

## Supreme Court limits the SEC's use of in-house administrative courts

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(July 01, 2024) - Holland & Knight attorneys Allison Kernisky and Patrick Selwood consider the U.S. Supreme Court's recent decision in *Securities and Exchange Commission v. Jarkesy* and its likely impact on administrative proceedings.

### Highlights

The Supreme Court held that defendants charged with securities fraud and facing civil penalties have the right to a jury trial in federal court under the Seventh Amendment.

The holding limits the SEC's use of its in-house administrative courts, but the immediate impact is likely dulled given the Commission's lessened use of administrative proceedings in such cases in recent years.

The decision may have far-reaching implications for other federal agencies' use of their own in-house courts for administrative proceedings seeking civil penalties.

### Introduction

On June 27, 2024, the U.S. Supreme Court ("Court") issued a highly anticipated decision in *Securities and Exchange Commission v. Jarkesy*, holding that, absent a defendant's consent, the Securities and Exchange Commission ("SEC" or "Commission") must bring securities fraud actions seeking civil penalties in federal court, rather than through administrative proceedings in its own in-house courts.<sup>1</sup>

In a 6-3 majority opinion penned by Chief Justice John Roberts, the Court held that the Seventh Amendment of the U.S. Constitution entitles a defendant to a jury trial for claims at common law — like the fraud claims brought by the SEC under federal securities laws — and that the "public rights doctrine" — a narrow exception to the Seventh Amendment's guarantee — did not apply to these kinds of actions.

This decision will pose significant issues for the SEC's currently pending, though relatively few, administrative proceedings, as well as for the SEC's continued use of its administrative courts for enforcement actions seeking civil penalties in the future.

More broadly, the Court's decision likely will have collateral implications for federal courts, as well as other federal administrative agencies and policy makers, as future litigation challenging whether and to what extent other federal agencies can adjudicate claims through administrative tribunals may be on the horizon.

## **Background**

### **I. Administrative proceedings**

This case arises out of a civil enforcement action initiated by the SEC against hedge-fund manager George Jarkey Jr. ("Jarkey") and his advisory firm Patriot28, LLC ("Patriot28") (collectively, the "Respondents").<sup>2</sup>

In 2011, the SEC began investigating Respondents for alleged violations of federal securities laws. The SEC had the choice of two forums in which it could bring an enforcement action: file a complaint in federal court or adjudicate the matter itself in its own administrative courts.<sup>3</sup>

The SEC opted for the latter and initiated an administrative proceeding against Respondents in March 2013, for allegedly misleading investors and inflating the value of certain investments to charge higher management fees, in violation of Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act, and Section 206 of the Investment Advisers Act.

Initially, Respondents sought judicial relief by contemporaneously filing a complaint and motion for a temporary restraining order in the U.S. District Court for the District of Columbia, requesting that the court enjoin the administrative proceeding because, Respondents claimed, the SEC violated (and would continue to violate) their various statutory and constitutional rights.

But those efforts were unsuccessful because the district court, and later the U.S. Court of Appeals for the D.C. Circuit, refused to enjoin the SEC on the grounds that: (i) the district court lacked subject matter jurisdiction because Respondents failed to exhaust their administrative remedies;

and (ii) even if those deficiencies were not so, judicial review of a final order from the SEC, which had not been issued at that time, must take place in a federal court of appeals, not the district court.

Accordingly, Respondents had to continue with the agency proceedings and petition the court of appeals to review any adverse final order.

In February and March of 2014, there was an evidentiary hearing before an SEC administrative law judge ("ALJ"). In October 2014, the ALJ issued an initial decision, finding that Respondents had committed securities fraud, and ordering an array of monetary penalties and sanctions.<sup>4</sup>

Respondents appealed the ALJ's order to the Commission. Eventually, in September 2020 — nearly six years after Respondents appealed, and nine years after the SEC had first investigated them — the Commission affirmed the ALJ's initial decision with slight modifications to the sanctions imposed.

The Commission ordered Respondents to cease and desist from committing or causing any future violations of federal securities laws, to pay a \$300,000 civil penalty jointly-and-severally, for Patriot28 to disgorge nearly \$685,000 in alleged ill-gotten gains plus prejudgment interest, and barred Jarkesy from a wide range of participation in the securities industry.<sup>5</sup>

Respondents appealed to the Fifth Circuit, challenging the SEC's decision on three constitutional grounds, discussed below.

## **II. The Fifth Circuit Court of Appeals overturns the ALJ's decision**

A divided three-judge panel of the Fifth Circuit overturned the SEC's judgment, finding that the Commission's use of administrative adjudicative proceedings suffered from three independent constitutional defects, namely that: (1) the administrative proceedings violated Respondents' Seventh Amendment right to a jury trial; (2) Congress had unconstitutionally delegated legislative power to the SEC by granting it discretion to choose the forum for enforcement actions; and (3) the statutory removal restrictions on SEC ALJs violated the President's removal power under Article II of the Constitution.<sup>6</sup>

The Fifth Circuit denied Respondents' request for a rehearing *en banc*, and the Supreme Court granted certiorari to consider the Commission's challenges to all three constitutional bases of the Fifth Circuit's decision.

## The court's decision

In a 6-3 majority opinion authored by Chief Justice Roberts, the Court held that the SEC's judgment against Respondents violated the Seventh Amendment because Respondents were entitled to a trial by jury in federal court.

Justices Clarence Thomas, Samuel Alito, Neil Gorsuch, Brett Kavanaugh, and Amy Coney Barrett joined the majority opinion. Justice Gorsuch authored a concurring opinion joined by Justice Thomas, and Justice Sonia Sotomayor issued a dissenting opinion, joined by Justices Elena Kagan and Ketanji Brown Jackson.

In reaching this holding, the Court employed the two-step analysis set out in *Granfinanciera, S.A. v. Nordberg*,<sup>7</sup> which asks: (i) whether the action against the respondents implicates the Seventh Amendment; and if so, (ii) whether the "public rights" exception applies, which permits Congress, under certain circumstances, to assign an action to an agency tribunal without a jury.

At the first, threshold step, the Court determined that the claims brought against Respondents were of the type that implicates the Seventh Amendment.

The Court explained that the claims levied against Respondents authorize common law-type remedies, like civil penalties, which are "designed to punish and deter, not to compensate," and thus "could only be enforced in courts of law."<sup>8</sup> Moreover, the Court underscored the "close relationship between federal securities fraud and common law fraud," noting they "target the same basic conduct," "employ the same terms of art," and "operate pursuant to similar legal principles."<sup>9</sup>

As for the second step, the Court rejected the SEC's arguments (embraced by the dissent) that the public rights exception applied, reasoning that the SEC's action against Respondents "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.<sup>10</sup>

The Court concluded that "Congress cannot conjure away the Seventh Amendment by mandating that traditional legal claims be ... taken to an administrative tribunal," and "the fact that the SEC action 'originated in a newly fashioned regulatory scheme, does [not] permit Congress to siphon this action away from an Article III court."<sup>11</sup>

Notably, because its resolution of the Seventh Amendment question resolved the case, the Court did not address the other two issues on which it granted certiorari.

The Court's majority opinion is met with both concurring and dissenting opinions that are, perhaps not unexpectedly, interesting reading.

Justice Gorsuch's concurrence, joined by Justice Thomas, purports to "reinforce the correctness" of the majority opinion, while also offering a far broader, unvarnished critique of the public rights exception.

The concurrence explains that the Court's decision is actually supported by three constitutional provisions, all of which work together to "vindicate the Constitution's promise of a 'fair trial in a fair tribunal,'" namely: Article III, which "entitles individuals to an independent judge who will preside over that trial"; the Fifth Amendment's Due Process Clause, which promises any trial will be held in accord with time-honored principles"; and of course, the Seventh Amendment's guarantee to a trial by jury.<sup>12</sup>

Drawing on the historical genesis and application of these principles, along with the substantive and procedural protections they provide, Justice Gorsuch likens the "modern development" of the administrative proceedings to many of the historical abuses of power that lead to the creation of the aforementioned-constitutional provisions.

Grounding this observation in the case at hand, Justice Gorsuch observed that the SEC's fairly recent shift to ALJs deprived Jarkesy of the right to an independent judge and a jury as well as the many procedural protections federal court provide.

In this way, the concurrence is notable for its treatment and discussion of prior decisions, in particular *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n*,<sup>13</sup> — relied on by the government and Justice Sotomayor's dissenting opinion.

In *Atlas Roofing*, the Court upheld as constitutional OSHA's authority to impose civil penalties through its in-house adjudication, explaining that Congress may constitutionally adopt "new statut[es]" assigning matters that qualify as "public rights ... to an administrative agency."

Justice Gorsuch called the practical implementation of *Atlas* "wholly unworkable," and espoused a view of a very limited set of circumstances that he believes should qualify as public rights while stopping short of calling for an abandonment of the public rights exception altogether.<sup>14</sup>

In her dissenting opinion, Justice Sotomayor (joined by Justices Kagan and Jackson) called the majority opinion a "power grab."<sup>15</sup> Relying heavily on *Atlas*, the dissent argues that "[a] faithful and straightforward application" of the Court's longstanding precedent should have resolved

*Jarkesy* in favor of the SEC. Finding unpersuasive the majority's attempts to distinguish *Atlas*, the dissent observed that going forward the Court's makes it "almost impossible" to discern what is a public right.

But the dissent's criticisms went further, lambasting the majority opinion as a direct contravention of the separation of powers. By disregarding well-established precedent and "telling Congress that it cannot entrust certain public-rights matters to the Executive because it must bring them first into the Judiciary's province," the Court's decision, according to the dissent, "oversteps its role and encroaches on Congress's constitutional authority."<sup>16</sup>

The dissent envisioned a post-*Jarkesy* future in which hundreds of federal statutes are overturned, and power is stripped from dozens of federal agencies that at present can impose civil penalties in administrative proceedings (including the Commodity Futures Trading Commission, the Department of Justice, the Consumer Financial Protection Bureau, the Department of the Treasury, and the Food and Drug Administration, among others).

The dissent further noted that some agencies, such as OSHA, the Federal Regulatory Commission, the Department of Agriculture, and others, can pursue civil penalties *only* in agency enforcement proceedings. According to Justice Sotomayor, "[f]or those and countless other agencies, all the majority can say is tough luck; get a new statute from Congress."<sup>17</sup>

## Implications and key takeaways

### Immediate and long-term implications for the SEC

The Court's decision is yet another blow to the SEC coming on the heels of recent setbacks like the Fifth Circuit's decision vacating the Private Funds Advisers Rule and the Commission's ongoing pause of the implementation of its new climate disclosure rule while it defends the regulation in court plus the Court's landmark decision to overturn the *Chevron* deference doctrine in *Loper Bright Enterprises v. Raimondo*.<sup>18</sup>

The ruling will most certainly have an immediate effect on the SEC's enforcement efforts in several ways.

First, and of immediate concern to the Commission, there are some currently pending administrative actions that may need to be re-filed in federal court if the respondents file motions to dismiss *en masse* or the SEC may opt to voluntarily drop its claims in some instances.

However, as a practical matter, the direct impact of the Court's decision is somewhat blunted because the SEC has used administrative proceedings rarely in recent years following the Court's 2018 decision in *Lucia v. SEC*, a trend that may accelerate. In other words, the Commission's day-to-day decision making on which cases to bring and where to bring them may not change all that much.

Second, the Court's decision is unlikely to impact a respondent's ability to settle a matter as an administrative proceeding after an enforcement investigation, even if that settlement involves a penalty.

There are practical reasons why a respondent might elect to have their action filed as a fully settled administrative case and be willing to waive their right to a jury trial. For instance, they may believe there are benefits to doing so such as potentially avoiding a press release or receiving a cease-and-desist order instead of an injunction, among other things.

Third, the Court's holding only addresses certain administrative proceedings under the anti-fraud statutes seeking civil penalties. Actions where the SEC is not seeking a money penalty but is attempting to bar or suspend a respondent or non-fraud actions or other actions that do not arise under common law likely can still be adjudicated by ALJs.

Longer term, the SEC will have to evaluate closely which cases it is willing to pursue in federal court. The Commission does not have unlimited resources and it may be forced to file fewer cases.

In any given year, the SEC only takes a handful of cases to trial, undoubtedly those actions which it believes it has the best chance of winning. The Court's decision may require the SEC to think twice before filing a complaint in federal court to conserve its resources for actions where it believes it is positioned to receive the highest penalties or set the most impactful example.

## **Litigation effects**

The clear winners here are the parties that currently, or may in the future, find themselves on the other side of the table from the SEC in actions under the anti-fraud statutes. These defendants will enjoy the benefits of having their cases heard in federal court, including: 1) more formal and predictable rules of procedure and evidence; 2) a more equitable discovery process and more



clearly-defined timing; 3) a neutral Article III judge not employed by the agency that is prosecuting the action; and 4) not least of all, a decision reached by a jury of their peers.

These likely are some of the reasons the SEC has not reached the same levels of success in federal court, where the Commission prevails 69 percent of the time, as in its in house proceedings, where the SEC's success rate is closer to 90 percent, as pointed out by Justice Gorsuch in his concurrence.<sup>19</sup> Without this home court advantage, the Commission is not likely to prevail as often, which may lead to it pursuing fewer enforcement actions.

Another consideration is that federal district courts are likely to see an uptick in their already busy dockets as more cases are litigated there. And the Court's decision, particularly when combined with its recent overturn of the *Chevron* deference doctrine, could lead to litigation *against* the SEC or potentially other federal agencies brought by defendants who believe the agency is acting outside its authority or in forum challenges.

### **Impact on other federal agencies**

The great unknown, for the moment, is what impact the Court's decision will have on other federal agencies, if any. To be sure, respondents facing administrative proceedings before other agency's in-house courts will be eager to cite to *Jarkesy* in challenges to those courts' authority. More broadly, agencies may need to implement short- and long-term changes for where and how they pursue enforcement actions.

In his concurring opinion, Justice Gorsuch signals that the Court's majority is skeptical of federal agency power more generally and takes a narrow view of the public rights exception to the Seventh Amendment. This suggests that challenges to agency administrative forums may soon find their way into federal court.

Finally, the Court did not address the other two constitutional issues — nondelegation and removal protections — which remain unanswered for the time being but may serve ultimately as further bases to curtail or even eliminate the SEC's (and potentially other federal agencies') use of administrative proceedings.

#### **Notes:**

1 *S.E.C. v. Jarkesy*, No. 22-859, 2024 WL 3187811 (June 27, 2024).



2 See *In the Matter of John Thomas Cap. Mgmt. Grp. LLC, d/b/a Patriot28 LLC, George R. Jarkesy, Jr., John Thomas Fin., Inc., & Anastasios Tommy Belesis*, Release No. 693 (Oct. 17, 2014) (ALJ's findings and order).

3 Prior to implementation of the Dodd-Frank Act in 2010, the SEC was limited to filing suit in federal court to seek civil penalties against unregistered entities. The act authorized the Commission to pursue such claims in administrative proceedings.

4 *In the Matter of John Thomas Cap. Mgmt. Grp. LLC, d/b/a Patriot28 LLC, George R. Jarkesy, Jr., John Thomas Fin., Inc., & Anastasios Tommy Belesis*, Release No. 693 (Oct. 17, 2014) (ALJ's findings and order).

5 See *Jarkesy v. S.E.C.*, 34 F.4th 446, 450 (5th Cir. 2022); see also *In the Matter of John Thomas Cap. Mgmt. Grp. LLC, d/b/a Patriot 28 LLC; & George R. Jarkesy, Jr.*, Release No. 5572 (Sept. 4, 2020) (Commission's order and opinion) (note, the ALJ's decision and the Commissioner's opinion vary on the penalty and disgorgement amounts).

6 See *Jarkesy v. S.E.C.*, 34 F.4th 446, 449 (5th Cir. 2022).

7 492 U.S. 33 (1989).

8 *S.E.C. v. Jarkesy*, No. 22-859, 2024 WL 3187811, at \*9 (June 27, 2024).

9 *Id.* at \*9, 14.

10 *Id.* at \*7.

11 *Id.* at \*14 (citations and quotations omitted).

12 *Id.* at \*17 (Gorsuch, J. concurring) (quoting *In re Murchison*, 349 U.S. 133, 136 (1955)).

13 430 U.S. 442 (1977).

14 *S.E.C. v. Jarkesy*, No. 22-859, 2024 WL 3187811, at \*25 (June 27, 2024) (Gorsuch, J. concurring).

15 *Id.* at \*44 (Sotomayor, J. dissenting).

16 *Id.* at \*46 (Sotomayor, J. dissenting).

17 *S.E.C. v. Jarkesy*, 2024 WL 3187811, at \*45.

18 No. 22-451 (June 28, 2024).

19 *S.E.C. v. Jarkesy*, 2024 WL 3187811, at \*18.

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