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U.S. SUPREME COURT CURBS SEC'S IN-HOUSE ENFORCEMENT PROCEEDINGS, INVITING MORE CHALLENGES TO OTHER AGENCIES

On June 27, 2024, the U.S. Supreme Court in *SEC v. Jarkesy* ruled by a 6-3 margin that the Securities and Exchange Commission's ("SEC") in-house administrative law judges ("ALJ") lack constitutional authority to impose civil monetary penalties for violations of the antifraud provisions of the federal securities laws.[1] Instead, the Court held that the Seventh Amendment to the U.S. Constitution entitles defendants in these cases to a jury trial. *Jarkesy* is the latest in a string of decisions by the Supreme Court curbing the SEC's enforcement power on constitutional grounds. This decision could impact how parties resolve enforcement actions by the SEC, and it could invite challenges to other federal agencies' use of administrative proceedings to prosecute fraud claims. Moreover, the decision leaves open the prospect for broader challenges to the administrative adjudicative function by numerous federal agencies, including the U.S. Federal Trade Commission ("FTC").

BACKGROUND

As it has done with many federal agencies, Congress has by statute empowered the SEC to elect to carry out its enforcement mandate either in the federal courts, or in its own administrative proceedings. In both settings, Congress has authorized the SEC to seek a variety of remedies, including disgorgement of ill-gotten gains to be returned to victims and monetary penalties intended to punish and deter wrongdoing. In its last fiscal year, the SEC's Division of Enforcement obtained more than $1.5 billion in civil monetary penalties in those settings.[2]

Similarly, the FTC has the authority to enforce antitrust and consumer protection laws either through its internal administrative process or by seeking injunctive relief in federal courts. In both settings, Congress has authorized the FTC to seek

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1 603 U.S. ____ (2024) (No. 22-859) ***available at*** https://www.supremecourt.gov/opinions/23pdf/22-859new_kjfm.pdf.

2 Press Release, SEC, SEC Announces Enf't Results for Fiscal Year 2023, (Nov. 14, 2023) https://www.sec.gov/newsroom/press-releases/2023-234.

various remedies, including consumer redress and civil penalties. In its last fiscal year, the FTC initiated dozens of administrative proceedings and federal court actions (sometimes simultaneously), leveraging its dual-path enforcement mechanism to its advantage.

For years, defendants in SEC or FTC administrative proceedings have complained that the agencies enjoy an unfair "homefield advantage." Actions filed in federal court are presided over by independent, life-tenured judges appointed by the U.S. President and confirmed by the Senate according to Article III of the U.S. Constitution. Those judges apply federal rules of evidence and procedure, including for the exchange of discovery. By contrast, agency administrative proceedings are heard by in-house ALJs employed by the agencies; those proceedings apply relaxed rules of evidence; and the decisions of the in-house ALJs are reviewed by the very authorities who voted to pursue the action in the first place, subject to a deferential standard of review by a federal appeals court. The record in *Jarkesy* reflects that in those administrative courts, the agencies prevail far more frequently than when litigating in federal court.

In recent years, respondents have challenged SEC and FTC enforcement proceedings in federal court on a variety of constitutional grounds. Some such challenges have found a receptive audience in the current Supreme Court. Just last year, in *Axon Enterprise, Inc. v. Federal Trade Commission*, a unanimous Court affirmed respondents' right to pause administrative proceedings while they exhaust such constitutional challenges in federal court.[3]

SEC V. JARKESY

In *Jarkesy*, an SEC ALJ imposed a monetary penalty and other remedies on a hedge fund manager and his advisory firm for violations of the antifraud provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Investment Advisers Act of 1940. The Commissioners of the SEC upheld the ALJ decision in a unanimous final order.

A divided panel of the Court of Appeals for the Fifth Circuit then vacated the Commission's final order, concluding that the ALJ proceedings had suffered from three constitutional defects: (1) that the SEC had deprived defendants of their Seventh Amendment right to a trial by jury for "suits at common law;" (2) that Congress had unconstitutionally delegated its legislative power to the SEC by failing to provide an intelligible principle to guide the SEC's discretion over whether to bring enforcement actions in federal court or in its own administrative proceedings; and (3) that statutes limiting the removal of ALJs "for cause" insulated them impermissibly from presidential oversight, in violation of Article II of the Constitution. The Fifth Circuit denied the SEC's petition for a rehearing *en banc.* The Supreme Court granted the SEC's petition for certiorari.

THE SUPREME COURT'S DECISION

The Supreme Court affirmed the Fifth Circuit's decision vacating the SEC's final order. The Court agreed with the Fifth Circuit that the Seventh Amendment's guarantee of a jury trial for "suits at common law" applies to SEC actions seeking

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3 598 U.S. 175 (2023). See here for a more in-depth analysis of the *Axon* decision.

monetary penalties for violation of the antifraud provisions of the federal securities laws.

First, the Court concluded that the action implicated Seventh Amendment protections because it was "legal in nature," and thus resembled suits at common law rather than suits in equity. Applying Court precedent for evaluating when that is true of statutory claims, the Court looked to both the cause of action and the remedy imposed. The Court concluded that the remedy was "all but dispositive" because civil monetary penalties under the securities laws serve to punish the wrongdoer rather than restore the status quo for victims. The Court explained that by statute, the availability of monetary penalties for securities fraud is conditioned on factors such as the threat of recidivism and the need for deterrence. The Court emphasized that those penalty statutes neither ask whether investors were harmed by the violation nor obligate the SEC to return penalty proceeds to victims. Looking to the cause of action itself, the Court adhered to decades of its precedents repeatedly affirming that Congress' decision to incorporate notions of common law fraud into federal securities law cemented an "enduring link" between the two.

Next, the Court concluded that the claims did not come within the so-called "public rights" exception to the Seventh Amendment's guarantee of trial by jury because they were akin to "suits at common law" and did not fall within any of the distinctive areas where the Court has concluded that a matter may be resolved outside of an Article III court. Certain of these areas include the collection of revenue; aspects of customs law; immigration law; relations with Indian tribes; the administration of public lands; and the granting of public benefits. The SEC had argued that these claims fell within the "public rights" exception because the claims were created by Congress and enforced by the government. The Court rejected this argument and explained that the applicability of the "public rights" exception is premised on the substance of the suit, not where it is brought, who brings it, or how it is labeled. Because the action adjudicated by the ALJ was "a common law suit in all but name," the Court held that it must be adjudicated in Article III courts.

Accordingly, the *Jarkesy* Court affirmed the Fifth Circuit's holding vacating the ALJ's decision, without addressing the appeals court's broader holdings that the SEC's administrative proceedings are unconstitutional. In a separate concurrence, Justice Gorsuch criticized the SEC's relaxed procedural rules before the ALJ as violating the constitutional guarantees of due process and trial by an impartial judge.

In a dissenting opinion, Justice Sotomayor rejected the majority's interpretation of the Seventh Amendment's "public rights" exception, arguing that empowering federal agencies to impose civil monetary penalties falls within the heartland of so-called "public rights" and warning that the majority decision would severely constrain federal enforcement authority across a number of agencies.

TAKEAWAYS AND BROADER IMPLICATIONS

Just how broadly *Jarkesy* will impact federal administrative proceedings remains to be seen. Most narrowly, the decision ensures that defendants accused of securities fraud will have claims for money penalties heard by federal courts, according to the federal rules of evidence, and with more customary standards of appellate review.

What is not yet clear is how the decision will impact strategies employed by the SEC and investigative targets to resolve investigations of possible violations of the antifraud provisions of the securities laws. For example, going forward, the SEC may file in the friendlier ALJ settings, forgoing penalties but pursing other remedies (e.g., disgorgement, bars, etc.), in some cases out of concern that federal courts may decline to impose those penalties on a given set of facts.

Moreover, now that the SEC can pursue civil monetary penalties for fraud claims in federal courts alone, defendants may seek to exert greater leverage in negotiating more reasonable penalty payments in negotiated settlements—especially since the SEC resolves most actions through settlements that do not explain the calculations behind the penalties imposed.

The narrow decision by the majority in *Jarkesy* also means that, for the moment, the Fifth Circuit's other holdings—that the SEC's use of its own ALJs violated the nondelegation doctrine, and that the SEC's restrictions on the removal of ALJs violated Article II of the Constitution and the separation of powers—remain good law. Respondents in future agency proceedings may continue to raise those arguments as direct attacks on the SEC's administrative proceedings.

But the implications of *Jarkesy* extend far beyond the SEC. For example, the Fifth Circuit's rulings on the unconstitutionality of the use of ALJs and restrictions on their removal could also implicate other agencies, such as the FTC. The FTC is enabled by a similar enforcement statute and FTC ALJs enjoy similar removal protections as those of the SEC's.

Without clear guidance from Congress or further clarification from the Supreme Court, the FTC's discretion in choosing between federal court and internal administrative proceedings is likely to face an increasing number of constitutional challenges. And like *Axon*, the *Jarkesy* decision will likely reinforce the trend of scrutinizing agency structures and procedures through pre-enforcement challenges in federal courts.

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