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ALERT MEMORANDUM

Supreme Court Limits SEC's Use of In-House Adjudication; Raises Questions for Other Agencies

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The Supreme Court recently held in a 6–3 decision in *SEC v. Jarkesy* that the Seventh Amendment prohibits the Securities and Exchange Commission from bringing administrative proceedings seeking civil monetary penalties for fraud claims.

The case addressed the SEC's statutory power to bring certain proceedings in its own administrative courts, rather than in federal district court. The SEC has essentially stopped bringing contested fraud claims through administrative proceedings because of recent constitutional challenges. Here, a respondent challenged the constitutionality of the SEC's in-house courts because they do not provide a right to a trial by jury in district court. The Supreme Court in *Jarkesy* agreed that these proceedings violate the Seventh Amendment insofar as they adjudicate traditionally legal claims without the protections of a jury trial overseen by an Article III judge, foreclosing the SEC and other agencies from bringing fraud claims seeking civil monetary penalties in administrative proceedings.

The decision's impact on other proceedings is less certain. But litigants will no doubt be armed with fresh legal arguments to challenge a broad range of administrative proceedings that either seek civil monetary penalties or are punitive in nature.

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Background

Congress authorized the SEC to bring enforcement actions either in federal district court or the SEC's own administrative proceedings. Administrative proceedings take place before administrative law judges (ALJ) who are appointed to fixed terms, and the proceedings afford litigants weaker procedural protections and more limited discovery and appeal rights than defendants in district court. For example, respondents in an administrative proceeding have no right to trial by jury, law judges are not bound by the rules of evidence, and appeals are heard by the SEC—the same body that authorized the enforcement action in the first place—before being heard by a federal appellate court under a deferential standard of review. When the SEC was bringing these types of proceedings before its own administrative courts more frequently, it was less likely to win in federal court before an impartial judge and lay jury,[1] and therefore there was a perception that it was less likely to bring highly technical or circumstantial cases lacking strong jury appeal. The SEC historically could only bring administrative proceedings against entities and individuals registered to work in the securities industry, such as broker-dealers and investment advisers. But after the 2008 financial crisis, Congress granted the SEC expanded authority to bring administrative proceedings alleging violations of the federal securities laws against anyone. The SEC started bringing more administrative proceedings under this expanded authority, inviting greater public criticism and legal challenges to the process.

The Supreme Court first pumped the brakes on this shift towards administrative proceedings in 2018, when it held in *Lucia* that the appointment process for ALJs was unconstitutional.[2] The SEC stayed all pending administrative proceedings as a result of *Lucia*, and the SEC began to directly hear administrative proceedings without an ALJ. As a practical matter, since *Lucia* the SEC has brought the vast majority of contested enforcement actions alleging substantive violations of the federal securities laws in district court. This left only a subset of contested claims in administrative proceedings, including claims that could only be brought in these proceedings such as actions seeking to bar lawyers and accountants from practicing before the SEC.

Before *Lucia*, however, the SEC brought an administrative proceeding against Jarkesy and his hedge fund, Patriot28, for fraud under the Securities Act, Securities Exchange Act, and Investment Advisers Act. An ALJ held a hearing and found Jarkesy and Patriot28 liable. The SEC later affirmed the decision and Jarkesy and Patriot28 were ordered to cease and desist from future violations and pay $300,000 in civil penalties and disgorge $685,000 in gains obtained through their alleged violations.[3] Jarkesy was also barred from participating in various securities industry activities. Jarkesy and Patriot28 appealed the order to the Fifth Circuit, raising a number of constitutional challenges.

The Fifth Circuit vacated the order and held that the SEC's administrative proceedings were unconstitutional on three grounds.[4] The Fifth Circuit first held that the SEC had deprived Jarkesy and Patriot28 of their Seventh Amendment right to a jury trial.[5] The Fifth Circuit further found that Congress unconstitutionally delegated its power to the SEC by giving it "unfettered authority" to choose the forum in which to bring most enforcement actions.[6] Finally, the Fifth Circuit held that the for-cause removal protections of ALJs violated Article II of the

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1 *See* Jean Eaglesham, *SEC Wins With In-House Judges* WALL ST. J. (May 6, 2015), available here (noting the SEC had a 90% win rate in contested cases before its own ALJs from October 2010 through March 2015, compared to a 69% win rate in federal court during that same period).

2 *Lucia v. SEC*, 585 U.S. 237 (2018).

3 Order of the Securities and Exchange Commission No. 3-15255.

4 *Jarkesy v. SEC*, 34 F.4th 446 (5th Cir. 2022).

5 *Id*. at 459.

6 *Id*. at 462-63.

Constitution.[7] The SEC petitioned the Supreme Court for review and the Supreme Court agreed to hear all three issues.

The Supreme Court Limits The SEC's Enforcement Power In Administrative Proceedings

On June 27, the Supreme Court affirmed the decision of the Fifth Circuit in a 6–3 decision written by Chief Justice Roberts, holding that the SEC violated Jarkesy's right to a trial by jury.[8] The Supreme Court did not reach the non-delegation or for-cause removal issues.

Writing for the Court, Chief Justice Roberts addressed the Seventh Amendment issue by explaining that a jury trial right typically attaches where the claims brought or remedies sought are those traditionally available in a common law legal action.[9] The Court noted that "the remedy [is] the more important" factor, and here "the remedy is all but dispositive" because "money damages are the prototypical common law remedy."[10] The Court elaborated that "[w]hat determines whether a monetary remedy is legal is if it is designed to punish or deter the wrongdoer, or, on the other hand, solely to restore the status quo."[11] Applying that constitutional framework to the proceedings against Jarkesy, the Supreme Court considered the statutory factors for imposing civil monetary penalties and found them to punish the defendant rather than to restore the victim. Finally, the Supreme Court held that the close relationship between the antifraud provisions (under the Securities Act, Securities Exchange Act, and the Investment Advisers Act) and common law fraud confirms that these proceedings were legal in nature, and thus required a jury trial.[12]

Once the Supreme Court determined that the claims implicated the Seventh Amendment, it then explained that Congress could not exempt the claims from a jury trial because the antifraud provisions are not "public rights," that is, they are not obligations created solely by statute that are unknown to common law, which can in some circumstances be enforced in administrative proceedings. Canvassing its own admittedly convoluted public rights jurisprudence, the Court drew a distinction between rights created solely by administrative statute that had no common law forebears, such as workplace safety rules administered by the Occupational Safety and Health Administration, and causes of action with a long history at common law, such as those rooted in fraud.[13]

The Supreme Court's decision drew a sharp dissent by Justices Sotomayor, Kagan, and Jackson, who argued that the Seventh Amendment was not implicated at all because Congress granted the SEC power to adjudicate these claims in administrative proceedings and thus these were not "suits at common law,"[14] and as suits brought by the government they were clearly brought to vindicate public rights.

The Decision's Potentially Far-Reaching Effects Inside And Outside The SEC

The Supreme Court's decision narrows the types of actions that the SEC can bring in administrative proceedings. But because the SEC now brings most contested proceedings in federal district court, the practical impact on the SEC's current practices will be minimal. The decision, however, likely impacts other administrative agencies as well and will spark new legal challenges to their use of administrative proceedings. Administrative proceedings seeking civil monetary penalties for claims that sound in fraud are most directly affected by this decision and likely require adjudication in federal district court. However, the Supreme Court's focus on the remedy sought likely

[7] *Id*. at 465.

[8] *SEC v. Jarkesy*, 603 U. S. ____ (2024).

[9] Slip Op. at 9.

[10] *Id*. (quotations omitted).

[11] *Id*. (quotations omitted).

[12] *Id*. at 11-13.

[13] *Id*. at 22-27; *see also Atlas Roofing Co. v. Occupational Safety and Health Review Comm.*, 430 U.S. 442 (1977).

[14] Slip Op. (dissent) at 5-7.

means that the absence of a fraud claim does not insulate an administrative proceeding from constitutional challenge. The decision at a minimum will provide fresh arguments for those challenging administrative proceedings that seek civil monetary penalties or are punitive in nature.

— ***Impact on the SEC.*** This decision will have little immediate impact on the SEC because the vast majority of contested SEC enforcement actions are litigated in federal district court. Nor does the decision disturb the common practice of having the SEC approve negotiated settlements rather than a federal court judge. But this decision's impact on other types of SEC proceedings is less certain. Even though the Supreme Court's decision focused on civil monetary penalties, the SEC may hesitate to bring administrative actions seeking equitable monetary relief (*e.g.*, disgorgement) because the Supreme Court has previously characterized such relief as punitive.[15] The SEC may continue to be able to bring administrative actions seeking remedies other than civil monetary penalties, such as proceedings seeking to bar attorneys and accountants from practicing before the SEC and proceedings seeking non-monetary equitable relief. But some courts have held such relief to be punitive too,[16] and we can expect to see litigants challenge SEC administrative proceedings by arguing that the relief sought by the SEC is punitive and not solely restorative, and therefore must be tried by a jury in federal court. Finally, the Supreme Court's decision leaves in place the Fifth Circuit's holdings on non-delegation and for-cause removal, and we expect these holdings will continue to cast a shadow on the use of administrative proceedings inside and outside the Fifth Circuit.

— ***Impact beyond the SEC.*** This decision will likely limit the ability of other agencies to bring administrative proceedings seeking civil monetary penalties under antifraud or analogous provisions. For instance, the Federal Trade Commission often brings consumer protection actions under Section 5 of the FTC Act, which prohibits deceptive practices and may be viewed as drawing on common law fraud concepts. The Consumer Financial Protection Bureau has the authority to seek penalties in administrative proceedings under a similarly worded, fraud-like statute. The fate of other proceedings remain uncertain, and will likely lead to further legal challenges. For instance, it is uncertain how this decision will impact the ability of banking regulators such as the OCC, FDIC and Federal Reserve to bring claims in administrative proceedings for breaches of fiduciary duty, unsafe or unsound practices, and violations of laws. Fiduciary duty claims are the most likely impacted of the three types of claims brought by federal banking regulators because those claims derive from common law claims, while the other two categories of claims are arguably closer to public rights. Finally, the decision may impact the ability of FINRA to employ private enforcement proceedings, an issue currently being litigated before the D.C. Circuit.[17]

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[15] *See Kokesh v. SEC*, 581 U.S. 455 (2017) (holding that disgorgement is a penalty for purposes of the statute of limitations proscribed in 28 U.S.C § 2462 because it sought to redress a wrong to the public rather than an individual and to deter others from violating public laws "as opposed to compensating a victim for his loss").

[16] *See, e.g., Johnson v. SEC*, 87 F.3d 484, 489 (D.C. Cir. 1996) (holding that a censure and six-month suspension was a penalty because the bar had been imposed solely in view of the defendant's misconduct and not because of unfitness or public risk).

[17] *Alpine Sec. Corp. v. Fin. Indus. Regul. Auth.*, No. 23-5129, 2023 WL 4703307, at *1 (D.C. Cir. July 5, 2023) (granting preliminary injunction pending appeal).