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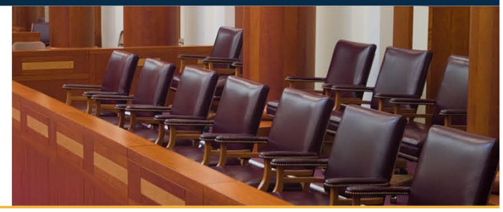
Client Alert | Investment Management and Securities Litigation & Enforcement



Supreme Court Limits SEC's Home Field Advantage

The U.S. Supreme Court on June 27 affirmed a decision by the U.S. Court of Appeals for the Fifth Circuit holding that when the U.S. Securities and Exchange Commission (SEC) seeks civil monetary penalties in an action to enforce the anti-fraud provisions of the federal securities laws, the Seventh Amendment entitles the defendant to a jury trial in federal district court.[1] In a 6-3 decision in *SEC v. Jarkesy*, Chief Justice John Roberts wrote the opinion for the majority finding that Congress, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), cannot eliminate the constitutional right to a jury trial by allowing common law claims to be pursued in an executive branch agency's administrative tribunal.

Legal and Procedural Background

In the wake of the financial crisis, Congress passed the Dodd-Frank Act in 2010, which granted the SEC the authority to seek civil monetary penalties in either the federal courts or through its own internal proceedings. In doing so, Congress codified a home field advantage for the SEC.[2]

Prior to the decision in *Jarkesy*, the SEC had two avenues to enforce the federal securities laws in civil actions. The first option was to bring the action in a federal district court where the defendant has a right to a jury trial, during which a presidentially appointed judge is required to apply the Federal Rules of Civil Procedure, conferring full discovery obligations on the SEC, as well as the Federal Rules of Evidence, restricting the SEC's ability to introduce irrelevant or inflammatory information and hearsay. The second option was to bring an administrative proceeding in which an SEC administrative law judge (ALJ) presides over the case. Under the Securities Act of 1933 (Securities Act), the Securities Exchange Act of 1934 (Exchange Act) and the Investment Advisers Act of 1940 (Advisers Act), among others, final orders of the commission affirming an ALJ's decision are reviewable before a U.S. court of appeals.

In 2013, the SEC sued investment adviser George Jarkesy Jr. in its administrative forum before an ALJ, charging, among other things, violations of the anti-fraud provisions of the Securities Act, the Exchange Act and the Advisers Act. Jarkesy sought to enjoin the action by filing suit in the U.S. District Court for the District of Columbia, alleging that the proceeding violated numerous provisions of the Constitution, including his right to a jury trial.[3] The district court dismissed the complaint on jurisdictional grounds, finding that Jarkesy was required to defend himself in the administrative proceeding and could only appeal to a U.S. court of appeals after

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[1] *SEC v. Jarkesy*, No. 22-859 (U.S. June 27, 2024).

[2] One report found that during its study period, the SEC won 90% of its actions adjudicated in-house versus 69% of the cases decided by a court. (See *Jarkesy*, slip op. at 3 (Gorsuch, J., concurring).)

[3] *Jarkesy v. SEC*, 48 F. Supp. 3d 32 (D.D.C. 2014).

receiving a final order from the SEC.[4] Subsequently, the ALJ issued an initial decision finding that Jarkesy violated the anti-fraud provisions of the federal securities laws under which he was charged, ordered him to pay civil monetary penalties and disgorge ill-gotten gains, and permanently barred him from operating as an investment adviser.[5] The SEC upheld the ALJ's findings.[6]

Jarkesy filed a petition for review in the Fifth Circuit, which ruled in favor of Jarkesy and vacated the SEC's decision on the following constitutional grounds: (1) the SEC's "in-house" proceeding violated the Seventh Amendment right to a jury trial; (2) Congress unconstitutionally delegated legislative power to the SEC by failing to provide an intelligible principle by which the SEC would exercise the delegated power; and (3) statutory removal restrictions on the SEC ALJs violate the Take Care Clause of Article II of the Constitution.[7] The Supreme Court granted certiorari on all three issues but only ruled on the right to a jury trial.[8]

Jarkesy Was Entitled to a Jury Trial

The Supreme Court ruled that where the SEC seeks civil monetary penalties for violations of the anti-fraud provisions of the federal securities laws, defendants are entitled to a jury trial pursuant to the Seventh Amendment of the Constitution.[9] The Seventh Amendment guarantees that in "[s]uits at common law ... the right of trial by jury shall be preserved."[10] The right "extends to a particular statutory claim" such as the federal securities laws that are rooted in common law and, therefore, are "'legal in nature.'"[11] The court rejected the SEC's insistence that the "public rights" doctrine eliminates the right to a jury trial simply because the agency's claims were brought pursuant to federal statutes.[12]

The SEC's Claims Against Jarkesy Are 'Legal in Nature': In determining that the SEC's claims against Jarkesy were legal in nature, the court looked to the cause of action and whether the relief sought was the type typically obtained in suits at common law.[13] The court stated that the "close relationship" between the statutory causes of action against Jarkesy and common law fraud established that the SEC's claim was legal in nature.[14] The court found that Congress incorporated prohibitions from common law fraud into the federal securities laws by using "'fraud' and other common law terms of art" in the various statutes.[15] The court acknowledged that while there are differences between federal securities fraud and common law fraud, there is a "close relationship" between the two, serving as further confirmation that SEC enforcement actions pursuant to the anti-fraud provisions of the federal securities laws are legal in nature.[16]

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[4] *Id.*

[5] *Jarkesy*, slip op. at 4-5.

[6] *Id.* at 5.

[7] *Jarkesy v. SEC*, 34 F.4th 446 (5th Cir. 2022), *cert. granted*, 143 S. Ct. 2688 (2023).

[8] *Jarkesy*, slip op. at 6, 7.

[9] *Id.* at 27.

[10] U.S. Const. amend. XII.

[11] *Jarkesy*, slip op. at 8 (quoting *Granfinanciera SA v. Nordberg*, 492 U.S. 33 (1989)).

[12] *See id.* at 13.

[13] *See id.* at 9.

[14] *Id.* at 13.

[15] *Id.* at 11.

[16] *Id.*

As some causes of action sound in both law and equity, the court looked to the remedy sought by the SEC to determine whether the claims against Jarkesy were legal in nature and, therefore, guaranteed him the right to a jury trial.[17] The SEC sought civil monetary penalties against Jarkesy, which the court found are "prototypical common law remed[ies]" that can only be enforced in courts of law.[18] Further, if the remedy seeks to punish and deter, rather than restore the status quo, the right to a jury trial is implicated because such a remedy can only be enforced in a court of law.[19] To determine that the remedy sought against Jarkesy was designed to punish and deter, rather than restore the status quo, the court looked at the considerations that determine the availability of a civil penalty under the applicable statutes, the factors that determine the size of the available remedy, and that the SEC is not required to return civil monetary penalties to victims.[20] These factors, the court held, demonstrated that the remedy was punitive and, therefore, the claims against him were legal in nature.[21]

The Public Rights Exception Does Not Apply: While the Seventh Amendment guarantees the right to a jury trial in all legal matters, the SEC maintained that defendants subject to enforcement actions were not entitled to a jury trial because the "public rights" exception applied.[22] Under the public rights exception, Congress may assign certain matters to an agency to adjudicate. The court, relying on the first case to recognize the public rights doctrine, held that the Constitution prohibits "'withdraw[ing] from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law."[23]

Ensuring that the public rights exception did not "swallow the rule" that guarantees the right to a jury trial, the court held that the exception is only available when Congress creates new rights that involve "'remedies ... unknown to the common law.'"[24] Conversely, when Congress grants statutory rights to an agency that parallel common law claims, such as those provided for under the securities laws, the public rights exception will not apply. To hold otherwise, the court emphasized, would violate the role of the judiciary laid out in the Constitution: "Under 'the basic concept of separation of powers ... that flow[s] from the scheme of a tripartite government' adopted in the Constitution, 'the judicial Power of the United States' cannot be shared with the other branches."[25]

Because the SEC's claims against Jarkesy constituted "traditional legal claims" that mirrored common law fraud claims and the remedy sought against him was punitive, the court determined that the public rights exception did not apply, and the claims must be heard before a jury.[26]

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[17] *Id.* at 8-9 (citing *Granfinanciera*, 492 U.S. at 33; *Tull v. United States*, 481 U. S. 412 (1987)).

[18] *Id.* at 9 (citing *Mertens v. Hewitt Associates*, 508 U.S. 248 (1993)). The court acknowledged that monetary relief, in general, can be legal or equitable. To determine whether a monetary remedy is legal, the court will look to whether the relief is designed to punish or deter the wrongdoer, or if it is to restore the status quo. In applying these principles, the court determined in *Tull* that civil penalties are a type of remedy at common law that can only be enforced in courts of law. (*Id.* (citing *Tull*, 481 U.S. at 422).)

[19] *Id.* (citing *Tull*, 481 U.S. at 422).

[20] *Id.* at 9-11.

[21] *Id.* at 11.

[22] *Atlas Roofing v. OSHA*, 430 U.S. 442 (1977).

[23] *Murray's Lessee v. Hoboken Land & Improvement*, 18 How. 272, 284 (1856).

[24] *Jarkesy*, slip op. at 24 (quoting *Atlas Roofing*, 430 U.S. at 461).

[25] *Id.* at 13-14.

[26] *Id.* at 26-27.

Key Takeaways

- As a result of the *Jarkesy* decision, the SEC must bring all actions to enforce the anti-fraud provisions of the federal securities laws that seek monetary penalties in federal district court, where the defendant is entitled to a jury trial. Federal district courts provide other protections, such as an Article III judge to preside over the proceeding, the application of the Federal Rules of Evidence, and the benefits of civil discovery. In addition, federal courts are no longer required to defer to the SEC's interpretation of the federal securities laws following the court's June 28 holding in *Loper Bright Enterprises v. Raimondo*,[27] and the forum also demands a higher evidentiary standard for certain claims and some forms of relief. In federal court, certain claims and forms of relief are not available to the SEC.
- The opinion could affect the SEC's ability to use the administrative forum as a clearinghouse for settled matters involving fraud or civil penalties. Entities and individuals facing enforcement actions should be sure that they understand the legal requirements for the SEC to prove liability and obtain injunctions, disgorgement, penalties and industry bars in federal court, as well as any benefits that they may gain or lose by settling such matters administratively.
- While *Jarkesy* addresses fraud, the guarantee of a jury trial before an Article III court could apply to other federal securities law violations rooted in common law principles and relief that serve to punish rather than restore the status quo. It remains to be seen how the SEC will interpret the decision and which, if any, matters the agency elects to adjudicate in its administrative forum. Moreover, the court did not decide the delegation and removal issues involving the ALJs and, thus, did not determine the constitutionality of the forum. Nonetheless, the *Jarkesy* decision alters the playing field for the SEC and entities and individuals facing any enforcement matter should be sure to understand how the decision affects them.
- The decision is not likely to lead to a significant increase in the number of SEC enforcement cases in the federal district courts. The SEC has significantly curtailed its use of its administrative forum in recent years, given numerous Supreme Court decisions that distinguished between legal and equitable relief and other matters that addressed the legitimacy of the administrative forum, including, but not limited to, *Jarkesy*'s challenges, which began at the SEC.
- When confronting an SEC or any other regulatory enforcement action, entities and individuals should be certain that they have consulted experienced enforcement and trial counsel knowledgeable about federal court practice and procedure as well as the claims and relief available in the forum to guide them through such matters, whether they chose to litigate or settle.

[27] *Loper Bright Enterprises v. Raimondo*, No. 22-451, (U.S. June 28, 2024).

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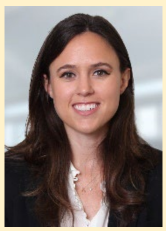

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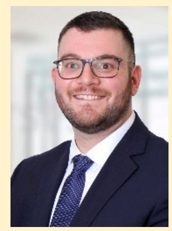

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