

# The Texas Lawbook

Free Speech, Due Process and Trial by Jury

## Constitutional Danger Zone Redux: SEC's Latest Supreme Court Battle Presents Significant Collateral Implications

DECEMBER 18, 2023 | BY SCOTT MASCIANICA & ALLISON KERNISKY

*Kokesh. Lucia. Lorenzo. Cochran.* The echoes of these recent Supreme Court cases continue to reverberate through the halls of the Securities and Exchange Commission, with their holdings impacting the forum of their cases and the relief they can obtain. On Nov. 29, the Supreme Court heard oral arguments in *SEC v. Jarkesy*, a matter that could have an even greater impact than its predecessors depending on how the Court rules.

With the Supreme Court considering the scope and application of the Seventh Amendment to agency administrative proceedings, the parameters of Congressional delegation of authority to administrative agencies, and whether removal restrictions for SEC administrative law judges violate the Constitution, *Jarkesy* threatens not only SEC enforcement efforts but also those for several administrative agencies.

While all will need to wait until 2024 for the Court's opinion and its true implications to the "administrative state," a review of the oral argument provides some insights into the potential impacts.

### ***Jarkesy* Background**

Given the constitutional issues at play, some high-level background is necessary. The commission consists of five members appointed by the president. The SEC has different policy divisions, including the Division of Enforcement, which enforces the federal securities laws through investigations and related enforcement actions. Enforcement may either (1) institute in-house administrative enforcement proceedings before ALJs seeking equitable or legal relief

(including civil penalties); or (2) file civil actions in federal district court seeking similar relief (including civil penalties), although the exact relief can differ materially depending on the nature of the case. For administrative proceedings, these matters are heard in the first instance before ALJs appointed by the commission without a jury. A party to an SEC administrative proceeding (a "respondent") can appeal the ALJ's decision to the five SEC commissioners and then, if necessary, to the appropriate federal circuit court.

In 2013, the SEC initiated an in-house administrative proceeding against respondents George Jarkesy and his advisory firm, Patriot28, for allegedly misleading investors and inflating the value of certain investments to charge higher management fees. Following some jurisdictional appeals, the ALJ issued an initial decision against the respondents and ordered them to disgorge \$685,000 in ill-gotten gains, pay a \$300,000 civil penalty and barred them from securities-industry activities. The respondents appealed the ALJ's order to the commission. On Sept. 4, 2020, the commission affirmed the ALJ's initial decision. The respondents appealed to the Fifth Circuit.

As we previously covered for the Lawbook, on May 18, 2022, a three-judge panel of the Fifth Circuit held that the SEC's action against the respondents suffered from three constitutional defects: 1) the administrative proceedings violated the respondents' Seventh Amendment right to a jury trial; 2) Congress had unconstitutionally delegated legislative power to the SEC by granting it discretion to choose the forum for enforcement actions; and 3) the statutory

# The Texas Lawbook

removal restrictions on SEC ALJs violated the president’s removal power. The Fifth Circuit determined that the first two bases warranted vacatur of the commission’s order (it did not reach the issue of whether vacatur was necessary for the third basis). The government petitioned for *en banc* review, which the Fifth Circuit denied on Oct. 21, 2022.

On March 8, the government petitioned the Supreme Court for a writ of certiorari, which the Supreme Court granted on June 30 for all three aspects of the Fifth Circuit’s opinion.

## **Oral Argument Summary**

During the two-hour oral argument, the Court focused almost exclusively on the first question — the Seventh Amendment issue. The crux of the oral argument and questioning focused on the inextricably intertwined issues of whether the SEC’s enforcement action involves “public rights” (which would not require a proceeding before an Article III court) or “private rights” (which would) and whether the nature of the forum impacts the applicability of the Seventh Amendment.

The government’s argument largely hinged on the Supreme Court’s 1977 decision in *Atlas Roofing*. The government asserted that the case “considered many of the same arguments presented today and reaffirmed that Congress does not violate the Seventh Amendment when it authorizes an agency to impose civil penalties in administrative proceedings to enforce a federal statute.” The government emphasized repeatedly that when an executive administrative agency acts in its sovereign capacity by filing an administrative enforcement proceeding pursuant to a comprehensive regulatory regime (such as the federal securities laws) it is enforcing public rights and the Seventh Amendment does not apply.

The conservative wing of the Court was skeptical. Justice Clarence Thomas pressed the government to confirm that the Court’s inquiry necessarily required a determination on whether public rights were involved.

Recently, in the *Axon v. FTC/SEC v. Cochran* matter, Justice Thomas detailed his narrow view of “public rights” and expressed “grave doubts” about the ability of administrative agencies to adjudicate private rights which, in his view, include any right that involves property, life, or liberty.

Justice Brett Kavanaugh was similarly skeptical, expressing concern that government proceedings being held before in-house ALJs might be perceived as not being impartial. He also identified an apparent conundrum in the public/private rights debate:

And it does seem odd from a constitutional perspective to say that a private suit triggers the Article III right to a federal court and a jury, a private suit against you for money, but a government suit against you for money is somehow exempt from those Article III and Seventh Amendment and due process requirements simply because the government attaches a different label, the public rights label to it.

Chief Justice John Roberts and Justice Samuel Alito echoed similar concerns, with the former noting that the government’s view seemingly “undermines the whole point of the constitutional protection in the first place.”

Justice Elena Kagan led the charge from the opposite perspective, questioning why the case was even before the Court at all in light of *Atlas Roofing*, a position Justice Ketanji Brown Jackson agreed with. Justice Kagan suggested this matter was not difficult to resolve given that the authorities advanced by the respondents all involved private parties whereas this one involved a government agency against private parties, later stating:

We’ve actually never had since *Atlas Roofing* another ... public/private case, where there’s a government entity on one side of the ‘v’, and the reason that we’ve not had those in 50 or 60 years is because those have been thought the easy cases. ... Nobody has had the ... chutzpah, to quote my people, to bring it up since *Atlas Roofing*.

The government also advanced that, given the text of the Seventh Amendment

(“suits at common law”), the forum in which a proceeding occurs materially impacts the applicability of the Seventh Amendment. Justices Neil Gorsuch and Alito pressed on this position, with Justice Alito noting it seems like a “pretty patent evasion of the Seventh Amendment” to claim Seventh Amendment rights “can be nullified simply by changing the label that is attached to a tribunal.” The government pushed back, noting that Article III and the Due Process Clause both provide protections, and the Court has long permitted administrative adjudications first and judicial review later.

The most curious aspect of the argument may have been what was not discussed, specifically no mention of nondelegation and virtually no questioning on ALJs. Even without the benefit of a back-and-forth on the topics, an analysis of what was discussed, and prior Court opinions, suggests that the SEC and other administrative agencies could be in store for some significant changes.

## Key Takeaways

### Impact on SEC Enforcement

Ironically, the issue that consumed nearly all of the oral argument may have the most limited immediate impact on SEC enforcement. If the Court were to find that the SEC could no longer seek civil penalties in administrative proceedings, the practical impact, while real, would be limited by three important factors.

First, since the Supreme Court’s 2018 decision *Lucia v. SEC*, where the Court held that the SEC’s ALJs had not been properly appointed in accordance with the appointments clause, the SEC has overwhelmingly filed litigated cases in federal district court, whether seeking civil penalties or not. Even though the Commission has since properly appointed the ALJs in line with *Lucia*, with few exceptions, Enforcement continues to avoid filing litigated cases in administrative proceedings.

Second, as respondent’s counsel acknowledged, when the SEC is only seeking remedies that have never required a trial

(namely, equitable remedies), they are not “arguing there’s a Seventh Amendment right for equitable relief.” This is critical for certain aspects of equitable relief the SEC pursues in administrative proceedings, such as certain bars and limitations on ability to appear and practice before the SEC. Generally, proceedings where the SEC is only seeking equitable relief would not be impacted.

Third, Justice Alito queried whether the Court could decide the case on narrow grounds, such as finding that securities fraud claims were “sufficiently close” to common law fraud to mandate a jury trial. If the Court adopted this view, it would limit the applicability of the holding to a subset of SEC enforcement matters.

### Collateral Implications

Even though an adverse Seventh Amendment ruling would likely have limited impact on immediate Enforcement efforts, the government acknowledged that such a decision could have “wide repercussions” to other government agencies. Justices also pressed both sides on whether a ruling would force more cases to federal courts. Justice Kavanaugh asked about the “burden” on federal courts by ruling in respondents’ favor while Justice Kagan stressed that “Congress is not required by the Seventh Amendment to choke the already crowded federal courts. ...”

Respondents’ counsel tried to blunt concerns from the Court, arguing that a ruling in respondents’ favor would affect “a tiny percentage” of administrative proceedings and would be limited to “traditional fraud claims.” But how would such a ruling impact other administrative agencies (such as the Consumer Financial Protection Bureau, the Commodity Futures Trading Commission, the Federal Trade Commission and others)? How the Court addresses these potentially significant ramifications remains to be seen. In the interim, we expect to see continued and increasing challenges to other administrative agency enforcement frameworks (as evidenced by Meta’s recent lawsuit against the FTC alleging several of the same arguments

advanced in *Jarkesy*).

## What about Non-Delegation?

Under the nondelegation doctrine, Congress cannot delegate its legislative powers to agencies but-for an intelligible principle to guide its use. Courts have applied the “intelligible principle” test to uphold exercises of agency discretion where Congress provided at least some level of guidance as to how that discretion should be exercised. In this case, the question is whether the Dodd-Frank Act provides that “intelligible principle” in permitting the SEC to select in what forum it enforces securities laws. The government contends that the commission is acting in a strictly executive capacity when it exercises this discretion.

Since 1935, the Supreme Court has rejected nondelegation arguments consistently. However, in a Supreme Court case four years ago — *Gundy v. United States* — several conservative justices signaled a willingness to accept the doctrine in certain circumstances. In a concurring opinion in *Gundy*, Justice Alito noted “[i]f a majority of this Court were willing to reconsider the approach we have taken for the past 84 years, I would support that effort.” Additionally, Justice Gorsuch (joined by the chief justice and Justice Thomas) penned a lengthy dissent on the concept of the “intelligible principle misadventure” he believes has wrongly led the Court to not properly adjudicate problematic grants of legislative activities to executive agencies.

But the Court completely sidestepped the non-delegation doctrine in oral argument, an interesting approach given (or perhaps because) the non-delegation issue arguably would have the biggest collateral impact on administrative agencies writ large. If the Court were to open the door by finding that Congress did not provide an intelligible principle to the SEC on forum choice, there could be collateral enforcement implications to not only the SEC but also several other administrative agencies. Further, such a finding would inevitably lead to increased legal challenges to other policymaking and

rulemaking activities of administrative agencies. Although it would be peculiar for the Court to uphold a nondelegation argument for the first time in 87 years without any questioning on the topic, given the revamped composition of the Court since *Gundy* and several justices’ expressed openness to revisiting the issue, it cannot be ruled out.

## ALJs Remain in Play

The crux of the ALJ issue involves Article II, Section 3 of the Constitution which reads, in relevant part, that the president “shall take Care that the Laws be faithfully executed, and shall Commission all the Officers of the United States.” In *Jarkesy*, the Fifth Circuit held that the statutory restrictions on the removal of the SEC’s ALJs violated Article II of the Constitution due to, among other things, dual layers of removal protection (meaning the president cannot directly remove ALJs from their position). The government countered that Congress may properly grant ALJs two layers of removal protection because they have an adjudicatory role, and the scope of the president’s power to remove adjudicatory officers differs from the scope of power to remove and control other executive officers.

Although the topic was only briefly addressed in oral argument, one must read tea leaves to predict how the Court will rule. The question is whether the Court agrees with the Fifth Circuit that the Supreme Court’s 2010 decision in *Free Enterprise Fund v. PCAOB* stands for the proposition that Congress may not grant executive officers two layers of for cause removal protection. However, in *Free Enterprise Fund*, the Court held that their ruling did not apply to ALJs who perform adjudicative rather than enforcement or policymaking functions.

Given the conservative lean of the court and those justices opinions in not only *Free Enterprise Fund* but also *Lucia* (discussed above), it would not be a surprise to see the Court find a constitutional defect. If this occurs, we expect the SEC to react quickly. As it had to do when faced with the *Lucia*

# The Texas Lawbook

decision, the agency was able to get ALJs properly appointed and resume operations relatively quickly. The open issue is, if this occurs, will the agency get the assistance it may require from Congress?

*Scott Mascianica is a Dallas partner in Holland & Knight's white collar defense and investigations and securities enforcement teams, the latter of which he co-chairs. He is a former assistant regional director in the SEC's Division of Enforcement. With more than 17 years of experience in the government and private sectors, Mascianica has a national practice where he regularly advises businesses and individuals*

*in connection with government and internal investigations, enforcement-related litigation, cybersecurity-related misconduct and regulatory and compliance issues.*

*Allison Kernisky is a Miami partner in Holland & Knight's litigation and dispute resolution practice and is a member of the firm's white collar defense and investigations team. Kernisky focuses her nationwide practice primarily on securities litigation, with an emphasis on U.S. Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) enforcement matters. She is editor for Holland & Knight's SECond Opinions Blog.*