require judicial approval. This distinction has proved consequential for the SEC, as proposed settlements have been rejected as unfair and unreasonable by judges in certain high-profile cases (most notably by Judge Jed Rakoff in the Southern District of New York).[36]

As a practical matter, this issue may not be tested any time soon. In most cases, parties who have resolved an investigation through a negotiated settlement would see no benefit to forcing the SEC to file a court case and expose an agreement to judicial scrutiny. And if a litigant who had settled with the SEC later got cold feet about the settlement, a court may decline to consider any subsequent attack to the settlement on the grounds that the litigant's argument is procedurally defaulted. By settling, rather than objecting to the agency process, the litigant could be deemed to have waived the argument (or failed to exhaust his or her administrative remedies before the SEC, as would be necessary to preserve it)—precluding any subsequent judicial relief.

If for-cause removal restrictions for ALJs are unconstitutional, can the SEC still bring administrative actions?

The SEC's decision to avoid filing contested cases as administrative actions over the past several years likely stemmed from concerns that a court would do what *Jarkesy* did—rule that ALJ removal restrictions are unconstitutional. Now what? In the short-term, the SEC will probably continue to file contested matters in federal court. Since *Jarkesy* was decided, at least one appellate court, the Sixth Circuit, has already reached a different conclusion on the removal issue, holding that two layers of removal restrictions are acceptable in the case of ALJs.[37] The Sixth Circuit reasoned, in a 2-1 split decision, that ALJs perform quasi-judicial functions that are meaningfully different from the functions performed by other inferior officers such as PCAOB members.[38] That a circuit split has emerged so quickly (by divided panel decisions in both the Fifth and Sixth Circuits) increases the likelihood that the Supreme Court will address this topic again and render a decision that will determine what reforms, if any, are necessary.[39]

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[36] *See e.g., S.E.C. v. Bank off Am. Corp.*, 653 F. Supp. 2d 507, 509 (S.D.N.Y. 2009) ("Here, however, the Court, even upon applying the most deferential standard of review for which the parties argue, is forced to conclude that the proposed Consent Judgment is neither fair, nor reasonable, nor adequate."); *S.E.C. v. Citigroup Glob. Markets Inc.*, 827 F. Supp. 2d 328, 332 (S.D.N.Y. 2011) (rejecting SEC settlement because "the proposed Consent Judgment is neither fair, nor reasonable, nor adequate, nor in the public interest[,] [m]ost fundamentally, . . . because it does not provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified under any of these standards"), *vacated and remanded*, 752 F.3d 285 (2d Cir. 2014).

[37] *See Calcutt v. Fed. Deposit Ins. Corp.*, 37 F.4th 293 (6th Cir. 2022).

[38] *Id.* at 319.

[39] On September 29, 2022, Justice Kavanaugh granted an application to stay the Sixth Circuit's decision and to recall the mandate, pending Supreme Court review. *Calcutt v. Fed. Deposit Ins. Corp.*, No. 22A255, 2022 WL 4546340 (U.S. Sept. 29, 2022). The Federal Deposit Insurance Corporation ("FDIC") agreed that the Sixth Circuit's decision should be stayed—but not on account of the removal issue. Instead, FDIC argued that the Sixth Circuit erred in failing to remand the case to the FDIC for further consideration after determining that the FDIC's administrative law judge had applied the wrong legal standard on the merits. *See* Resp. to Appl. for a Stay of Proceedings & Recall of the Sixth Circuit's Mandate

Looking ahead, if *Jarkesy*'s removal holding carries the day, Congress could amend statutory removal restrictions to allow ALJs to be fired by the Commission without cause, or a court could issue a declaratory judgment that severs statutory "for cause" removal protections, as the Supreme Court ruled was necessary in *Free Enterprise*.[40] From a policy perspective, however, such cures might be worse than the disease. Eroding the tenure protection afforded to ALJs would exacerbate long-standing criticisms about the fairness of the SEC's in-house proceedings. Specifically, allowing the Commission—which is comprised of political appointees—to get rid of an ALJ without cause would undermine (already shaky) confidence in the independence of ALJs and may result in renewed calls for SEC cases to be brought exclusively before Article III judges whose tenure is not subject to shifting political winds.

While these issues get sorted out by courts and policymakers, *Jarkesy* could impact the strategic options available to entities and individuals currently facing SEC actions in some cases. Take, for example, the not uncommon scenario of an audit firm subject to charges for a failure to adhere to professional standards because an issuer audit client engaged in alleged fraud. As noted above, the statutory framework typically used by the SEC to discipline the firm involves claims that can only be brought administratively pursuant to SEC Rule 102(e) and Section 4C of the Exchange Act or for causing a violation by the issuer. Let's assume, in this hypothetical, that there is insufficient evidence that the audit firm itself engaged in fraud, intentionally or recklessly aided and abetted a securities law violation, or engaged in any direct securities law violation of the of the sort commonly pursued in district court. If the audit firm refused to settle, the SEC may be left in a pickle. If it brings a case against the firm in federal court by stretching available legal theories and evidence—including, for example, by premising liability on vaguely worded PCAOB rules—it risks losing badly.[41] On the other hand, if the SEC pursues a contested administrative case, an appellate court may find restrictions on the ALJ's removal unconstitutional and vacate a favorable decision. Time will tell whether the SEC can come up with a creative work-around, and it is unclear whether entities like audit firms would be willing to roll the dice and risk the collateral consequences of litigating with the SEC in an administrative forum or in federal court.
But *Jarkesy*'s removal holding—which essentially makes filing any contested administrative action fraught with peril for the SEC—may create opportunities for advocacy that defense practitioners should bear in mind.

Pending a Pet. for a Writ of Cert. and for an Administrative Stay, *Calcutt v. Fed. Deposit Ins. Corp.*, No. 22A255 (Sept. 28, 2022), *available at* https://www.supremecourt.gov/search.aspx?filename=/docket/docketfiles/html/public/22a255.html.

[40] *See, e.g., Free Enter. Fund v. Pub. Co. Acct. Oversight Bd.*, No. 1:06-cv-00217-RMU (D.D.C. Feb. 23, 2011), ECF. No. 66 (issuing declaratory judgment consistent with the Supreme Court's remand order).

[41] Section 3(b)(1) of the Sarbanes-Oxley Act deemed any violation of a PCAOB rule to be a violation of the Securities Exchange Act, thereby allowing the SEC to seek penalties for violations of those rules in federal court. But the SEC's ability to do so is circumscribed by the statutory requirement that it may only bring an action for a violation of a PCAOB rule if it appears to the Commission that the PCAOB is "unwilling or unable to take appropriate action" or "such action is otherwise necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78u(f). Defendants may also be able to muster various legal arguments to challenge PCAOB rules that require compliance with ill-defined standards such as "due professional care" and "professional skepticism." PCAOB AU § 230.07. It is unclear whether the SEC has any appetite for litigating these largely untested issues in federal court, especially in a jury trial. Furthermore, the SEC's ability to extract a large penalty in cases premised solely on improper professional conduct may be limited because the statutory framework for penalties in SEC actions allows for higher amounts only in scenarios involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." 15 U.S.C. § 78u(d)(3). This, too, may make pursuing claims against accountants in federal court less palatable for the SEC.

THE ROAD AHEAD

Having lost the *en banc* petition, the SEC is likely to appeal to the Supreme Court. That appeal may forestall any immediate rush to find legislative solutions to the myriad challenges created by *Jarkesy*. But the ultimate resolution of the case before the Supreme Court could invite congressional action.

If the Supreme Court affirmed *Jarkesy*'s Seventh Amendment holding, there may be a push for statutory amendments that allow the SEC to bring actions for "causing" violations and for failures to supervise, among other claims, in federal court. If the non-delegation holding is upheld, Congress would need to supply an "intelligible principle" to govern SEC forum-selection. And if the Supreme Court agreed that restrictions on the ability of the Commission to remove ALJs are unconstitutional, Congress would need to consider whether there is an available fix that allows for an internal adjudicative process that will not come under heavy fire as depriving defendants of due process rights.

Calls for legislative action may also be driven by the fact that, to use the words of the SEC, *Jarkesy* "casts a cloud of uncertainty over the adjudications of all independent agencies that use ALJs."[42] Indeed, the Commodities Futures Trading Commission, Consumer Fraud Protection Bureau ("CFPB"), Federal Communications Commission, Federal Trade Commission, National Labor Relations Board, National Transportation Safety Board, Social Security Administration and the Occupational Safety and Health Review Commission, are all independent agencies that use ALJs to adjudicate a variety of matters. Such agencies may be vulnerable to constitutional challenges to the extent that their ALJs decide claims arguably akin to those traditionally available at common law or might be deemed inferior executive officers. Additionally, at least the CFPB (like the SEC) has discretion to bring some types of cases in either federal court or administrative forums, which could trigger a challenge based on the non-delegation doctrine.[43]

The issues raised by *Jarkesy* could also come to a head quickly based on the Supreme Court's forthcoming decision in *SEC v. Cochran*, which is scheduled to be argued on November 7, 2022.[44] At issue in *Cochran* is whether respondents in SEC administrative proceedings may immediately challenge the constitutionality of such proceedings in district court prior to a ruling by an ALJ, or whether respondents must wait until a final order has been issued by the Commission to raise constitutional challenges before a federal court of appeals.[45] The underlying constitutional issue at play in Cochran is the same statutory restriction on removal of ALJs that *Jarkesy* has declared impermissible. If the Supreme Court allows for interlocutory challenges to the constitutionality of administrative proceedings in district court—whether premised on removal restrictions or based on the Seventh Amendment and non-delegation holdings in *Jarkesy*—the "settlement calculus" may change for entities or individuals who were hesitant to risk litigating with the SEC in an administrative forum because they would have to lose before they could raise any constitutional defense in court.

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[42] SEC Petition at 17.
[43] *See* 12 U.S.C. §§ 5563, 5564, 5565.
[44] *Cochran v. SEC*, 20 F.4th 194 (5th Cir. 2021), *cert. granted*, 142 S. Ct. 2707 (May 16, 2022).
[45] *See* 15 U.S.C. § 78y.

The bottom line is that, until the issues raised by *Jarkesy* are resolved, the case will continue to have significant practical consequences for the SEC's enforcement program. It is unlikely that the SEC will commence contested administrative cases in the near-term, making it challenging (if not impossible) to hold gatekeepers and supervisors responsible for negligent oversight of those who commit fraud. The decision also creates significant uncertainty about the SEC's authority to bring certain categories of cases, where it has the choice to proceed in federal court or in an administrative forum (presenting non-delegation issues), or where it only has the ability to proceed in an administrative forum (presenting removal issues). This sets the stage for potential Supreme Court review that could shape the future of the SEC's enforcement program.