Supreme Court Punches SEC APs Right in the Seventh Amendment

June 28, 2024

Yesterday, in a long-awaited ruling with significant implications for the securities industry and administrative agencies more generally, the U.S. Supreme Court affirmed the Fifth Circuit's decision in *Jarkesy v. SEC*, holding that the Seventh Amendment right to a jury trial precluded the U.S. Securities and Exchange Commission (the "SEC") from pursuing monetary penalties for securities fraud violations through in-house administrative adjudications. The key takeaways are:

- The Court's ruling was limited to securities fraud claims, but other SEC claims seeking legal remedies may be impacted, as well as claims by other federal agencies that may have been adjudicated in-house previously.
- We expect that the SEC will continue its practice of bringing new enforcement actions in district court, except when a claim only is available in the administrative forum.
- Because of the majority decision's focus on fraud's common-law roots, the decision raises questions about whether the SEC may bring negligence-based or strict liability claims seeking penalties administratively.
- The Court did not resolve other constitutional questions concerning the SEC's administrative law judges, including whether the SEC's use of administrative proceedings violates the non-delegation doctrine and whether the SEC's administrative law judges are unconstitutionally protected from removal in violation of Article III.
- We anticipate additional litigation regarding these unresolved issues.

Background

In 2010, Congress expanded the SEC's enforcement authority through the passage of the Dodd-Frank Wall Street Reform Act ("the Act"). Among other things, the Act

permitted the SEC to pursue civil penalties in its in-house administrative tribunal to the same extent as it could pursue that relief in a civil enforcement action in district court. In administrative proceedings, historically, the SEC's Division of Enforcement brings the case before an administrative law judge ("ALJ"), appointed by the SEC, who makes the initial factual and legal determinations, which may then be "appealed" to the SEC itself.

In 2007, George Jarkesy established a hedge fund and selected Patriot28 LLC as the fund's investment adviser.[1] In 2009, he launched a second fund.[2] The two funds had approximately $24 million in assets under management from approximately 120 investors.[3] The SEC's enforcement division began investigating Jarkesy's and Patriot28's investing activities in 2011.[4]

In March 2013, the SEC commenced administrative proceedings against Jarkesy and Patriot28,[5] charging the respondents with violating various antifraud provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Advisers Act of 1940.[6] The Division of Enforcement alleged that they: "(1) misrepresented who served as the prime broker and as the auditor; (2) misrepresented the funds' investment parameters and safeguards; and (3) overvalued the funds' assets to increase the fees that they could charge investors."[7]

On October 17, 2014, an ALJ issued an initial decision and concluded that Jarkesy and Patriot28 had violated the antifraud provisions of the federal securities laws.[8] Jarkesy and Patriot28 then petitioned the SEC for review of the decision.[9] Six years later, on September 4, 2020, the SEC ruled against Jarkesy and Patriot28, largely affirming the

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1 *Jarkesy v. SEC*, 34 F.4th 446, 450 (5th Cir. 2022), cert. granted, 143 S. Ct. 2688 (2023) (hereinafter "*Jarkesy Circuit Op.*"); *see Jarkesy v. SEC*, 48 F. Supp. 3d 32, 34 (D.D.C. 2014), aff'd sub nom. *Jarkesy v. SEC*, 803 F.3d 9 (D.C. Cir. 2015) (finding that the district court had no jurisdiction over claims that proceedings infringed on constitutional rights, rejecting request for an injunction, and requiring Jarkesy and Patriot28 to continue with agency proceedings) (hereinafter "*Jarkesy D.D.C. Op.*").

2 *See* Order Instituting Administrative and Cease-and-Desist Proceedings at 2, *In the Matter of John Thomas Capital Management Group LLC, d/b/a Patriot28 LLC, George R. Jarkesy Jr., et al.* (https://www.sec.gov/files/litigation/admin/2013/33-9396.pdf) (hereinafter "OIP").

3 *Jarkesy Circuit Op.* at 450; Brief for Petitioners at 5, *George R. Jarkesy, Jr. and Patriot28, LLC v. SEC*, No. 20-61007 (5th Cir. May 17, 2021); *see SEC v. Jarkesy*, 603 U.S. ___ (2024), No. 22-859, slip op. at 4 (U.S. 2024) (hereinafter "*Jarkesy SCOTUS Op.*").

4 *See Jarkesy SCOTUS Op.* at 4; *Jarkesy Circuit Op.*, 34 F.4th at 450; *Jarkesy D.D.C. Op.*, 48 F. Supp. 3d at 34.

5 OIP at 2; *see also Jarkesy SCOTUS Op.* at 4–5.

6 OIP at 15–16 (listing charges); *see also Jarkesy SCOTUS Op.* at 5; *Jarkesy D.D.C. Op.*, 48 F. Supp. 3d at 34.

7 *Jarkesy Circuit Op.*, 34 F.4th at 450; OIP at 15–16; *see Jarkesy SCOTUS Op.* at 4.

8 *In the Matter of John Thomas Cap. Mgmt. Grp. LLC, d/b/a Patriot28 LLC, George R. Jarkesy, Jr., John Thomas Fin., Inc., & Anastasios Tommy Belesis*, Release No. 693 (Oct. 17, 2014) at 1.

9 *In the Matter of John Thomas Cap. Mgmt. Grp. LLC, d/b/a Patriot 28 LLC & George R. Jarkesy, Jr.*, Release No. 5572 (Sept. 4, 2020) (hereinafter "2020 SEC Op.").

ALJ and finding that they had committed various forms of securities fraud.[10] The SEC "impose[d] bars on Jarkesy; cease-and-desist orders on [both Jarkesy and Patriot28]; civil penalties of $300,000 on [both parties] jointly and severally; and disgorgement of $684,935.38 plus prejudgment interest on [Patriot28]."[11] The SEC also barred Jarkesy from participating in various securities industry activities, including "associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, [or] transfer agent."[12]

Jarkesy and Patriot28 appealed the agency's decision to the U.S. Court of Appeals for the Fifth Circuit. On May 18, 2022, the Fifth Circuit ruled in their favor, finding three constitutional defects in the proceedings against Jarkesy and Partiot28. Specifically, the Fifth Circuit found that: (1) they were deprived of their constitutional right to a jury trial;[13] (2) Congress had unconstitutionally delegated legislative power to the SEC by failing to provide it with an intelligible principle upon which to exercise the delegated power;[14] and (3) the statutory removal restrictions on the SEC's ALJs—who presently may be removed only "for cause"—violate the Take Care Clause in Article II of the Constitution.[15]

The SEC then appealed the Fifth Circuit's decision to the U.S. Supreme Court, which granted certiorari in June 2023 and issued an opinion approximately one year later, on June 27, 2024.[16] In a 6 to 3 ruling authored by Chief Justice Roberts, the Court affirmed the Fifth Circuit's ruling in *Jarkesy*, solely on the Seventh Amendment grounds.[17] Justices Gorsuch and Thomas concurred with the majority decision; Justices Sotomayor, Kagan, and Jackson dissented.

The Supreme Court's Ruling

Seventh Amendment Guarantees in Suits at Common Law

The Supreme Court's opinion addressed only the following question, which the majority described as a "straightforward" one: "whether the Seventh Amendment

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[10] 2020 SEC Op. at 1; *see Jarkesy Circuit Op.* at 450.

[11] 2020 SEC Op. at 2.

[12] 2020 SEC Op. at 29; *see also Jarkesy Circuit Op.* at 450.

[13] *Jarkesy Circuit Op.* at 453–54 (citing *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989)).

[14] *Jarkesy Circuit Op.* at 459.

[15] *Jarkesy Circuit Op.* at 451.

[16] *SEC v. Jarkesy*, 143 S. Ct. 2688 (2023).

[17] *Jarkesy SCOTUS Op.* at 27.

entitles a defendant to a jury trial when the SEC seeks civil penalties against him for securities fraud."[18] The majority answered this question in the affirmative.

The Seventh Amendment provides that "[i]n Suits at common law . . . the right of trial by jury shall be preserved."[19] This constitutional guarantee, the Court underscored, is not limited only to the "common-law forms of action recognized" at the time the Seventh Amendment was ratified, but extends to a statutory claim if the claim is "legal in nature."[20] The Court held that any curtailment of the Seventh Amendment right "should be scrutinized with the utmost care."[21]

The Court explained that when determining whether a suit is "legal in nature," courts must consider both the cause of action and the remedy.[22] The remedy is the "more important consideration," and money damages are the "prototypical" common law remedy.[23]

As applied to Jarkesy and Patriot28, the Supreme Court concluded that the remedy sought by the SEC—civil penalties—was dispositive as to whether the suit was legal in nature. The Court noted 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.'"[24] The Court reasoned that the statutory factors relevant to SEC penalties included several that concerned "culpability, deterrence, and recidivism," which "tie the availability of civil penalties to the perceived need to punish . . . rather than to restore the victim."[25] Accordingly, the Court concluded that civil penalties were legal in nature. The Court held that on this basis alone, Jarkesy and Patriot28 were entitled to a jury.[26] But the Court also noted that this conclusion is bolstered by the "close relationship" between federal securities fraud and common law fraud, as the causes of action in this case and common law fraud target "the same basic conduct: misrepresenting or concealing material facts."[27] The Court noted that Congress purposefully included the term "fraud" in the federal securities laws (*i.e.*, the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Advisers Act of

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18 *Jarkesy SCOTUS Op.* at 4.

19 U.S. CONST. amend. VII.

20 *Jarkesy SCOTUS Op.* at 8 (citing *Granfinanciera*, 492 U.S. at 53).

21 *Jarkesy SCOTUS Op.* at 7 (citing *Dimick v. Schiedt*, 293 U.S. 474, 486 (1935)).

22 *Jarkesy SCOTUS Op.* at 8 (citing *Tull v. United States*, 481 U.S. 412, 418–19 (1987)).

23 *Jarkesy SCOTUS Op.* at 8 (citing *Mertens v. Hewitt Associates*, 508 U.S. 248, 255 (1993)).

24 *Jarkesy SCOTUS Op.* at 9.

25 *Jarkesy SCOTUS Op.* at 10.

26 *Jarkesy SCOTUS Op.* at 21.

27 *Jarkesy SCOTUS Op.* at 11 (comparing 15 U.S.C. §§ 77q(a)(2), 78j(b), 80b–6(4); 17 CFR §§240.10b–5(b), 275.206(4)–8(a)(1), with Restatement (Third) of Torts: Liability for Economic Har §§ 9, 13 (2018)); *see id.* at 13.

1940), which demonstrates that Congress incorporated prohibitions from the common law into these statutes.[28]

"Public Rights" Exception Does Not Apply

Relying on its earlier decision in *Granfinanciera*, the Court rejected the SEC's argument that the "public rights" exception applies, which excuses the jury trial requirement in certain categories of cases involving matters that historically could have been determined exclusively by the executive and legislative branches. Examples of such matters include "the collection of revenue; aspects of customs law; immigration law; relations with Indian tribes; the administration of public lands; and the granting of public benefits."[29] The Court reasoned that the securities fraud actions at issue were closely analogous to common law fraud actions and therefore were not the sort of matters historically decided by the legislative or executive branches. The Court rejected the SEC's argument that the exception applies whenever Congress created a new claim and delegated those claims to an executive agency. It reasoned that construing the exception so broadly would make it too easy for the legislature to evade the Seventh Amendment's protections.

Unresolved Issues

The Supreme Court's opinion did not reach two of the constitutional questions considered and decided in the Fifth Circuit.[30] *First*, the Court did not address the Fifth Circuit's holding that Congress violated the non-delegation doctrine by authorizing the SEC to choose whether to pursue a civil penalty action before an administrative law judge or to litigate in an Article III court. *Second*, the Court did not opine on whether the SEC's structure violates Article II because of the tenure protections afforded to ALJs. A finding that these agency adjudicators are unconstitutionally protected from removal would have required the agency to fundamentally restructure itself and would have disrupted the core of its enforcement capabilities.[31]

Since the Fifth Circuit's decision, the SEC has been limiting or avoiding assigning new cases to ALJs and instead has assigned itself, *i.e.*, the five-member SEC, as the hearing officer in some cases. This strategy presents its own constitutional due process issues as there is no established procedure for the Commissioners to act as hearing officer in the

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[28] *Jarkesy SCOTUS Op.* at 11.

[29] *Jarkesy SCOTUS Op. Syllabus* at 4.

[30] *See Jarkesy SCOTUS Op.* at 27 ("We do not reach the remaining constitutional issues and affirm the ruling of the Fifth Circuit on the Seventh Amendment ground alone.").

[31] *See* Transcript of Oral Argument at 59, *SEC v. Jarkesy* (No. 22-859) (government underscoring that it is "a core exercise of executive power sometimes to adjudicate matters and apply the law to the facts and impose consequences" and noting "concern . . . [with] reexamin[ing] all of that . . . [and] the consequences it would have both jurisprudentially and practically").

first instance. And indeed, we understand that the SEC has itself never presided over an administrative hearing. It remains to be seen whether the SEC will change its practices now that a ruling from the Court is not imminent (though there is other litigation pending challenging administrative proceedings).

The majority decision's focus on fraud's long history at common law also raises important questions regarding the appropriate venue for the SEC's non-fraud causes of action—particularly the many negligence-based and strict liability claims set forth in the securities laws. Whether these often very technical violations implicate the "public rights" doctrine is unresolved by the Court's decision.

Looking Ahead

Jarkesy is an extremely important milestone in SEC jurisprudence as it confirms that SEC fraud claims seeking legal remedies, such as civil penalties, must be tried by a jury. As a practical matter, however, its impact may be limited in the near term, as the SEC has already been bringing nearly all of its new enforcement actions—whether sounding in fraud, negligence, or strict liability—in district court since the Supreme Court's *Lucia* decision, which addressed but declined to resolve the constitutional questions regarding the agency's use of ALJs. Although the majority's holding was limited to securities fraud cases, we expect the SEC to continue its existing practice of going to district court whenever possible, regardless of the claim.

We would expect there to be further litigation over whether other types of remedies, such as Rule 102(e) bars which prevent attorneys or accountants from appearing or practicing before the SEC, are punitive in nature and therefore require a jury trial. The SEC currently may only seek 102(e) relief in administrative proceedings and does not have the option of seeking such relief in district court. Due process and other challenges to such proceedings are also likely.

The decision also represents another significant loss by the SEC in the Supreme Court, and an additional setback in the courts more generally. It follows the SEC's recent losses in challenges to rulemakings, including its PFAR and proxy rules rulemakings, and comes in tandem with today's significant decision in *Loper Bright Enterprises v. Raimondo* (No. 22-451), reversing four decades of deference to federal agency expertise.

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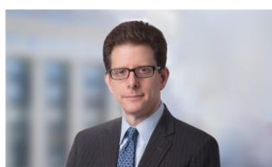

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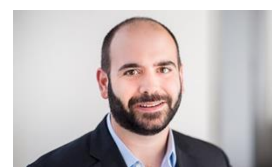

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