

Supreme Court Curtails Role of SEC Administrative Courts

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June 28, 2024

The Supreme Court held yesterday in *Securities and Exchange Commission v. Jarkesy* that the Securities and Exchange Commission (“SEC” or “Commission”) may not impose civil penalties in fraud cases through litigated administrative judicial proceedings. The Court explained that the Seventh Amendment guarantees a right to a jury trial for such claims and that, therefore, the SEC may prosecute them only in an Article III federal court. The Court’s decision will have important implications for SEC enforcement. And it represents a continuing trend by the Supreme Court to circumscribe the SEC’s enforcement process and remedies.

Decision of the Court and Proceedings Below

Jarkesy’s procedural history reaches back over a decade, to 2013 when the SEC charged George Jarkesy (“Jarkesy”) and an investment adviser he owned in an administrative and cease-and-desist proceeding for fraud under the Securities Act, the Securities Exchange Act, and the Investment Advisers Act. The SEC charged that Jarkesy and others: (1) misrepresented who was the prime broker and auditor; (2) misrepresented the funds’ investment parameters and safeguards; and (3) overvalued the funds’ assets to increase fees for investors.² After a hearing, an SEC Administrative Law Judge (“ALJ”) concluded that Jarkesy and others committed, and aided and abetted and caused, securities fraud and ordered, among other remedies, approximately \$1.3 million in disgorgement and \$450,000 in civil penalties.³ On appeal, the Commission affirmed that Jarkesy and others committed securities fraud; rejected Respondents’ various constitutional arguments; ordered Respondents to pay \$300,000 in civil penalties; ordered the investment adviser to pay \$684,935.38 in disgorgement and prejudgment interest; and imposed industry bars and a cease-and-desist order.⁴

The U.S. Court of Appeals for the Fifth Circuit vacated the Commission’s decision, holding that the administrative proceeding suffered from three independent constitutional defects: (1) Jarkesy and others were “deprived of their constitutional right to a jury trial”; (2) “Congress unconstitutionally delegated legislative power to the SEC by failing to provide it with an intelligible principle by which to exercise the delegated power”; and (3) “statutory removal restrictions on SEC ALJs violate Article II” of the Constitution.⁵ The Fifth Circuit stated that the Seventh Amendment guarantees Jarkesy a jury trial because the SEC’s enforcement proceeding is similar to “traditional actions at law to which the jury-trial right attaches,” and “Congress, or

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² *In the matter of John Thomas Capital Management Group LLC*, Rel. 33-9396 (Mar. 22, 2013), <https://www.sec.gov/files/litigation/admin/2013/33-9396.pdf>.

³ *John Thomas Cap. Mgmt. Grp., d/b/a Patriot28 LLC*, Initial Decision Release No. 693, 2014 WL 5304908 (Oct. 17, 2014).

⁴ *In the matter of John Thomas Capital Management Group LLC*, Rel. 33-10834 (Sept. 4, 2020).

⁵ *Jarkesy v. Securities and Exchange Commission*, 34 F.4th 446, 450-51 (5th Cir. 2022).

an agency acting pursuant to congressional authorization, cannot assign the adjudication of such claims to an agency because such claims do not concern public rights alone.”⁶

The Supreme Court granted the petition for review filed by the U.S. Solicitor General on all three issues from the Fifth Circuit opinion. During the November 29, 2023 oral argument, the Justices largely focused on the Seventh Amendment jury trial right, with a few remarks about the ALJ removal issues. During the argument, several justices expressed concerns with the growing power and role of federal agencies in the United States, particularly with respect to in-house enforcement programs.

The Court affirmed the Fifth Circuit and remanded for further proceedings. In determining that the Seventh Amendment applied, the Court largely focused on the close relationship between the federal securities fraud causes of action at issue and common law fraud claims. Writing for the majority, Chief Justice Roberts stated, “[t]he SEC’s antifraud provisions replicate common law fraud, and it is well established that common law claims must be heard by a jury.”⁷ Further, because the civil penalties in *Jarkesy* “are designed to punish and deter,” they are “a type of remedy at common law that could only be enforced in courts of law,” which “effectively decide[d] that this suit implicates the Seventh Amendment right, and that a defendant would be entitled to a jury.”⁸ The Court rejected the dissent’s position that the public rights exception applied, stating that the exception does not “extend to these civil penalty suits for fraud.”⁹ Notably, the Court did not reach the argument by *Jarkesy* that prior precedent overruled the public rights exception to permit the adjudication of civil penalty suits in administrative tribunals. The Court declined to reach the remaining constitutional issues.

Although the decision did not find SEC administrative proceedings to be unconstitutional altogether, it will cause serious complications for SEC enforcement. The Court has shut the door on SEC administrative proceedings that seek civil penalties, which are remedies at law, at least in litigated cases involving fraud. This means the SEC will not be able to prosecute such cases using the somewhat more efficient and streamlined processes of an administrative court, which lacks the extensive discovery devices, evidentiary rules, and other procedures applicable to civil litigation in federal district court.

Continuing Trend Curtailing SEC Enforcement Processes and Remedies

The Court’s decision in *Jarkesy* continues a trend. It builds upon a line of recent decisions curtailing the SEC’s enforcement processes and remedies.

Statute of Limitations. In *Kokesh v. SEC*, the Court held that a general five-year statute of limitations applied to SEC claims for disgorgement. There, the SEC brought an enforcement action against the owner of two investment-adviser firms for misappropriation of funds obtained from business development companies in violation of federal securities laws. Following a jury trial, *Kokesh* was found liable for multiple violations of federal securities laws and the federal district court imposed various remedies, including an order for disgorgement. On certiorari, the

⁶ *Id.* at 451.

⁷ *Securities and Exchange Commission v. Jarkesy*, No. 22-859, slip op. at 6 (June 27, 2024).

⁸ *Id.* at 11 (citation and internal quotation marks omitted).

⁹ *Id.* at 22.

Supreme Court confronted whether disgorgement is a penalty or forfeiture under 28 U.S.C. § 2462. A unanimous Court held that disgorgement is a penalty under the statute, and thus, disgorgement actions must be commenced within five years of the date of accrual.¹⁰

Appointments Clause. In 2018, the Court held in *Lucia v. SEC* that SEC ALJs are “Officers of the United States” within the meaning of the Appointments Clause, and thus, their appointment is subject to the requirements of the Appointments Clause.¹¹ There, an SEC ALJ had found that Lucia violated the law and imposed a civil penalty and sanctions. The Court ultimately found that the SEC did not comply with the Appointments Clause in appointing its ALJs, and thus, Lucia was entitled to a hearing before a “properly appointed official.”¹² The ramifications of this decision were felt by the SEC and across federal agencies, which regularly use ALJs to conduct administrative hearings, make findings of fact and law, and enforce orders.

Disgorgement. The Court limited the SEC’s disgorgement remedy in *Liu v. Securities and Exchange Commission*. There, the SEC brought an enforcement action against developers of a proposed cancer therapy, alleging that the developers funneled money received through an immigrant investor program to themselves and other improper uses. The district court granted summary judgment to the SEC, imposed a civil penalty, and ordered disgorgement equal to the amount the developers had raised from investors, minus the funds remaining in corporate accounts for the project. The Court granted certiorari to determine whether the SEC was authorized to “seek disgorgement beyond a defendant’s net profits from wrongdoing.”¹³ Although the Court upheld the SEC’s ability to seek disgorgement in federal court, it curtailed the remedy in important ways – requiring that disgorgement awards not exceed a wrongdoer’s net profits and be awarded to the victims of the unlawful conduct.¹⁴ Because the district court had declined to deduct business expenses from the disgorgement award, the Court vacated and remanded for further proceedings.¹⁵

Enjoining SEC APs. Most recently, in *Axon Enterprise, Inc. v. Federal Trade Commission*, the Court held that federal district courts have jurisdiction to hear constitutional challenges to agency enforcement action in federal court without having to wait for the agency proceedings to conclude.¹⁶ There, in a pair of cases, two individuals subject to an administrative enforcement action by the FTC and SEC, respectively, sued in federal court seeking to enjoin the agency proceeding. The individuals alleged that some aspect of the agency’s structure violates the Constitution, that the violation rendered the proceeding unlawful, and that they were injured as a result.¹⁷ The Court found that such constitutional challenges to agency structure could be subject to collateral review by a federal court because such claims “cannot receive meaningful

¹⁰ *Kokesh v. S.E.C.*, 581 U.S. 455, 457 (2017).

¹¹ *Lucia v. S.E.C.*, 585 U.S. 237, 251 (2018).

¹² *Id.* at 251-52 (citation and internal quotation marks omitted).

¹³ *Liu v. Securities and Exchange Commission*, 591 U.S. 71, 78 (2020).

¹⁴ *Id.* at 79-86.

¹⁵ *Id.* at 92. Congress codified the SEC’s ability to seek disgorgement and modified the application of statutes of limitations to disgorgement and certain other remedies, in the 2021 National Defense Authorization Act. NDAA § 6501, 134 Stat. at 4625-26 (2021).

¹⁶ *Axon Enterprise, Inc. v. Federal Trade Commission*, 598 U.S. 175, 180 (2023).

¹⁷ *Id.* at 182.

judicial review” through the relevant agency acts, they are collateral to decisions in individual enforcement proceedings, and they fall outside the agency’s area of expertise.¹⁸ This decision opened the door for collateral federal litigation during agency administrative enforcement proceedings.

Where Do We Go From Here?

Jarkesy opens a Pandora’s Box of questions for ongoing SEC enforcement and beyond. For example:

Settlements. Will the SEC continue to impose civil penalties in *settled* administrative proceedings? Although *Jarkesy* was a litigated case, the SEC might choose to settle civil penalties cases through federal court consent judgments rather than administrative proceedings further to avoid constitutional issues. On the other hand, over the past several years, while constitutional issues clouded various aspects of SEC administrative proceedings, the SEC continued to settle cases administratively including settlements for civil money penalties. Announced SEC settlements over the next several days might provide clues to this.

Focus on Fraud. Will the SEC seek to confine the holding in *Jarkesy* only to cases for fraud as opposed to non-fraud regulatory violations? At the end of the majority opinion, Justice Roberts summed up by saying: “[a] defendant facing a *fraud suit* has the right to be tried by a jury of his peers before a neutral adjudicator” and much of his opinion focuses on the nature of fraud cases as common law actions for private rights, to which the Seventh Amendment applies.¹⁹ On the other hand, the Court’s decision also focuses on the nature of civil money penalties, which are universally applicable to most SEC violations, as remedies at law warranting jury trials.

Effect on prior cases. Will the SEC revisit existing orders that imposed civil penalties in litigated administrative proceedings? There is precedent for that from several years ago when courts held that the Dodd-Frank Wall Street Reform and Consumer Protection Act did not allow for retroactive collateral bars in SEC administrative proceedings.

Resume Litigated Administrative Proceedings. Over the past couple of years, the SEC avoided litigating cases as administrative proceedings altogether while courts grappled with constitutional issues, opting instead for federal court. Now, even in matters not involving civil penalties or fraud cases – *i.e.*, matters not strictly covered by *Jarkesy* – will the SEC resume litigating administrative proceedings? Other constitutional challenges to administrative proceedings survive after *Jarkesy* and, as noted above, *Axon Enterprise* now allows respondents to challenge the constitutionality of administrative proceedings in parallel federal litigation.

Other Agencies. How will *Jarkesy* affect other federal administrative agencies? In her dissent, Justice Sotomayor predicts a widespread impact, expressing concern over “the

¹⁸ *Id.* at 195-96.

¹⁹ *Jarkesy*, slip op. at 27 (emphasis added).

momentous consequences that flow from the majority's insistence that the Government's rights to civil penalties must now be tried before a jury in federal court."²⁰

In the weeks and months ahead, securities enforcement and regulatory practitioners will keep a careful eye out for answers to these questions.

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²⁰ *Id.* at 33.