



Securities Litigation ADVISORY ■

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The Supreme Court Hears Constitutional Challenges to SEC Enforcement Actions

by [Susan Hurd](#) and [Carissa Lavin](#)

On November 29, 2023, the Supreme Court heard oral argument in the *SEC v. Jarkesy* case, which was the subject of a [prior advisory](#). *Jarkesy* involves an appeal of a Fifth Circuit decision in which the court of appeals ruled that the Securities and Exchange Commission (SEC) in-house adjudication system was unconstitutional in several respects.

Historically, the SEC had the discretion to bring contested enforcement actions in either federal court or in an administrative proceeding before one of the SEC's in-house administrative law judges (ALJs). For cases that are brought in federal court, the defendants are entitled to certain protections, including the right to a trial by a jury of their peers and the presence of an independent trier of fact. The defendants do not receive these same protections if the SEC decides to bring an action before their in-house tribunal.

The SEC's success rate for cases brought before its ALJs is approximately 90%, notably higher than the 69% success rate for the cases it brought in federal court.¹ The SEC has affirmed the orders of its ALJs in approximately 95% of appeals.² If the oral argument held recently is any indication, the Supreme Court may have enough votes to deprive the SEC of this perceived home court advantage.

The central theme of the oral argument, as described in more detail below, was the fundamental unfairness of giving a governmental agency the unilateral right to decide when a defendant will be allowed access to an important constitutional protection. Should the Court rule against the SEC on the jury trial issue, the SEC will be forced to continue the practice of the past few years of only bringing disputed actions in federal court to avoid constitutional challenges.

Factual and Procedural History

George Jarkesy and his alleged co-conspirators were investment managers and advisers for two hedge funds that held about \$24 million in assets.³ The SEC began investigating Jarkesy in 2011 and, in 2013,

¹ See, e.g., Jean Eaglesham, *SEC Wins with In-House Judges*, Wall St. J. (May 6, 2015), <https://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803>.

² *Id.*

³ *Jarkesy v. SEC*, No. 20-61007, at 2 (5th Cir. May 18, 2022).

brought an administrative proceeding against Jarkesy and his investment advisory firm alleging various violations of securities laws.⁴

Specifically, the SEC alleged that the defendants “(1) misrepresented who served as the prime broker and as the auditor; (2) misrepresented the funds’ investment parameters and safeguards; and (3) overvalued the funds’ assets to increase the fees that they could charge investors.”⁵ The defendants sought to enjoin the agency proceedings, arguing, among other things, that the administrative proceeding infringed on their Seventh Amendment right to a jury trial.⁶ The district court and the U.S. Court of Appeals for the D.C. Circuit refused to issue an injunction, stating that the defendants must complete the agency proceedings and then petition the court of appeals for review of any adverse final order.^{7,8}

Ultimately, the ALJ found the defendants liable for securities fraud.⁹ This judgment was affirmed by the SEC. The defendants were ordered to cease and desist all further violations, and certain civil penalties and disgorgement were also awarded. In addition, Jarkesy was barred from participating in the securities industry.¹⁰ The defendants then appealed this order to the Fifth Circuit.

The Fifth Circuit’s Ruling on Appeal

The Fifth Circuit’s ruling dealt three critical blows to the SEC’s in-house tribunal process. Each of these issues is now on appeal to the Supreme Court.

The Fifth Circuit agreed with the defendants that they had been unconstitutionally denied their Seventh Amendment right to a jury trial. The Court held that “because the SEC’s enforcement action is akin to traditional actions at law to which a jury trial right attaches,” the SEC cannot unilaterally decide to deny defendants their constitutional right to a jury trial simply by selecting the SEC’s in-house tribunal as the forum.¹¹

The Fifth Circuit further noted that the SEC was not entitled to the benefit of the public-rights doctrine. This doctrine is an exception that allows agency proceedings to advance, despite Seventh Amendment implications, when the agency is seeking to vindicate public, not private, rights.¹² The Fifth Circuit reasoned that because SEC enforcement actions have a common-law counterpart that existed at the time the Seventh Amendment was enacted—common-law fraud actions—and because allowing jury trials of these issues would not “dismantle the statutory scheme” or “impede swift resolution” of these claims, the SEC was not entitled to the public-rights exception.¹³

⁴ *Id.*

⁵ *Id.*

⁶ *Id.* at 2-3.

⁷ *Jarkesy v. SEC*, 48 F. Supp. 3d 32, 40 (D.D.C. 2014), *aff’d*, 803 F.3d 9, 12 (D.C. Cir. 2015).

⁸ The Supreme Court recently declared that litigants who challenge the constitutionality of the existence or structure of an administrative agency are not required to exhaust the entirety of the agency proceedings before accessing the federal court system. See *Axon Enter. v. FTC*, 143 S. Ct. 890, 906 (2023).

⁹ *Jarkesy v. SEC*, No. 20-61007, at 3.

¹⁰ *Id.*

¹¹ *Id.* at 5.

¹² *Id.* at 8-9.

¹³ *Id.* at 9-13.

The Fifth Circuit also found a constitutional violation in Congress's delegation of power to the SEC to determine, without any guidance or limitation, whether to bring enforcement actions in federal courts or in the SEC's in-house tribunal. The Fifth Circuit found that this delegation of power violated the "non-delegation doctrine" because Congress gave the SEC the "legislative power" to determine the proper venue of its enforcement actions but did not provide the SEC with an "intelligible principle" to guide this decision-making power.¹⁴

Finally, the Fifth Circuit held that there were unconstitutional limitations on the President's power to appoint and remove SEC's ALJs, as the ALJs are protected by "two layers of for-cause protection."¹⁵ The Court held that the SEC ALJs performed "substantial executive functions" because (1) they "exercise considerable power over administrative case records by controlling the presentation and admission of evidence"; (2) "they may punish contemporaneous conduct"; and (3) "their decisions are [often] final and binding."¹⁶ The Fifth Circuit held that the scope of this executive authority requires the President to be able to remove SEC ALJs without embarking on an inefficient and multilevel process.¹⁷

Supreme Court Oral Argument

The discussion at the recent oral argument focused primarily on Seventh Amendment considerations, and it seems likely that the Supreme Court will issue its ruling on that basis. The questions posed by several Justices suggested discomfort with the proposition that the SEC could control whether a defendant receives a jury trial by strategically selecting the forum in which to proceed.

Certain Justices suggested that one must look to the Seventh Amendment first, not the SEC's unilateral choice of forum, to decide whether the claims are of the type that entitle a defendant to a jury trial. Certain Justices also voiced skepticism over the notion that the identity of the party wearing the "plaintiff's hat" should be outcome-determinative on the defendant's right to a jury trial. In other words, it seemed illogical that you would need the protections of a jury trial any less when the government is pursuing you versus a private litigant.

At the argument and in its briefs, the SEC relied heavily on a prior Court decision, *Atlas Roofing Co.*,¹⁸ which held that the Seventh Amendment does not attach when Congress properly assigns matters that seek to adjudicate public rights to a non-Article III tribunal.¹⁹ The SEC maintained that, even though a private individual could have brought the exact same securities claims for the exact same conduct in federal court, the SEC's claims were sufficiently different because certain elements of a securities fraud claim that apply to private litigants do not apply to the SEC.

Certain Justices seemed unconvinced that the same underlying conduct and the same basic fraud claim—whether in the hands of the government or private litigants—could trigger different constitutional outcomes. Certain Justices also suggested that *Atlas Roofing*, now nearly 50 years old, may require limited application,

¹⁴ *Id.* at 22-25.

¹⁵ *Id.* at 25-26.

¹⁶ *Id.* at 25, 28. (Internal citations omitted.)

¹⁷ *Id.* at 30.

¹⁸ *Atlas Roofing Co. v. Occupational Safety & Health Rev. Comm'n*, 430 U.S. 442 (1977).

¹⁹ *Id.* at 430 U.S. 442, 450, 455.

as it was decided during a time when agencies had not permeated the United States government to the extent they have today.

The discussion at the oral argument also signaled concern by the Court for the broader implications of its ruling in *Jarkesy* for administrative proceedings in other agencies. The Court did not appear interested in issuing a broad-sweeping rule that would have a potential negative impact on other federal agencies. There was clear reluctance to issue a ruling that might flood the federal court system with new cases that are arguably more appropriately addressed by specialized agencies.

It seems likely, therefore, that any ruling in the defendants' favor would be narrowly tailored to impact only the SEC's past practices at issue in *Jarkesy*. Such a ruling is possible because, as discussed above, fraud-based claims of the type brought by the SEC against *Jarkesy* already existed "at common law" in 1791 when the Seventh Amendment was passed.

The same could not be said for other matters currently in the hands of other federal agencies. An adverse ruling against the SEC would not open the floodgates to a large number of "new" federal court actions, given that the SEC already brings all contested fraud actions in federal court and has done so for several years.

We will continue to monitor developments with this appeal and report on the Court's ultimate decision when issued.

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ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ +1 404 881 7000 ■ Fax: +1 404 881 7777

BEIJING: Hanwei Plaza West Wing ■ Suite 21B2 ■ No. 7 Guanghua Road ■ Chaoyang District ■ Beijing, 100004 CN ■ +86 10 8592 7500

BRUSSELS: Rue Guimard 9 ■ Brussels, B-1040 ■ Belgium ■ +32 2 550 3700 ■ Fax: +32 2 550 3719

CHARLOTTE: Vantage South End ■ 1120 South Tryon Street ■ Suite 300 ■ Charlotte, North Carolina, USA, 28203-6818 ■ +1 704 444 1000 ■ Fax: +1 704 444 1111

DALLAS: Chase Tower ■ 2200 Ross Avenue ■ Suite 2300 ■ Dallas, Texas, USA, 75201 ■ +1 214 922 3400 ■ Fax: +1 214 922 3899

FORT WORTH: City Center Fort Worth ■ Bank of America Tower ■ 301 Commerce ■ Suite 3635 ■ Fort Worth, Texas, USA, 76102 ■ +1 682 354 2000 ■ Fax: +1 682 354 2299

LONDON: LDN:W ■ 6th Floor ■ 3 Noble Street ■ London ■ EC2V 7EE ■ United Kingdom ■ +44 20 8161 4000

LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ +1 213 576 1000 ■ Fax: +1 213 576 1100

NEW YORK: 90 Park Avenue ■ 15th Floor ■ New York, New York, USA, 10016-1387 ■ +1 212 210 9400 ■ Fax: +1 212 210 9444

RALEIGH: 555 Fayetteville Street ■ Suite 600 ■ Raleigh, North Carolina, USA, 27601-3034 ■ +1 919 862 2200 ■ Fax: +1 919 862 2260

SAN FRANCISCO: 560 Mission Street ■ Suite 2100 ■ San Francisco, California, USA, 94105-0912 ■ +1 415 243 1000 ■ Fax: +1 415 243 1001

SILICON VALLEY: 755 Page Mill Road ■ Building C - Suite 200 ■ Palo Alto, California, USA, 94304 ■ +1 650 838 2000 ■ Fax: +1 650 838 2001

WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ +1 202 239 3300 ■ Fax: +1 202 239 3333