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Jarkesy Supreme Court Ruling Limits SEC's Enforcement Authority

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In a 6-3 decision issued on June 27, 2024 in *SEC v. Jarkesy*, the U.S. Supreme Court curtailed the U.S. Securities and Exchange Commission's ("SEC") enforcement authority in recognizing that there is a right to a jury trial in SEC actions alleging securities fraud where civil penalties are sought. Prior to the *Jarkesy* opinion, the SEC had unfettered discretion to bring securities fraud actions in the forum of its choosing (whether that be in federal court or an SEC administrative proceeding), the choice of which was not required to be disclosed prior to the action being brought. It can no longer forum shop.

The choice of forum can dictate both a defendant's procedural protections and the available remedies for the SEC. When a case is heard in federal court, a life-tenured, salary-protected Article III judge presides, the litigation is governed by the Federal Rules of Evidence and ordinary rules of discovery, a jury finds the facts depending on the claim, and there is an appellate path should one be necessary and appropriate. Contrarily, when the SEC adjudicates the matter in-house, the Commission or a delegated Administrative Law Judge ("ALJ") presides acting as both judge and jury; it finds facts, it decides discovery disputes, it determines the scope and form of permissible evidence, and the SEC's Rules of Practice govern.

Most importantly, the Commission-appointed ALJs have broad power that includes issuing significant civil monetary penalties even when no investor has suffered loss, issuing sanctions, and permanently barring market participants from associating with SEC-regulated entities. This power follows the expansion of the SEC's enforcement authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") in 2010, which granted the SEC the "authority in administrative penalty proceedings coextensive with its authority to seek penalties in Federal court."[1] While a full Commission can review the official findings and conclusions of in-house enforcement actions, it is not obligated to do so, and any judicial review after the proceedings conclude is highly deferential to the agency's factual findings.

[1] *SEC,* 604 U.S. ___ at 4 (quoting H.R. Rep. No. 111–687, p. 78 (2010)).

The SEC will no longer have such discretion. As the Supreme Court held, securities fraud claims "replicate" common law fraud claims, which trigger the Seventh Amendment's jury trial guarantee, and civil penalties are the type of monetary remedy that can only be awarded by a jury. The *Jarkesy* decision means that the SEC must now litigate all securities fraud enforcement actions for civil penalties in federal court if the respondent requests a jury trial.

Factual Background

Between 2007 and 2010, Jarkesy launched two investment funds which raised approximately $24 million from over 100 investors. Jarkesy managed Patriot28 which in-turn acted as the funds' investment advisor. In 2011, the SEC launched an investigation into the Defendants' investing activities. In 2013, the SEC initiated an enforcement action asserting that the Defendants committed fraud under the Securities Act, the Securities Exchange Act and the Investment Advisers Act. Specifically, the SEC charged Defendants for: (1) misrepresenting the investment strategies they employed; (2) lying about the identity of the fund's auditor and prime broker; and (3) inflating the funds' claimed value so the Defendants could collect larger management fees. The SEC chose to adjudicate the matter in-house rather than federal court, reviewed the decision and released its final order which levied a civil penalty against the Defendants of $300,000 and ordered Patriot28 to disgorge $685,000 in improper gains. In addition, Jarkesy was barred from various securities industry activities and from serving as an officer or director of an advisory board or investment advisor.

Procedural Posture

Defendants originally sued in the U.S. District Court for the District of Columbia to enjoin the agency proceedings, arguing the proceedings infringed on various constitutional rights. Both the district court and the U.S. Court of Appeals for the D.C. Circuit refused to enjoin the action and decided that Defendants needed to continue with the agency proceedings and petition the court of appeals to review any adverse final order. [2] The SEC rejected several constitutional arguments in adjudicating its order including determining that: "(1) the ALJ was not biased against [Defendants]; (2) the Commission did not inappropriately prejudge the case; (3) the Commission did not use unconstitutionally delegated legislative power—or violate [Defendants'] equal protection rights—when it decided to pursue the case within the agency instead of an Article III court; (4) the removal restrictions on SEC ALJs did not violate Article II separation-of-powers principles; and (5) the proceedings did not violate [Defendants'] Seventh Amendment right to a jury trial."[3]

[2] *Jarkesy v. SEC*, 48 F. Supp. 3d 32, 40 (D.D.C. 2014), *aff'd*, 803 F.3d 9, 12 (D.C. Cir. 2015).

[3] *Jarkesy v. Securities and Exchange Commission*, 34 F.4th 446, 451 (5th Cir 2022).

The Defendants petitioned for judicial review, and a divided Fifth Circuit panel granted their petition and vacated the final order. The panel applied the two-part test from Granfinanciera, S.A. v. Nordberg, 492 U.S. 33 (1989), and held that the agency's decision to adjudicate the matter in-house violated the Defendants Seventh Amendment right to a jury trial. The panel looked to history in reasoning that trial by jury is a "fundamental" component of our legal system and include suits brought under a statute seeking common-law-like legal remedies. The panel then underwent an analysis dictated by Granfinanciera to determine that the Seventh Amendment was implicated and the rights at issue were not entitled to an exception from a jury trial. In undertaking this analysis, the panel noted that while some of the elements brought by the SEC are equitable in nature those elements do not invalidate the jury-trial right attached to the civil penalties sought. In determining the issue was not entitled to a public rights exception, the panel found that a jury trial would not dismantle the statutory scheme, impede swift resolution, or that the agency was uniquely suited for adjudication.

The panel also identified two further constitutional problems. Firstly, it determined that Congress had violated the non-delegation doctrine in allowing the agency to choose the forum for litigation. Rather, the panel found that the government action was "legislative" in nature and as a result should have been—but was not—grounded in a guiding intelligible principle. As a result, the panel found that Congress was too open-ended in granting the SEC exclusive authority and absolute discretion in selecting a forum.

Secondly, the panel ruled that the two-tiered insulation of the SEC ALJs from executive supervision violated separation of powers principles. Relying on Article II appointment and removal analysis, the panel recognized that SEC ALJs are inferior officers because of their substantial authority within enforcement actions. As a result, the President needs to have adequate control over the officers in how they carry out their function, and the ALJs cannot be subject to two layers of for-cause only removal. In this case however, the panel found that the SEC ALJs are sufficiently insulated such that the President cannot take care that the laws are faithfully executed. The panel thus found that the removal restrictions were likewise unconstitutional.

The Supreme Court's Ruling

The United States Supreme Court, in a 6-3 ruling written by Chief Justice John Roberts, affirmed the Fifth Circuit panel, relying only on the Seventh Amendment issue to resolve the case. The Court decided that the action implicates the Seventh Amendment as the antifraud provisions replicate common law fraud, which must be heard by a jury. The Court then decided that the "public rights" exception to Article III jurisdiction, which does not violate the Seventh Amendment, did not apply.

Rationale

In determining the application of the Seventh Amendment, the Court first turned to the historical requirement of a trial by jury, and the framer's decision to "embed" the right into the Constitution through the Seventh Amendment. While the text of the Amendment guarantees a jury in "[s]uits at common law," the Court noted that the right is not limited to a common-law form of action at the time of ratification. Rather the phrase is used in contradiction to equity, admiralty, and maritime jurisprudence. Here, the fact that the SEC sought monetary relief through civil penalties is "all but dispositive" in determining that the SEC's claim was legal in nature, which would implicate the Seventh Amendment.[4] The Court reasoned that because the factors to determine when the SEC can levy civil penalties and the size of the remedy are both tied directly to culpability, deterrence, and recidivism, that the penalties at issue were to punish rather than restore the victim. Because of the punitive design, the Court ruled that the remedies are ones which could, at common law, only be enforced in courts of law, and thus, implicated the Seventh Amendment. The Court then reasoned that the similarities between common law fraud and federal securities fraud was further evidence that the Seventh Amendment was properly implicated.

The Court next held that the claims at issue did not implicate the "public rights" exception. That exception allows Congress to assign a matter for decision to an agency without a jury, but consistent with the Seventh Amendment. Public rights, such as matters historically determined exclusively by other branches, would not require the involvement of an Article III court.[5] Conversely, the Court notes, matters concerning private rights may not be removed from Article III courts. The Court has found public rights to include the collection of revenue, powers over foreign commerce, and the imposition of tariffs, as well as other historic categories such as tribal relations, administration of public lands, and the granting of public benefits.[6] The Court then found, relying on *Granfinanciera*, that the public rights exception did not apply.

As a result of the Seventh Amendment's implication in the fraud statutes, and the inaptness of the public rights exception, the Court found that the Defendants were entitled to a jury trial in an Article III court.

Takeaways

- Jury trials are significantly more burdensome than administrative proceedings; a federal court proceeding will include more onerous discovery obligations, extensive motion practice, stricter limits on admissible evidence, lengthier trials, and more appellate risk for the SEC. While it

[4] *Id.* at 8–9 (citing *Granfinanciera*, 492 U.S., at 53).

[5] *Id.* at 14 (citing *Murray's Lessee v., Hoboken Land & Improvement Co.*, 18 How. 272, at 284).

[6] *See id.* at 15–17.

remains to be seen, the threat of a jury trial may encourage the SEC to be more open to more favorable resolutions with respondents before any such proceeding is initiated.

- As to pending matters, there is no clear "right to remove" a matter from an ALJ to federal court. New procedural rules should be expected in the short-term.
- The *Jarkesy* ruling will not be limited to the specific issue it addressed: fraud actions brought before SEC ALJs. As Justice Sotomayor raised in her dissent, more than two dozen agencies are authorized to seek civil penalties in enforcement actions before administrative tribunals. The majority opinion did distinguish cases involving tariffs, immigration, pensions and other government benefits, public lands, and patents as involving true "public rights." It also declined to overrule *Atlas Roofing*,[7] which permitted the Occupational Safety and Health Administration to impose administrative penalties for workplace safety violations. It remains to be seen what other categories of enforcement claims will trigger Seventh Amendment protection.
- The *Jarkesy* ruling is nonetheless narrow. The Fifth Circuit opinion challenged SEC agency adjudication as unconstitutional for three independent reasons: (1) civil penalties for fraud liability violate the Seventh Amendment right to a jury trial; (2) Congress violated the non-delegation doctrine by failing to set forth principles that the SEC should use to determine whether to bring an administrative proceeding or try a matter in federal court; and (3) the SEC structure violates the constitutional rule set forth in *Free Enterprise Fund v. PCAOB*[8] in imposing two levels of removal protection for ALJs. However, only the first issue was addressed in the *Jarkesy* opinion.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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[7] *Atlas Roofing Co. v. Occupational Safety and Health Review Commission*, 430 U.S. 442 (1977).

[8] *Free Enterprise Fund v. Public Company Accounting Oversight Board*, 561 U.S. 477 (2010).