BRACEWELL

Supreme Court Declares SEC Lacks In-House Authority to Impose Civil Penalties

Update

July 01, 2024 | 4 minute read

The United States Supreme Court struck another major blow to the Securities Exchange Commission's enforcement arsenal, finding that its oft-used practice of imposing monetary penalties in its in-house administrative proceedings violates the Seventh Amendment's right to a jury trial. The Court's ruling in *SEC v. Jarkesy* is a profound blow to the Securities Exchange Commission's (the SEC or Commission) enforcement program and may have broader impact on the enforcement abilities of other federal agencies.

Background

This case originated from an SEC administrative proceeding against George R. Jarkesy Jr. (Jarkesy), his firm Patriot28 LLC (Patriot28), and other former co-parties, in which the SEC alleged that Jarkesy, his firm, and others committed fraud under the Securities Act, the Securities Exchange Act and the Investment Advisers Act. Jarkesy and Patriot28 initially sued the SEC in the United States District Court for the District of Columbia to enjoin the administrative proceeding, but that court and the US Court of Appeals for the DC Circuit held that it would only have jurisdiction to review any constitutional challenges to the administrative proceeding after an adverse final order. Accordingly, the administrative proceedings against Jarkesy and Patriot28 went forward, and the administrative law judge (ALJ) concluded that Jarkesy and Patritot28 committed securities fraud. Jarkesy and Patriot28 then sought review from the full Commission, which affirmed the ALJ's ruling. The SEC ordered Jarkesy and Patriot28 to pay $300,000 in civil penalties, ordered Patriot28 to disgorge $685,000 in illegal profits and barred Jarkesy from various securities industry activities. On appeal, the US Court of Appeals for the Fifth Circuit vacated the SEC decision, finding that the SEC's in-house administrative enforcement

Related People

Matthew
Partner
DALLAS
+1.214.758.1039
matthew.nielsen@bracewell.com

Nicole
Partner
NEW YORK
+1.212.508.6103
nicole.boeckmann@bracewell.com

Anissa
Associate
NEW YORK
+1.212.938.6403
anissa.adas@bracewell.com

Related Practices

Government Enforcement & Investigations
Litigation

proceedings are unconstitutional based on several grounds, in a decision on which we previously reported.

The Court's Decision

The three federal securities antifraud provisions are Section 17(a) of the Securities Act, Section 10(b) and Rule 10b-5 of the Securities Exchange Act, and Section 206 and Rule 206(4)8 of the Investment Advisers Act. To enforce these antifraud provisions, the SEC may either file a suit in federal district court or institute a proceeding through its in-house courts. In federal district court, the case is overseen by an Article III federal judge, the defendant has a right to a jury trial if the SEC seeks monetary relief, and the federal rules of procedure and evidence govern. In contrast, in an SEC administrative proceeding, an ALJ appointed and funded by the Commission presides as judge and factfinder, the ALJ determines the scope and form of permissible evidence and may admit hearsay and other testimony that would be inadmissible in federal court, and an appeal is to the full Commission, which upholds the vast majority of ALJ decisions. Federal court review of an administrative proceeding is available, but by law, a reviewing court must treat the agency's factual findings as "conclusive" if sufficiently supported by the record.

As may be expected, the administrative process has historically provided the SEC with a significant home-court advantage and the SEC wins more often than it does when in federal court. The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 gave the SEC the ability to seek monetary penalties against anyone in administrative proceedings, which up to then had been limited to cases against securities firms and professionals. Against this backdrop, the Court considered the constitutionality of the SEC's administrative proceedings.

Writing for the majority, Chief Justice Roberts began with the text of the Seventh Amendment, which confers the right to a jury trial in "suits at common law." Noting that securities fraud is rooted in common law and the civil penalties authorized by the securities laws are designed to punish and deter the defendant, rather than compensate victims, the Court held that the Seventh Amendment right to a jury trial was implicated.

The issue thus became whether the public rights exception to the Seventh Amendment applied, which would allow a non-Article III Court to preside over the case. The public rights exception recognizes a class of cases concerning public rights, as opposed to private rights, that have historically been left exclusively to the executive and legislative branches. Some categories of cases implicating public rights are those involving immigration, relations with Native American tribes and the administration of public lands.

In its holding, the Court determined that securities fraud did not fall within any category of cases implicating public rights. That Congress had assigned securities fraud cases to the Commission rather than to federal courts exclusively was not dispositive. Rather, the Court focused on the fact that the substance of a securities fraud claim was more akin to a traditional legal claim involving private rights, and that as such, the SEC must seek monetary penalties in federal court.

Impact of *SEC v. Jarkesy*

The Court's decision in *Jarkesy* will have a massive impact on the SEC's enforcement program. While the SEC had already begun to ratchet down its use of administrative proceedings based on constitutional challenges, the Court's ruling now severely limits the types of cases that can be brought administratively. Beside the home-court advantage that the administrative process provides, its in-house courts generally give the SEC a quicker avenue to prosecute cases with less resources than required in a federal court case. While there still remains other remedies that the SEC may pursue in an administrative proceeding, civil penalties are among the Commission's most powerful and often-used tools to combat securities fraud. Because the Commission will need to pursue virtually all securities fraud cases in federal court, its resources will be stretched further without additional personnel or a decrease in its litigated cases.

Jarkesy may have a more profound impact on other federal agencies' enforcement programs. In a strongly worded dissent joined by Justices Elena Kagan and Ketanji Brown Jackson, Justice Sonya Sotomayor warned of the "momentous consequences" of the majority's ruling, noting the more than two dozen federal agencies that can impose civil penalties in administrative proceedings. She argued this decision "means that 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." Justice Sotomayor pointed out that unlike agencies like the SEC, the Consumer Financial Protection Bureau, the Environmental Protection Agency, and the Federal Trade Commission, all who may pursue civil penalties in both administrative proceedings and federal court, other federal agencies such as the Occupational Safety and Health Administration and the Federal Energy Regulatory Commission operate under statutes that allow civil penalties only in agency enforcement proceedings. While *Jarkesy* was limited to the SEC's administrative process, there is little doubt that litigants will use the decision to attack the ability to obtain civil penalties in other federal agency administrative proceedings.