Proskauer

Supreme Court Bars SEC Administrative Proceedings for Civil Penalties

Corporate Defense and Disputes on **June 27, 2024**

The U.S. Supreme Court held that the Seventh Amendment to the U.S. Constitution entitles a defendant to a jury trial when the Securities and Exchange Commission seeks to impose civil penalties for violations of the federal securities laws. The decision in *SEC v. Jarkesy* means that the SEC must file enforcement actions in federal court, rather than before an administrative law judge, when it seeks civil penalties for alleged securities fraud.

The *Jarkesy* ruling on its face is somewhat limited: it applies only to enforcement proceedings seeking civil penalties, and it addresses only the Seventh Amendment considerations that such proceedings raise. The decision might not cover administrative enforcement proceedings seeking other types of relief, such as disgorgement or injunctive relief, and it does not address whether any constitutional issues other than the Seventh Amendment might bar those proceedings. Nevertheless, the Court's ruling will limit the SEC's ability to proceed in an administrative forum against alleged wrongdoers, and it could lead to further attacks on administrative proceedings based on grounds not covered here.

Background

The *Jarkesy* litigation began as an SEC enforcement proceeding before an in-house administrative law judge ("ALJ"). The SEC alleged that the defendants – the founder and the investment adviser of two hedge funds – had committed fraud under the Securities Act, the Securities Exchange Act, and the Investment Advisers Act by misrepresenting the funds' investment strategies, misrepresenting the identities of the funds' auditor and prime broker, and overvaluing the funds' assets to increase the fees chargeable to investors.

After procedural wrangling about whether the administrative proceeding infringed on defendants' constitutional rights and whether defendants could enjoin it on that basis, the ALJ held an evidentiary hearing and concluded that defendants had committed securities fraud. The Commission affirmed the ALJ's conclusions and ordered defendants to cease and desist from future violations, pay a civil penalty, and disgorge ill-gotten gains. The Commission also rejected defendants' various challenges to the constitutionality of the ALJ proceeding.

Defendants sought review from the U.S. Court of Appeals for the Fifth Circuit, which – in a divided 2-1 decision – granted the petition and vacated and remanded the Commission's rulings. The majority held that (*i*) the ALJ administrative proceeding had deprived defendants of their constitutional right to a jury trial under the Seventh Amendment, (*ii*) Congress had unconstitutionally delegated legislative power to the SEC by granting it sole discretion to choose between administrative and judicial proceedings without prescribing an "intelligible principle" to guide the SEC's exercise of that delegated authority, and (*iii*) the statutory removal restrictions on SEC ALJs violate Article II of the Constitution by imposing two layers of for-cause protection, impeding the President's ability to remove ALJs.

The SEC sought *en banc* rehearing from the Fifth Circuit, which denied the petition in a 10-6 split. The Supreme Court granted certiorari and affirmed in a 6-3 decision, reaching only the Seventh Amendment issue.

Supreme Court Decision

The majority opinion, by Chief Justice Roberts, held that the SEC's enforcement proceeding implicates the Seventh Amendment because the securities laws' anti-fraud provisions "replicate common law fraud, and it is well established that common law claims must be heard by a jury." The majority rejected the contention that the "'public rights' exception" to Article III jurisprudence applies here "because the present action does not fall within any of the distinctive areas involving governmental prerogatives where the Court has concluded that a matter may be resolved outside of an Article III court, without a jury."

Seventh Amendment's Applicability

The Court began with the principles that the Seventh Amendment “extends to a particular statutory claim if the claim is legal in nature” and that governmental actions to recover statutory civil penalties “historically ha[ve] been viewed as [a] type of action in debt requiring trial by jury.” “What 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.”

Examining the civil penalties available under the securities laws, the Court concluded that they were designed at least in part to punish and deter.

- Of the six statutory factors determining the availability of civil penalties, three of them involved “culpability, deterrence, and recidivism.” Because those factors “tie the availability of civil penalties to the perceived need to punish the defendant rather than to restore the victim, such considerations are legal rather than equitable.”
- The considerations affecting the size of the available remedy are also legal in nature because they condition the penalty “on the culpability of the defendant and the need for deterrence, not the size of the harm that must be remedied.”
- In addition, “the SEC is not obligated to return any money to victims,” so the civil penalty is punitive, not remedial.

The Court also reasoned that “the close relationship between the causes of action in this case and common law fraud” confirm that statutory securities-fraud claims are the “type of remedy at common law that could only be enforced in courts of law,” with a right to a jury trial.

Inapplicability of “Public Rights” Exception

The Court held that the “public rights” exception to the Seventh Amendment and Article III jurisprudence does not apply to the claims at issue here. That exception historically applied only to matters that “could have been determined exclusively by [the executive and legislative] branches, . . even when they were presented in such form that the judicial power [wa]s capable of acting on them.” But “if a suit 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.”

In this case, the Court ruled, private rights were at issue. The securities laws' anti-fraud provisions "provide civil penalties, a punitive remedy that we have recognized could only be enforced in courts of law," and "they target the same basic conduct as common law fraud, employ the same terms of art, and operate pursuant to similar legal principles." Congress therefore could not withdraw the action "from judicial cognizance."

Other Justices' Opinions

Justice Gorsuch, joined by Justice Thomas, concurred in the majority opinion but wrote a separate concurrence explaining that "other constitutional provisions reinforce the correctness" of the majority's holding on the Seventh Amendment issue. Justice Gorsuch opined that "the Seventh Amendment's jury-trial right does not work alone"; it operates together with Article III, which "entitles individuals to an independent judge who will preside over that trial," and the Due Process Clause, which "promises any trial will be held in accord with time-honored principles."

Justice Sotomayor dissented, joined by Justices Kagan and Jackson. The dissent concluded that, "throughout our Nation's history, Congress has authorized agency adjudicators to find violations of statutory obligations and award civil penalties to the Government as an injured sovereign." The dissenters warned that "more than 200 statutes authoriz[e] dozens of agencies to impose civil penalties for violations of statutory obligations" and that "Congress had no reason to anticipate the chaos today's majority would unleash after all these years."

Implications

The Court's ruling on the Seventh Amendment appears to apply only to the SEC's (and perhaps other government agencies') enforcement proceedings to obtain civil penalties, which are considered legal rather than equitable relief. The SEC will now need to bring such actions in federal court, where a jury-trial right exists, instead of before ALJs in an administrative proceeding. For those who believe that SEC ALJ proceedings unduly favor the SEC and disadvantage the defendant, the decision will be viewed as a victory for present and future defendants faced with enforcement proceedings. The SEC now will likely be forced to proceed in federal court in many instances, rather than before ALJs.

Jarkesy's Seventh Amendment ruling, however, does *not* appear to apply where the SEC (or some other agency) seeks relief other than civil penalties. As the Court noted: "What 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*" (emphasis added). Similarly, the Court observed that, although "only courts of law issued monetary relief to punish culpable individuals," "courts of equity could order a defendant to *return unjustly obtained funds*" (emphasis added). Thus, *Jarkesy*'s Seventh Amendment analysis might not apply where the SEC (or some other agency) seeks disgorgement or injunctive relief.

However, *Jarkesy* addressed only the Seventh Amendment arguments against ALJ proceedings. The majority did not consider the other points the Fifth Circuit had decided: (*i*) the allegedly unconstitutional delegation of legislative power to the SEC to exercise sole discretion to choose between administrative and judicial proceedings in the absence of an "intelligible principle" to guide the SEC's exercise of that discretion and (*ii*) the allegedly unconstitutional statutory removal restrictions on SEC ALJs. Nor did the majority address the Article III and due-process arguments that Justices Gorsuch and Thomas raised in their concurrence.

Thus, if the SEC (or another agency) tries to avoid *Jarkesy*'s restrictions by bringing administrative proceedings only for disgorgement or injunctive relief, one can imagine that litigants might raise the panoply of arguments that the majority did not address. Accordingly, the assault on ALJ administrative proceedings probably is not over if the SEC (or some other agency) continues to use them as an alternative to suits in an Article III federal court. And potential challengers appear likely to have at least two votes (from Justices Gorsuch and Thomas) in support of their contentions.

Moreover, to the extent the dissent is correct that the majority's ruling could affect the authority of "dozens of agencies" to impose civil penalties under "more than 200 statutes," *Jarkesy* could have a major impact on administrative proceedings across the board and could channel those actions into federal court.

View original.