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Evolution of Administrative Adjudication Post-*Jarkesy*

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On June 27, 2024 the US Supreme Court released its 6-3 decision in *SEC v. Jarkesy, et al.,* ending the Securities and Exchange Commission's (SEC) long-standing use of in-house Administrative Law Judge (ALJ) tribunals in cases involving allegations of fraud in which the SEC seeks civil penalties.[1] The majority held that the Seventh Amendment entitles the defendant to trial by jury when the SEC seeks civil penalties for securities fraud, thus requiring that the action be brought in a court of law. This effectively closes one of the SEC's key enforcement avenues for seeking financial penalties when it believes investors have been misled and forces the SEC to bring more of its actions in courts of law.

This decision is a significant step towards limiting the authority of a number of federal agencies, not just the SEC. It arises from years of resistance to ALJ adjudication by the defense bar and other recent decisions by the Supreme Court that together diminish the authority of the administrative state overall.

While *Jarkesy* dealt explicitly with SEC enforcement via ALJ proceedings, in the months since this decision, the majority's reasoning has been used to challenge ALJ proceedings across a number of federal agencies. Similarly, the majority's reasoning is being used by litigants in SEC administrative proceedings to contest not just claims for civil penalties, but other types of penalties including bans on working in the securities industry. Whether enforcement actions can be brought by agencies internally and when to challenge the legitimacy of such enforcement actions is a salient issue for regulated entities and individuals.

Background on *Jarkesy*

Jarkesy arose from a 2011 SEC investigation into George Jarkesy's hedge funds and investment adviser, Patriot28. The SEC instituted an administrative enforcement action against Jarkesy and Partiot28 before an ALJ for securities fraud claims involving alleged mismanagement of the hedge funds in violation of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Advisers Act of 1940.

Jarkesy initially challenged the constitutionality of the SEC's administrative enforcement powers in federal court,[2] but he was ultimately required to proceed through the SEC's administrative process first. In the SEC administrative proceeding, an ALJ found, and the SEC affirmed, that Jarkesy and Patriot28 had committed various forms of securities fraud and ordered them to pay civil penalties. Pursuant to the judicial review provisions of the relevant statutes,

Jarkesy and Patriot28 appealed their constitutional challenge to the Fifth Circuit Court of Appeals.

In May 2022, a divided three-judge panel in the Fifth Circuit agreed with Jarkesy and Patriot28 that the SEC proceedings suffered from three independent constitutional defects: (1) Jarkesy and Patriot28 were deprived of their constitutional right to a jury trial; (2) Congress unconstitutionally delegated legislative power to the SEC by failing to provide it with an intelligible principle by which to exercise the delegated power; and (3) statutory removal restrictions on SEC ALJs violate Article II of the Constitution.

The Supreme Court's Decision

A majority of the Supreme Court affirmed the Fifth Circuit as to the first point, holding that the Seventh Amendment requires that actions in which the SEC seeks civil penalties for securities fraud be brought in a court of law where the defendant is entitled to trial by jury.

Notably, the Supreme Court did not address the nearly $685,000 that the SEC had ordered in disgorgement against Jarkesy, nor did it rule on the industry bar imposed on Jarkesy.[3] Rather, the Court's analysis focused on whether the SEC could impose civil penalties in-house for securities fraud violations.

The majority opinion, authored by Chief Justice John Roberts, determined that a defendant facing such civil penalties must be afforded the right to a jury trial because (1) civil fraud is akin to common law fraud, which is traditionally heard by juries, and (2) the SEC's civil penalties, which are designed to punish and deter rather than to compensate, are sanctions that at common law could only be enforced in courts of law. Chief Justice Roberts noted that pursuant to the so-called public rights exception, agencies can internally adjudicate some types of cases, however, the exception must be used sparingly. He suggested that punitive penalties do not come within the public rights exception and concluded that when a claim shares the same base conduct as a common law claim and the enforcement remedies for that conduct include civil penalties, the action involves a private right and is not covered by the exception.

The majority did not reach the other two constitutional issues raised by the Fifth Circuit concerning the nondelegation doctrine and removal restrictions on SEC ALJs, noting that the Seventh Amendment issue resolved the case in its entirety.

The three-Justice dissent authored by Justice Sonia Sotomayor argued that this ruling represents "a seismic shift in this court's jurisprudence," noting that "[t]he 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."[4]

Use of ALJs

ALJ tribunals are used by dozens of federal agencies to prosecute violations of statutes and regulations.[5] Some agencies, like the SEC, have the ability to address statutory violations either in internal administrative proceedings or by filing claims in federal court.[6] Others, like the Federal Deposit Insurance Corporation, the Federal Reserve, and Office of the Comptroller of the Currency, can only seek civil penalties in administrative proceedings.[7]

Differences between Federal Court and ALJ Proceeding

One of the reasons this decision is important is that the ALJ process provides the SEC with certain home court advantages. According to a 2015 report, the SEC won approximately 90 percent of contested matters in ALJ proceedings, compared with about 69 percent of cases litigated in district court.[8]

This is attributable, at least in part, to differences in the process and protections afforded litigants in federal court versus in ALJ proceedings.[9] Discovery in ALJ tribunals is both limited and on an expedited timeline, meaning respondents are afforded less opportunity to accumulate evidence. As underscored in *Jarkesy*, ALJ proceedings do not afford respondents the opportunity to be heard by a jury of their peers. Additionally, the SEC serves as both

judge and prosecutor in ALJ proceedings, whereas in federal court, the judiciary is in a separate branch of government from the prosecution which maintains its neutrality.

Prior Supreme Court Decisions Limiting Agency Enforcement

Jarkesy is within a line of other recent Supreme Court decisions that have limited the power of federal agencies. In June 2018, the Supreme Court held in *Lucia v. SEC* that ALJs are officers of the United States and must be appointed by the president, a court of law, or department head rather than SEC Staff.[10] In April 2023, the Supreme Court held in *Axon v. FTC* (consolidated with *Cochran v. SEC*) that parties may raise constitutional challenges to the Federal Trade Commission's (FTC) and SEC's in-house administrative proceedings directly to district courts without having to first exhaust the administrative process, finding that the constitutionality of a proceeding is a "here-and-now" injury that merits immediate review.[11] Most recently, in *Loper Bright Enterprises v. Raimondo*, announced the day after *Jarkesy*, the Supreme Court overruled *Chevron* deference in certain circumstances, expanding the ability of courts to review and disagree with agency determinations and rulemaking.[12]

Aftermath of *Jarkesy*—Expansion of Argument to Industry Bar

Given the increased scrutiny on both the SEC's ALJ proceedings and agency action generally, the SEC had begun backing away in large part from using its administrative courts for contested cases even before *Jarkesy*.

In the wake of *Jarkesy*, the SEC seems to be adapting its approach. The SEC recently dropped misconduct charges against at least eight accountants who had faced suspensions or permanent bars for charges stemming from poor audit work.[13] Among these cases was an action against a Marcum LLP partner who had been challenging the SEC's administrative enforcement process in federal court.[14] The SEC declined to comment on the reason for these dismissals, but such action in the wake of *Jarkesy* seems to indicate that the SEC is now adjusting its approach and may be concerned that *Jarkesy* could be read to cover bars and suspensions as well as financial penalties.[15]

In fact, litigants are already working to extend the application of the *Jarkesy* holding, arguing that it applies to require trial by jury not just for claims involving civil penalties, but also to claims seeking to impose a ban on future work in the securities industry. The SEC commonly files follow-on administrative proceedings seeking to prevent investment advisers and brokers from continuing to work in the industry after a conviction in court or settlement with the agency. These are now in jeopardy.

In August 2024, Emmanuel Lemelson filed a lawsuit in D.C. district court seeking to prevent the SEC from banning him from the securities industry after a jury found him liable for making misleading statements.[16] Lemelson argues that like *Jarkesy*, the case against him does involve a financial punishment—a ban from working in the industry—and that he is being prosecuted in an administrative proceeding in violation of the Seventh Amendment.[17] The success of this argument will hinge on whether an industry bar is a punishment, potentially supporting an argument for a jury trial, or is equitable relief, which provides no right to a jury trial.[18]

Application in Other Administrative Proceedings

In light of *Jarkesy*, other federal agencies that impose civil penalties in administrative proceedings, including the Consumer Financial Protection Bureau and the Commodity Futures Trading Commission, may be reexamining their use of ALJs and in-house tribunals in enforcement actions involving punitive remedies and common law-like claims.

Recently, the Eastern District of Pennsylvania rejected a broker's bid to use *Jarkesy* to challenge Financial Industry Regulatory Authority's (FINRA)

enforcement authority, finding that the broker, D. Allen Blankenship, had not met the requirements for collaterally challenging an administrative enforcement in federal court.[19] In evaluating whether Blankenship's Seventh Amendment claim was wholly collateral to the administrative proceeding, the judge found that his claims were not wholly collateral because rather than challenge FINRA's existence, the "Seventh Amendment claims rest on whether FINRA's relevant rules, guidance, and penalties, properly interpreted and construed, show that the claims asserted against Mr. Blankenship sufficiently resemble common law causes of actions with legal remedies."[20] In a way, reliance on *Jarkesy* thus undermined Blankenship's argument.

Looking Ahead

The limitations imposed on the SEC and other financial regulators by the *Jarkesy* decision may increase these agencies' incentives to settle. While the SEC—unlike some of its counterpart financial regulators—can bring claims in federal court in lieu of internal adjudication, federal litigation is resource-intensive, and the SEC will have to be strategic about which and how many cases it can feasibly litigate.

The SEC still prioritizes, and rewards, cooperation and self-reporting. Regulated entities and individuals should continue to leverage these avenues where available to maximize their chances for a favorable settlement outcome.

Takeaways

The majority's analysis strongly suggests that any enforcement action by the SEC or other federal agency designed to punish or deter an individual, other than those that fall under the limited public rights exception, must proceed in federal court.[21]

As a result of the *Jarkesy* decision, the SEC is unlikely to litigate securities fraud matters before ALJs. Rather, SEC investigations will proceed with the understanding that if no settlement is reached, the SEC will have to litigate its case before a federal judge and jury. As we have already seen, administrative proceedings may result in even further federal court challenges to agency adjudication.

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NOTES

1 The case is SEC v. Jarkesy, 144 S. Ct. 2117 (2024).

2 Jarkesy first filed his constitutional claim in the District Court for the District of Columbia and it reached the US Court of Appeals for the D.C. Circuit before being remanded to the SEC administrative process.

3 *Id*.

4 *Jarkesy*, 144 S. Ct. at 2173–2174 (Sotomayor, J., dissenting).

5 Approximately 30 federal agencies have ALJs. ALJs by Agency, U.S. Office of Personnel Management (last visited Oct. 2, 2024), *https://www.opm.gov/services-for-agencies/administrative-law-judges/#url=By-Agency*; *Jarkesy*, 144 S. Ct. at 2173 (Sotomayor, J., dissenting) ("there are, at the very least, more than two dozen agencies that can impose civil penalties in administrative proceedings").

6 The SEC is authorized by the Securities Exchange Act of 1934, the Securities Act of 1933, and the Investment Advisers Act of 1940 to address statutory violations either by bringing lawsuits in federal court or by instituting its own administrative proceedings. These administrative enforcement proceedings typically involve an initial adjudication by an ALJ and a subsequent review by the SEC. Final SEC decisions are appealable directly to federal courts of appeals.

7 Jon Hill, "SEC's High Court Loss May Sting For Banking Enforcement," *Law360* (Jul. 1, 2024), *https://www.law360.com/articles/1853403/sec-s-high-court-loss-may-sting-for-banking-enforcement*.

[8] D. Thornley & J. Blount, "SEC In-House Tribunals: A Call for Reform," 62 *Vill. L. Rev.* 261, 286 (2017) (*quoting* Jean Eaglesham, "SEC Wins with in-House Judges," *Wall St. J.* (May 6, 2015, 10:30 PM), *http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803* ("The SEC won against 90 percent of defendants before its own judges in contested cases from October 2010 through March of [2015], according to the *Journal* analysis. That was markedly higher than the 69 percent success the agency obtained against defendants in federal court over the same period, based on SEC data. Going back to October 2004, the SEC has won against at least four of five defendants in front of its own judges every fiscal year.")).

[9] Brian North, *et al.*, "*SEC v. Jarkesy*: Why Curtailing the Use of ALJs Will Help SEC Targets," *Buchanan* (Jul. 24, 2024), *https://www.bipc.com/sec-v.-jarkesy-why-curtailing-the-use-of-aljs-will-help-sec-targets.*

[10] Lucia v. SEC, 585 U.S. 237 (2018).

[11] Axon Enter., Inc. v. Fed. Trade Comm'n, 598 U.S. 175 (2023), decided together with No. 21-1239, SEC v. Cochran.

[12] Loper Bright Enters. v. Raimondo, 144 S. Ct. 2244 (2024).

[13] Amanda Iacone, "SEC Drops Auditor Misconduct Cases After In-House Judges Ruling," *Bloomberg Law* (Sept. 24, 2024), *https://news.bloomberglaw.com/securities-law/sec-drops-auditor-misconduct-cases-after-in-house-judges-ruling?utm_source=securitiesdocket.beehiiv.com&utm_medium=newsletter&utm_campaign=all-five-sec-commissioners-testify-before-house-committee-on-oversight-of-the-sec&_bhlid=c8612a4ca9004b3833b1ba32ebc6c10beda0e492.*

[14] *Id.*

[15] *Id.*

[16] Jessica Corso, "'Jarkesy 2.0': SEC Sees New Attack On In-House Courts," *Law360* (Aug. 26, 2024), *https://www.law360.com/whitecollar/articles/1872561?nl_pk=451e8607-061d-409d-8366-8e8870c9718b&utm_source=newsletter&utm_medium=email&utm_campaign=whitecollar&utm_content=2024-08-27&read_main=1&nlsidx=0&nlaidx=0.*

[17] *Id.*

[18] *Id.*

[19] Katryna Perera, "FINRA Beats Post-Jarkesy Challenge To Enforcement Powers," *Law360* (Sept. 4, 2024), *https://www.law360.com/articles/1876585/finra-beats-post-jarkesy-challenge-to-enforcement-powers*. The case is Blankenship v. Financial Industry Regulatory Authority, case number 2:24-cv-3003, in the U.S. District Court for the Eastern District of Pennsylvania.

[20] *Id.*

[21] Joel M. Cohen, *et al.*, "Supreme Court Rules SEC Use of In-House Tribunals is Unconstitutional in Potentially Far-Reaching Decision," White & Case (July 1, 2024), *https://www.whitecase.com/insight-alert/supreme-court-rules-sec-use-house-tribunals-unconstitutional-potentially-far-reaching#:~:text=On%20June%2027%2C%202024%2C%20the,to%20a%20trial%20by%20jury.*