

## U.S. Supreme Court Declares Unconstitutional SEC's Admin Courts Hearing of Fraud Cases When Seeking Civil Penalties

On June 27, 2024, the U.S. Supreme Court in *SEC v. Jarkesy* struck a major blow to the U.S. Securities and Exchange Commission's enforcement powers by declaring as unconstitutional the SEC's use of its in-house administrative courts when seeking civil penalties against defendants charged with securities fraud. The high court's ruling not only places in doubt the SEC's use of the administrative court forum to pursue civil penalties other than in fraud cases but also raises legitimate concerns about the authority of other administrative agencies to pursue the same type of administrative relief.

### How did we get here?

In 2013, the SEC's administrative court system found George Jarkesy violated various antifraud provisions of the Securities Act, the Securities Exchange Act, and the Advisers Act, and as a result, ordered him and his investment advisory firm, Patriot28 LLC, to pay a penalty of \$300,000 and disgorge \$685,000 in illicit profits. Jarkesy was also barred from the industry.

Jarkesy appealed the decision to the U.S. Fifth Circuit Court of Appeals, which held that the SEC's use of its administrative courts for seeking civil penalties for alleged violations of the antifraud provisions of the U.S. securities laws violates an individual's constitutional right to a trial by jury under the Seventh Amendment. Additionally, the Fifth Circuit concluded that the SEC's administrative courts system was unconstitutional because it violated the:

- i. Nondelegation Doctrine by improperly delegating legislative authority to a federal agency and
- ii. Take Care Clause of Article II by the SEC's creation of impermissible removal protections for Administrative Law Judges (ALJs).

The SEC appealed the decision to the Supreme Court.

### How did the Supreme Court rule?

In a 6-3 decision, the Supreme Court upheld the Fifth Circuit ruling, finding that the Seventh Amendment guarantees the right to a trial by jury for statutory claims that are legal in nature. To determine which of those claims are legal in nature, the Court examined whether the cause of action resembles a suit at common law that would have been heard by a jury and whether the remedy sought is one that is traditionally obtained in a court of law. The Court found that the civil penalties sought by the SEC in an alleged fraud action are legal in nature because they are the prototypical common law remedy designed to punish culpable defendants. The Court further found a close relationship between federal securities fraud and common law fraud, namely that both claims target the same conduct of false or misleading statements. Accordingly, the Court concluded that the Seventh Amendment applies such that the SEC's claims should have been heard at a trial by a jury.

The SEC argued that the Jarkesy case was properly brought as an administrative action without a jury consistent with the Seventh Amendment because the public rights exception applied to Jarkesy's case. The public rights exception provides that an Article III court is not necessary where the claim being adjudicated concerns matters of public rights (e.g., collection of revenue, immigration laws, and certain aspects of customs law). However, the Court rejected the notion that Congress' passage of Dodd-Frank in 2010, empowering the SEC to pursue civil penalties in the administrative context, was alone sufficient to make the antifraud claims against Jarkesy a matter of public rights. Rather, the Court concluded that suits at common law or ones brought under the



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statutory analog have a presumption of being subject to Article III review, and what ultimately matters is the substance of the action at bar – not how it is labeled, who brings it, or where it is brought. Here, and as discussed above, the Court found that an antifraud claim seeking civil penalties designed as a form of punishment or deterrence is inherently legal in nature and, as a result, implicates an individual’s private (not public) rights.

Notably, the Majority opinion did not address the Fifth Circuit’s other two rulings regarding the nondelegation doctrine or the removal protections for the SEC’s ALJs.

## What does this all mean?

*Jarkesy* is a groundbreaking decision that now forces the SEC to shift its strategy for how it will pursue its securities fraud cases and possibly other cases as well.<sup>1</sup> If the SEC desires to pursue a civil penalty against an individual for a claim rooted in common law, it can no longer utilize the forum of an administrative court proceeding. Which claims are legal in nature may not be easy to determine, and we should expect to see the lower courts struggle with the question of whether a particular claim has roots in the common law.

The Supreme Court’s ruling pushes the SEC’s administrative courts closer to an era before the passage of the 2010 Dodd-Frank legislation where these adjudicatory bodies heard securities cases about complex SEC Rules and were only authorized to grant equitable remedies such as industry suspensions and bars. Examples of potential claims still suited for the administrative proceeding would be registration revocation actions brought pursuant to Section 12(j) of the Exchange Act as well as disciplinary proceedings against accountants, lawyers, or other experts appearing before the Commission pursuant to SEC Rule of Practice 102(e).

The relative decrease in administrative proceedings filed by the SEC over the last year arguably signals that the Commission may have been anticipating a loss of its administrative court proceedings as the forum of choice for its enforcement cases. However, it has still been a common practice for the SEC to institute administrative proceedings for purposes of entering into settlements with defendants, especially if the defendants are broker-dealers, investment advisers, or other regulated persons and entities. It remains an open question, however, whether the SEC will recalibrate its approach to certain causes of action and pursue a resolution by obtaining a final judgment in an Article III proceeding to foreclose any possible legal challenges after *Jarkesy*.

Looking ahead, the SEC’s litigation of securities cases in Federal District Court is simply a far more expensive and time-consuming process than going through the SEC’s administrative courts. The rules of evidence and discovery are more robust and create far more inroads for litigants to pursue their defenses. In fact, even the Majority in *Jarkesy* recognized the stark reality that the SEC has had a historically higher rate of success when pursuing civil penalties in an administrative context as opposed to a court of law. It remains an open question how much this decision will impact an agency like the SEC, which has only finite resources but aims to implement and enforce what can best be described as an ambitious enforcement agenda promulgated under the Gensler regime. If *Jarkesy* does lead to significant limitation of the SEC’s administrative courts authority, we may see an enforcement division that is more selective about litigation and more apt to settle cases on terms more favorable for defendants.

Finally, perhaps the biggest question of all is what *Jarkesy* means for other federal agency adjudicatory court systems. As Justice Sotomayor wrote in her dissent, “the constitutionality of hundreds of statutes may now be in peril, and dozens of agencies could be stripped of their power to enforce laws enacted by Congress.” In other words, federal government agencies that are also authorized to impose civil penalties in administrative forums, such as the Federal Energy Regulatory Commission, the Consumer Financial Protection Bureau, and the Occupational Safety and Health Review Commission, may be confronted with challenges of their own, and for some agencies, that could present as an even greater challenge than it does for the SEC because they do not have the ability to pursue such relief in a Federal District Court.

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<sup>1</sup> Perhaps that strategy shift started to occur in 2018 specifically with fraud actions, as the SEC has

only filed them in District Court since the Supreme Court required the SEC to reappoint its ALJs in a manner consistent with the ruling in *Lucia v. SEC*.

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