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SEC v. Jarkesy disrupts securities enforcement actions

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The Supreme Court's decision changes how federal agencies approach enforcement actions and allocate resources.

What's the impact?

- The court ruled that the SEC must cease using its in-house courts when seeking civil penalties against individuals charged with securities fraud.
- This decision, coupled with the recent opinion striking down *Chevron* deference, represents a major shift in the administrative and regulatory landscape and limits federal agencies' enforcement authority.

On June 27, 2024, the US Supreme Court issued its decision in *Securities and Exchange Commission v. Jarkesy*, which ruled that the SEC must cease using its in-house courts when seeking civil penalties against individuals charged with securities fraud. Although *Jarkesy* may appear relatively narrow in scope on its face, the legal and practical ramifications of the decision on the SEC and other US agencies are sure to be wide-ranging and significant. At a minimum, defendants charged with securities fraud are, pursuant to the Seventh Amendment, entitled to a jury trial in federal court. More broadly, the SEC and many other federal agencies must now rethink not only their enforcement activities and strategies but also many of their resourcing and organizational decisions.

SEC v. Jarkesy: Overview and background

Over a decade ago, the SEC commenced an administrative enforcement action against George Jarkesy Jr. and Patriot28, LLC (Patriot28), an investment adviser Jarkesy managed. The SEC alleged that Jarkesy and Patriot28 misled investors and, as a result, violated the antifraud provisions of the Securities Act, the Exchange Act, and the Investment Advisers Act. The SEC initiated the proceeding before an administrative law judge (ALJ), as opposed to filing suit in federal court, based on a then-recent grant of authority conferred by the Dodd-Frank Act. The ALJ made an initial finding in favor of the SEC, which released its final order several years later in 2020. Jarkesy and Patriot28 sought judicial review from the Fifth Circuit Court of Appeals, which vacated the SEC's final order. The Fifth Circuit found that (a) Jarkesy and Patriot28 were entitled to a jury trial pursuant to the Seventh Amendment and (b) the "public rights" exception to that Seventh Amendment right did not apply. The SEC then petitioned the Supreme Court, which granted certiorari.

The Supreme Court examines administrative enforcement

Writing for a 6-3 majority, Chief Justice John Roberts affirmed the decision of the Fifth Circuit, concluding that the "SEC's antifraud provisions replicate common law fraud, and it is well established that common law claims must be heard by a jury." The majority stated that "common law claims" include all claims that are "legal in nature" and that the primary consideration when determining whether a claim is "legal in nature" is the remedy sought. Monetary penalties, concluded the majority, are "the prototypical common law remedy." The majority further stated that the "close relationship" between securities fraud and common law fraud bolsters its conclusion.

Relying again on the similarities between the SEC's antifraud actions and common law fraud suits, the majority next concluded that the "public rights" exception to the Seventh Amendment did not apply. Although the majority declined to "definitively explain[]" the exception, which allows Congress to assign certain matters to agency adjudication without a jury in compliance with the Seventh Amendment, it did state that "[i]f a suit is in the nature of an action at common law, then the matter presumptively concerns private rights, and adjudication by an Article III court is mandatory."

Notably, although the majority declined to "reach the suggestion made by Jarkesy and Patriot 28" that two decisions cited heavily by the majority, *Tull v. United States*, 481 U.S. 412 (1987) and *Granfinanciera, S. A. v. Nordberg*, 492 U.S. 33 (1989), overruled the Court's prior ruling in *Atlas Roofing Co. v. Occupational Safety and Health Review Commission*, 430 U.S. 442 (1977), it stated in a footnote that the "author of *Atlas Roofing* certainly thought that *Granfinanciera* may have done so." According to the dissent, *Atlas Roofing* "presented the same question as" *Jarkesy* and was "the last time [the Supreme Court] considered a public-rights case where the constitutionality of an in-house adjudication of statutory claims brought by the Government." The majority, however, concluded that *Atlas Roofing* was not controlling because the Occupational Safety and Health Act "did not borrow its cause of action from the common law" and instead "resembled a detailed building code."

Consequences of the *Jarkesy* decision

At first glance, the *Jarkesy* decision could be read to apply only to the SEC's antifraud enforcement actions. As detailed above, because of the conduct underlying the SEC's enforcement action against Jarkesy and Patriot28, much of the language in the decision refers directly to securities fraud and the commonalities therein with common law fraud. One could reasonably conclude, therefore, that other parts of the Securities Act, the Exchange Act, and the Investment Advisers Act, such as the books and records, registration, and other similar provisions, are more like "a detailed building code" than "common law fraud."

It is possible, if not likely, that the *Jarkesy* decision will mean that any instance in which the SEC seeks to levy civil monetary penalties triggers the protections of the Seventh Amendment. The Court's focus on the remedy sought in determining whether a claim is "legal in nature" increases the likelihood that this occurs. As the majority expressly states, '[w]hile monetary relief can be legal or equitable, money damages are the prototypical common law remedy. What determines whether a monetary remedy is legal is if it is designed to punish or deter the wrongdoer, or, on the other hand, solely to 'restore the status quo.'" It is difficult to envision how a civil monetary penalty levied for a compliance-related violation could be seen as anything other than an effort to punish or deter. Accordingly, should courts continue to focus on the remedy sought when determining whether Seventh Amendment protections apply, it stands to reason that any action seeking civil monetary penalties would afford the defendant the right to a jury trial.

Separate and apart from the legal ramifications of *Jarkesy* discussed above, from a practical perspective, it is almost certain that the SEC will have to fundamentally rethink its enforcement efforts and, in particular, resourcing. This is even more true given the Court's subsequent decision in *Loper Bright Enterprises v. Raimondo*, which overturned *Chevron v. Natural Resources Defense Council*, 467 U.S. 837 (1984). Even if *Jarkesy* is determined to apply only to SEC antifraud actions and not all cases in which the SEC seeks a civil monetary penalty, the SEC's Division of Enforcement will be forced to allocate more resources—financial, workforce, and otherwise—to prosecuting those suits in federal court. Indeed, the SEC has already made a shift in this direction in recent years, electing to bring more and more cases in federal courts instead of trying them internally for fear of a decision like *Jarkesy* coming down. Assuming that this trend continues in the wake of *Jarkesy*, it makes sense that additional resources will need to be diverted from other SEC efforts, such as, perhaps, investigating and enforcing books and records and other compliance-related laws and regulations. Further, given *Loper*, the SEC will be forced to reallocate more resources to rulemaking, issuing guidance, and other agency work previously given deference under *Chevron*.

Expect future challenges to federal agency authority

The *Jarkesy* decision will certainly cause shockwaves across the administrative and regulatory landscape. The full extent of the effects remains to be seen, and further litigation against the SEC and other federal government agencies is sure to follow.

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