

ALERT

# SEC v. Jarkesy: SCOTUS Restores Constitutional Protections to Agency Enforcement Actions

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In a broadside to in-house agency adjudications, the U.S. Supreme Court affirmed the constitutional right to a jury trial for defendants in Securities and Exchange Commission (SEC) enforcement proceedings seeking civil penalties. While the impacts on the SEC and those under SEC investigation are likely minimal – though not illusory – *SEC v. Jarkesy* is certain to have ramifications across the Executive branch.

## Background

In the world of securities fraud, the facts of *Jarkesy* are unremarkable, save for the decade-long odyssey the defendant endured before his legal position was vindicated in the Supreme Court. In 2013, the SEC accused George Jarkesy, a hedge fund manager and radio host, of violating the anti-fraud provisions of the securities laws. The SEC alleged that Jarkesy and his firm, Patriot28, misled investors about two hedge funds they managed, which had over 100 investors and \$24 million in assets. Specifically, the SEC claimed Jarkesy and Patriot28 made false statements to investors, manipulated asset valuations, and misused investors' funds.

Instead of filing charges in federal court, the SEC opted to pursue its case through its internal administrative process. This meant the case would be heard by an administrative law judge (ALJ) employed by the SEC and, importantly, without a jury. After a 12-day hearing in 2014, the SEC ALJ found Jarkesy liable for securities fraud, ordering him to pay a \$300,000 civil penalty and disgorge \$685,000 in illicit profits. Jarkesy appealed the decision to the full Commission, which affirmed the ALJ's ruling.

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Throughout the process, Jarkesy argued that the SEC's administrative proceedings violated his Seventh Amendment right to a jury trial. He further challenged the constitutionality of the ALJ's removal protections and the agency's unfettered discretion to choose to pursue enforcement between administrative proceedings, where procedural rights can be curtailed, and federal court.

### **The Fifth Circuit Decision**

The Fifth Circuit agreed with Jarkesy. In May 2022, a divided panel for the Fifth Circuit found in Jarkesy's favor on three key grounds. *First*, the court held that the SEC's in-house adjudication of fraud claims seeking civil penalties violated Jarkesy's Seventh Amendment right to a jury trial. *Second*, the court found that Congress unconstitutionally delegated legislative power to the SEC by allowing it to choose between administrative proceedings and federal court without providing an "intelligible principle" to guide the agency's decision. *Finally*, the divided panel held that the statutory removal protections for the SEC's ALJs violated Article II of the Constitution and separation of powers.

### **SCOTUS Weighs in**

In its much-anticipated 6-3 decision, the Supreme Court agreed that Jarkesy was deprived of his right to a jury. The Court held that when the SEC seeks to impose civil penalties for fraud, defendants retain their Seventh Amendment rights. Writing for the majority, Chief Justice Roberts emphasized the historical significance of the jury trial right in Anglo-American jurisprudence, particularly in cases involving fraud and monetary penalties.

First, the Court held that the SEC's antifraud provisions were an analogue to common law fraud and, therefore, "must be heard by a jury." The Court explained that the Seventh Amendment extends to statutory claims which "are designed to punish and deter, not to compensate." As such, the claims against Jarkesy "could only be enforced in courts of law."

Second, the Court rejected the SEC's argument that the "public rights" exception applied. The Court explained that if a claim is "in the nature of an action at common law, then the matter presumptively concerns private rights, and adjudication by an Article III court is mandatory." The Court cited the similarities between the antifraud provisions of federal securities law and common law fraud, stating that the provisions "target the same basic conduct as common law fraud, employ the same terms of art, and operate pursuant to similar legal principles." Congress could not, therefore, "withdraw" these statutory fraud claims "from judicial cognizance."

Notably, the Court expressly declined to go as far as the Fifth Circuit to reach the issues of nondelegation and ALJ removal protections, affirming only on the Seventh Amendment ground.

### **Takeaways**

While the full implications of *Jarkesy* remain unclear, observers will be watching closely as the SEC and other agencies react to the decision.

- **Impact on the SEC.** *Jarkesy* is unlikely to impact the SEC's current approach to actions seeking civil penalties for securities fraud. Since litigants began challenging the SEC's administrative proceedings as unconstitutional, the SEC has brought the vast majority of those cases in federal court. *Jarkesy* will likely carve that practice in stone, at least where the SEC Enforcement staff believes penalties are a necessary remedy for the alleged conduct.

While the SEC's choice of forum may be minimally affected, everything is not rosy for potential SEC defendants. The SEC Enforcement Division prosecutes its cases through an experienced trial unit with a high success rate in litigated matters. As anyone who has litigated against the SEC knows, as a specialized government litigant, the SEC has litigation advantages not available to those engaged in everyday commercial litigation. Those include, among other advantages, the ability to investigate for years pre-filing using subpoenas to compel the production of documents and testimony, and the ability to coordinate with the U.S. Department of Justice to force defendants into asserting their Fifth Amendment Rights in the SEC's investigation and litigation, resulting in a damaging adverse inference.

Yet, despite these inherent advantages, those facing an SEC Enforcement action may be able to deploy *Jarkesy* in settlement negotiations to improve their ultimate resolution with the SEC. Pressing the SEC in federal court pre-trial litigation and discovery consumes time and resources for the trial unit, who may be less likely to support the filing of marginal cases – or cases of marginal importance – in federal court, leading the Enforcement staff to accept diminished remedies or lesser charges as part of a negotiated resolution.

Finally, some legal commenters speculate that we may see the SEC implement a right of removal to federal court. The SEC may argue that allowing defendants the option to remove their cases from the agency to federal court would dispel Seventh Amendment issues and fit with the essential holding of *Jarkesy*.

- **Implications for Other Federal Agencies.** The SEC is not the only agency that will need to shift its approach to enforcement. As Justice Sotomayor explains in her dissent, at least two dozen agencies impose civil penalties in administrative proceedings, including the Consumer Financial Protection Bureau (CFPB). Indeed, many agency enforcement regimes are largely indistinguishable from the one at issue in *Jarkesy*. And some of those agencies rely on revenue from penalties to support their budgets. To the extent these agencies pursue claims with a common law analogue, or that otherwise seek to impose penalties designed for deterrence, we can expect litigants to marshal *Jarkesy* in support of future challenges. *Jarkesy* thus stands as a warning for agencies, including the CFPB, to review their statutory enforcement procedures and, specifically, determine whether those procedures might be vulnerable to challenge. It also provides defendants with leverage in negotiations, particularly in cases where the agency is asserting novel interpretations of laws or regulations that may be more difficult to pass muster before a federal court judge than an ALJ.
- **ALJ Removal Protections.** As mentioned above, the Court declined to reach the issue of whether the robust removal protections for ALJs render their authority unconstitutional. This issue is not going away. Cases challenging ALJ removal protections are working their way through the lower courts, and it is

only a matter of time before the Supreme Court will need to face the issue head-on. This remains a critical question for agencies like the Federal Trade Commission (FTC), which can choose to bring enforcement actions before its own ALJ rather than in federal court.

- **The Supreme Court's Trend Toward Limited Agency Powers.** *Jarkesy* will also have an important interplay with other administrative law decisions this term. In particular, the Court's decision in *Loper Bright Enterprises v. Raimondo* overruled the *Chevron* doctrine and held that the Administrative Procedures Act prohibits courts from deferring to agency interpretations of statutes simply because the statutes are ambiguous. Parties dealing with potential enforcement matters likely will argue that federal courts should not defer to agencies' interpretations of laws and regulations they enforce, particularly novel interpretations that agencies seek to establish through enforcement actions.

At bottom, the implications of *Jarkesy* are yet to be realized. While the immediate ramifications for the SEC are expected to be relatively minimal, expect other agencies to take preemptive measures in light of the Court's decision. Out of an abundance of caution, some agencies may opt to follow the SEC's lead and bring their most consequential claims to federal court if they have that ability. Further, it is reasonable to expect litigants to continue to press the constitutional issues *Jarkesy* left on the table, as they perceive this Court to be more inclined to cabin administrative power.