

# Supreme Court Holding That SEC Actions Seeking Civil Penalties for Securities Fraud Must Be Heard by a Jury Calls Into Question Other In-House Enforcement Procedures

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In *Securities and Exchange Commission v. Jarkesy*, the U.S. Supreme Court held that “the Seventh Amendment entitles a defendant to a jury trial when the [Securities and Exchange Commission] seeks civil penalties against him for securities fraud.”

In its [June 27 decision](#), the Court concluded that the civil penalties the agency (SEC or Commission) sought against George Jarkesy were legal, not equitable, because they sought to punish and deter, and that they thus implicated the Seventh Amendment guarantee of trial by jury.

The Court then rejected the SEC’s argument that it could proceed outside of federal court under the “public rights” exception to Article III jurisdiction. The Court reasoned that the SEC’s fraud claims did not fall within one of the “historic categories of adjudications” that the Court has held can be adjudicated in agency proceedings, like revenue-collection issues or customs or immigration disputes. Instead, the fraud claims involved adjudication of private rights, and thus required trial by jury.

The Court’s holding not only limits the SEC’s authority to pursue civil penalties for fraud-based claims, but it also may create uncertainty for other agencies that commonly pursue civil penalties through in-house agency proceedings if those penalties are akin to common law remedies and the claims have common law analogues. Indeed, Justice Sotomayor’s dissent, citing the federal government’s statements at oral argument, identified “more than two dozen agencies that can impose civil penalties in administrative proceedings,” including the Commodity Futures Trading Commission, the Consumer Financial Protection Bureau, the Department of Health and Human Services and Food and Drug Administration, the Department of the Treasury, the Environmental Protection Agency, the Federal Communications Commission, and the Department of Transportation.

Parties facing civil penalties in in-house proceedings may want to consider challenging those proceedings on Seventh Amendment grounds and are increasingly likely to do so.

## Background: The SEC’s Enforcement Procedures

The SEC is charged with enforcing the federal securities laws, including the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Advisers Act of 1940. Those statutes regulate different facets of the securities markets, but they all include provisions that target the misrepresentation or concealment of material facts. The relevant provisions are Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act, and Section 206 of the Investment Advisers Act.

One way the SEC enforces the federal securities laws is by bringing enforcement actions in federal court, where an Article III judge presides, a jury is the factfinder, and the Federal Rules of Evidence and ordinary discovery rules govern. Alternatively, the SEC can pursue enforcement actions within the agency, where the Division of Enforcement is the prosecutor, an administrative law judge (ALJ) typically presides, and the Commission’s Rules of Practice and evidentiary rules govern. In such in-house proceedings, the losing party can ask the full Commission — which is made up of five presidentially appointed commissioners — to review the decision.

Once the proceedings finish, a federal court also can review the decision, but its review is deferential, with the agency’s factual findings considered conclusive if supported by the record, even if the evidence would not be admissible in federal court.

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The SEC can seek penalties in federal court and, as a result of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, in its own in-house proceedings. The SEC's ability to secure civil penalties is a critical enforcement tool. The Commission can seek civil penalties of up to \$725,000 per violation, even if no investor suffered financial loss.

SEC ALJs are insulated from the presidential removal by two layers of for-cause removal protection. The ALJs themselves can be removed only by the SEC commissioners if the Merit Systems Protection Board finds good cause for removal. And the commissioners and Board members, in turn, can be removed by the President only for cause.

## History and Facts of *Jarkesy*

### Agency Enforcement Proceedings

George Jarkesy established two hedge funds and chose Patriot28 as their investment advisor. The funds attracted more than 100 investors and held around \$24 million in assets. The SEC began investigating Jarkesy and Patriot28's investing activities in 2011, and several years later, brought an in-house administrative action against them under the antifraud provisions of the securities laws. The SEC alleged that they had misled investors by misrepresenting the investment strategies they were using, lying about the identity of the funds' auditor and prime broker, and inflating the funds' claimed value so they could collect larger management fees.

The ALJ concluded that Jarkesy and Patriot28 had committed securities fraud. The full Commission affirmed and ordered Jarkesy and Patriot28 to cease and desist from committing further securities violations and to pay a \$300,000 civil penalty. The SEC also ordered Patriot28 to disgorge around \$685,000 in ill-gotten gains and barred Jarkesy from participating in the securities industry by, for example, serving as an officer or director of an advisory board or as an investment adviser.

### Fifth Circuit Review

Jarkesy and Patriot28 then petitioned the Fifth Circuit for review, asserting several constitutional challenges to the agency proceedings. A divided panel held that the agency proceedings were unconstitutional and vacated the SEC's order.

Jarkesy and Patriot28 raised three main arguments. *First*, they argued that the agency proceedings deprived them of their Seventh Amendment right to trial by jury. They asserted that the securities fraud action against them was akin to a traditional action at law to which the constitutional jury-trial right attaches, and Congress couldn't permit the SEC to decide the action because it did not involve adjudicating solely public rights.

*Second*, Jarkesy and Patriot28 argued that Congress unconstitutionally delegated legislative power to the SEC by giving the SEC unbounded authority to decide whether to bring enforcement actions in Article III courts or within the agency.

*Third*, Jarkesy and Patriot28 argued that the statutory removal restrictions for ALJs violate Article II's Take Care Clause, which requires the President to "take Care that the Laws be faithfully executed." U.S. Const. art. II, § 3. Because ALJs perform executive functions, they argued, the President must have sufficient authority over them. But the dual layers of for-cause protection from removal prevent the President from exercising that authority.

The Fifth Circuit agreed with Jarkesy and Patriot28, holding that the agency proceedings were unconstitutional on Seventh Amendment, nondelegation, and Article II grounds. The Fifth Circuit vacated the SEC's decision based on the Seventh Amendment and nondelegation violations and remanded for further proceedings.

## The Supreme Court's Decision

The Supreme Court granted the government's petition for a writ of certiorari and affirmed the Fifth Circuit 6–3 on the Seventh Amendment question, holding that the SEC must proceed in court where trial by jury is available, without reaching the other constitutional challenges. Chief Justice Roberts authored the majority opinion, in which Justice Thomas, Justice Alito, Justice Gorsuch, Justice Kavanaugh, and Justice Barrett joined. Justice Gorsuch authored a concurring opinion, which Justice Thomas joined. Justice Sotomayor, joined by Justice Kagan and Justice Jackson, dissented.

### Majority Opinion

The majority held that the Seventh Amendment "entitles a defendant to a jury trial when the SEC seeks civil penalties against him for securities fraud," and that Jarkesy and Patriot28 thus were entitled to a jury trial. The Court did not address whether Congress impermissibly delegated legislative power to the SEC, or whether the removal restrictions for SEC ALJs are unconstitutional.

Deciding that a defendant is entitled to a jury trial when the SEC seeks civil penalties for securities fraud violations was "straightforward," according to the Court. The Seventh Amendment guarantees "the right of trial by jury" in "[s]uits at common law." That means there is a right to a jury trial in all suits not based in "equity or admiralty jurisdiction." When it comes to statutory claims, the Seventh Amendment guarantees a trial by jury when the claim is legal as opposed to equitable. One way to determine whether a claim is legal or equitable is by looking to the type of remedy involved. Money damages are considered a legal remedy — implicating the Seventh Amendment jury right — if they are

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meant to punish or deter the defendant. In contrast, money damages that only “restore the status quo” are an equitable remedy that does not trigger the constitutional right to a jury trial.

Here, the SEC’s decision to seek civil penalties was “all but dispositive” in showing that the Seventh Amendment applied, Chief Justice Roberts wrote. “[M]oney damages are the prototypical common law remedy,” and the civil penalties here depended on six statutory factors, several of which “concern culpability, deterrence, and recidivism.” Because the civil penalties served “to punish the defendant rather than to restore the victim,” they were legal — not equitable — thus implicating the Seventh Amendment right to trial by jury. The “close relationship” between the antifraud provisions in the federal securities statutes and common law fraud “confirm[ed]” that the action was legal, rather than equitable.

Next, the Court concluded that Congress could not allow the SEC to adjudicate the action under what is known as the “public rights” exception to Article III jurisdiction. Under that exception, if an action involves adjudication of public — rather than private — rights, Congress can permit an agency to resolve it in-house rather than a jury in an Article III court. The Court observed that the public rights exception has “no textual basis in the Constitution and must therefore derive instead from background legal principles.” Wary of letting “the exception ... swallow the rule,” the Court concluded that the action against Jarkesy and Patriot28 was not one of the limited “historic categories of adjudication fall[ing] within the exception,” like those involving the collection of revenue; customs and immigration issues; relations with Indian tribes; the administration of public lands; and the granting of public benefits. The fraud claims here involved classic private rights, so Jarkesy and Patriot28 were entitled to a jury trial.

## Concurring Opinion

In his concurring opinion, Justice Gorsuch, joined by Justice Thomas, highlighted the differences between proceedings in federal courts and agency proceedings. For example, the SEC’s proceedings have entirely different discovery and evidentiary rules and allow an appeal, but only to the same “politically accountable body” “that approved the charges” in the first place. Justice Gorsuch stated that the Seventh Amendment’s jury-trial right, along with two other constitutional provisions — Article III, which guarantees an independent judge, and the Due Process Clause of the Fifth Amendment — easily resolve this case. Together, the provisions ensure a “fair trial in a fair tribunal” before the government can deprive someone of life, liberty, or property.

## Dissenting Opinion

In her dissenting opinion, Justice Sotomayor, joined by Justice Kagan and Justice Jackson, accused the majority of ignoring, and completely upending, the “Court’s longstanding precedent and established government practice.” That precedent and practice, she explained, “uniformly support the constitutionality of administrative schemes like the SEC’s: agency adjudications of statutory claims for civil penalties brought by the Government in its sovereign capacity.”

In Justice Sotomayor’s view, the majority’s contrary decision effectively guts the public-rights doctrine. She warned that the majority’s decision will “unleash” “chaos.” She also wrote that, instead of “acknowledg[ing] the earthshattering nature of its holding, the majority has tried to disguise it.”

Justice Sotomayor observed that Congress “has enacted more than 200 statutes authorizing dozens of agencies to impose civil penalties for violations of statutory obligations,” and many agencies can impose civil penalties in administrative proceedings. She cited the following, among others:

- Department of Agriculture.
- Department of Health and Human Services.
- Department of the Treasury.
- Department of Transportation.
- Consumer Financial Protection Bureau.
- Commodity Futures Trading Commission.
- Federal Energy Regulatory Commission.
- Food and Drug Administration.
- Environmental Protection Agency.
- Federal Communications Commission.
- Merit Systems Protection Board.

According to Justice Sotomayor, the majority’s decision threatens to undermine those agencies’ in-house enforcement proceedings.

## Implications

The Court’s decision is important because it constrains the SEC’s ability to secure civil penalties — a potent tool the Commission has long wielded in enforcing the federal securities laws. Although the SEC has sometimes opted to bring securities fraud actions in Article III courts, it often has relied on administrative proceedings to seek civil penalties as well.

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Now, however, if the SEC wants to pursue civil penalties for securities fraud violations, it will have to do so in federal court; it no longer can turn to its own in-house courts. That might mean that the Commission will consider pursuing more securities fraud actions in federal court — where such civil penalties are available — than it has historically. Alternatively, the Commission might bring only what it views as the most serious violations to federal court, while continuing to pursue other equitable remedies, like injunctive relief, through agency proceedings.

More broadly, as Justice Sotomayor observed, the Court’s holding may create uncertainty for other agencies that typically pursue civil penalties through in-house agency proceedings if those penalties are akin to common law remedies and the claims have common law analogues. Citing the federal government’s statements at oral argument, Justice Sotomayor identified “more than two dozen agencies that can impose civil penalties in administrative proceedings.” Parties dragged into in-house proceedings may want to consider challenging those proceedings on Seventh Amendment grounds, and are increasingly likely to do so.

Beyond the majority’s Seventh Amendment holding, *Jarkesy* suggests that other constitutional challenges could be promising. Justice Gorsuch’s discussion of how Article III and the Due Process Clause of the Fifth Amendment play critical roles in securing the right to a fair trial before a fair tribunal may spur challenges to agency enforcement proceedings under those constitutional provisions. While the Supreme Court did not reach *Jarkesy* and *Patriot28*’s nondelegation and removal arguments, it also did not disturb the Fifth Circuit’s holdings on those issues. Litigants brought into in-house proceedings thus may also want to consider those constitutional arguments as well.

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If you have questions, please reach out to any of the attorneys listed below.

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