

Supreme Court Review May Prove the Death Knell to SEC Administrative Courts

WRITTEN BY

Mary Weeks | Ghillaine A. Reid | Dominyka Plukaite | Jay A. Dubow

On June 30, the U.S. Supreme Court granted certiorari in *SEC v. Jarkesy, et al.* and agreed to hear the case that could potentially end the use of administrative courts and administrative law judges (ALJ) in administrative agency proceedings, including SEC administrative proceedings. The Court will soon decide the fate of the 2022 Fifth Circuit ruling that overturned an SEC judgment against hedge fund manager George Jarkesy Jr.

By way of background, in the aftermath of the Great Depression, Congress passed legislation to rein in the markets for trading securities and other financial commodities. To enforce this legislation, Congress created the Securities and Exchange Commission (SEC). It granted the agency the power to regulate investors through either lawsuits brought within the federal court system or internal hearings in front of an ALJ.

In 2010, in the aftermath of the Great Recession, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Prior to enacting Dodd-Frank and providing enhanced remedies in administrative enforcement actions, the SEC employed ALJs primarily for enforcement actions involving registered persons, such as brokers, investment advisers, and investment companies.

During internal hearings, the SEC, in a sense, acts as both prosecutor and judge. As such, the Constitution constrains the SEC's powers by protecting individual rights and the rights of the other branches of the government. *Jarkesy* addresses the nature and extent of those constraints in securities fraud cases in which the SEC seeks monetary penalties.

As [discussed previously](#), the Securities Exchange Act of 1934 (Exchange Act) — the SEC's enabling statute — authorizes the SEC to address statutory violations 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, either upon appeal of the ALJ's decision by the losing party or by the SEC *sua sponte*. The SEC then issues a final decision following its review, or if no such review has occurred, the ALJ's decision becomes the final decision of 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.

In 2007 and 2009, Jarkesy established two hedge funds and selected Patriot28 as the investment adviser. The funds brought in over 100 investors and held approximately \$24 million in assets. In 2011, the SEC launched an investigation into Jarkesy's and Patriot28's investing activities, and in 2013, it instituted an administrative enforcement action against Jarkesy and Patriot28 before an ALJ regarding their alleged mismanagement of the two hedge funds. In its order instituting proceedings, the SEC alleged that Jarkesy and Patriot28 (along with some

former co-parties) committed securities fraud under the Securities Act of 1933, the Exchange Act, and the Investment Advisers Act of 1940.

Subsequently, Jarkesy sued the SEC in the U.S. District Court for the District of Columbia, arguing that the SEC's structure and administrative enforcement powers violated the Constitution. The District Court, and later the U.S. Court of Appeals for the D.C. Circuit, refused to grant any relief, reasoning that the District Court had no jurisdiction, and Jarkesy and Patriot28 had to go back to the SEC for internal agency proceedings and only then petition the Court of Appeals to review any adverse final order.

In the SEC administrative proceeding, an ALJ found that Jarkesy and Patriot28 committed various forms of securities fraud. The SEC reviewed the ALJ's decision and likewise found that Jarkesy and Patriot28 had committed securities fraud. 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. A divided three-judge panel issued its decision in May 2022. 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 U.S. Supreme Court appears to have agreed to hear arguments on all three questions in granting certiorari on June 30.

In light of the high Court's current view of the administrative state, there is a strong possibility that the SEC might lose *Jarkesy*. Just three months ago, the Supreme Court ruled in favor of SEC challenger Michelle Cochran, allowing the accountant to proceed with her lawsuit, alleging that the SEC's internal administrative proceedings against her violated the Constitution. Another major blow to the SEC's administrative power occurred in 2018 when the Court, in *Lucia v. SEC*, forced the SEC to properly reappoint all of its ALJs. If the Fifth Circuit ruling stands, it could essentially put an end to administrative proceedings nationwide, shocking administrative agencies and flooding the federal court system with cases once reserved for administrative agencies' in-house review.

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