Articles + Publications | July 3, 2024

Supreme Court Limits SEC's In-House Adjudication

WRITTEN BY

Jay A. Dubow | Ghillaine A. Reid | Alyssa P. Cavanaugh

On June 27, the U.S. Supreme Court released a 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 where the SEC seeks civil penalties. The majority held that for actions in which SEC seeks civil penalties for securities fraud, the Seventh Amendment requires that the action be brought in a court of law where the defendant is entitled to trial by jury.

The SEC can no longer force a defendant facing civil penalties to litigate in an internal administrative proceeding before an ALJ. This decision accompanies other decisions by the Court this term that diminish the authority of the administrative state overall, casting doubt on the validity of ALJ tribunals beyond the SEC.

The SEC's Use of ALJs

The Securities Exchange Act of 1934 (Exchange Act), the Securities Act of 1933, and the Investment Advisers Act of 1940 authorize the SEC 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. The Exchange Act provides for review of a final SEC decision in a federal court of appeals directly, rather than a federal district court.

The SEC's use of ALJ proceedings has been under scrutiny and challenge for several years. As a result of prior Supreme Court decisions limiting the availability of ALJ proceedings, the SEC has largely backed away from using its administrative courts for contested cases. Nevertheless, the SEC currently has more than 200 open administrative cases on its docket.[1]

Background on *Jarkesy*

As discussed previously, *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 Patriot28 before an ALJ for securities fraud claims involving alleged mismanagement of the hedge funds in violation of the Securities Act of 1933, the Exchange Act, and the Investment Advisers Act of 1940.

Jarkesy challenged the constitutionality of the SEC's administrative enforcement powers in the District Court for the District of Columbia and later the U.S. Court of Appeals for the D.C. Circuit, but he was ultimately required to proceed through the SEC's internal agency process first. In the SEC administrative proceeding, an ALJ found, and the SEC affirmed, that Jarkesy and Patriot28 committed various forms of securities fraud and ordered them to

©2026 Troutman Pepper Locke

pay civil penalties. In accordance with 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 the Jarkesy nor did it rule on the industry bar imposed on Jarkesy.[2] 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, 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, unless excepted as public rights that can be adjudicated by agencies. The majority concluded that the penalties sought are not akin to public rights enforcement like collecting tax revenue and enforcing immigration laws, and thus could not be adjudicated by ALJs under the exception.

The majority did not reach the other two constitutional issues raised by the Fifth Circuit, 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." In light of *Jarkesy*, dozens of other federal agencies that impose civil penalties in administrative proceedings — including the Consumer Financial Protection Bureau and the Environmental Protection Agency — may reexamine their use of ALJs and in-house tribunals in enforcement actions involving potentially punitive or common law-like claims.

Takeaways

The majority's analysis strongly suggests that any enforcement action by a 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.[3]

As a result of the 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. Moreover, the SEC will have to decide how to proceed with its more than 200 open administrative proceedings. Some of these may fall within the facts of *Jarkesy* but others may result in further federal court challenges of the issues that the Supreme Court chose not to address.

---

[1] Jessica Corso, Justices Limit SEC's Use Of In-House Courts, *Law 360* (June 27, 2024), https://www.law360.com/articles/1803073/justices-limit-sec-s-use-of-in-house-courts .

[2] *Id.*

[3] 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 June 27%2C 2024%2C the,to a trial by jury.

RELATED INDUSTRIES + PRACTICES

- Securities Investigations + Enforcement
- White Collar Litigation + Investigations