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REPORT

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ASK THE PROFESSOR

How Will the Recent U.S. Supreme Court Decision in *Jarkesy* Impact Past, Current and Future SEC, CFTC and SRO Enforcement Actions?

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INTRODUCTION AND BACKGROUND

On June 27, 2024, the U.S. Supreme Court held in *Securities and Exchange Commission v. George R. Jarkesy et al.* that, since securities fraud claims which seek civil penalties brought by the U.S. Securities and Exchange Commission ("SEC") in an enforcement action are similar to common law fraud, the defendant is entitled to a trial by jury and that hearings before a SEC administrative law judge ("ALJ") are illegal.[1]

The SEC had initiated an enforcement action against George Jarkesy and Patriot28, LLC, a hedge fund mananged by Mr. Jarkesy, in 2013, in which the SEC sought civil penalties for alleged securities fraud claims.[2] The SEC had chosen to adjudicate this matter before one of its own ALJs.[3] The issue before the Supreme Court was whether the Seventh Amendment permitted the SEC to compel the respondents to defend themselves before the agency tribunal rather than before a jury in federal court. [4]

In 2014, the ALJ issued his initial decision, the SEC reviewed the decision in 2020, and the Fifth Circuit vacated the SEC's Order in 2022.[5] This case was before the Supreme Court on appeal from the Fifth Circuit.

ANALYSIS OF THE *JARKESY* CASE

The Supreme Court analyzed the basic anti-fraud provisions in the federal securitites laws, namely, Section 17(a) of the Securities Act of 1933 ("1933 Act"), Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act") and Section 206 of the Investment Advisers Act of 1940 ("IA Act") and SEC Rule 10b-5.[6] It then analyzed the differeces between an enforcement action brought by the SEC before one of its ALJs versus going to federal court.[7] It noted that there were significant procedural differences between these two types of forums, in particular, what evidentiary and discovery rules apply and who finds the facts.[8] In particular, it noted that, in federal court, a jury finds the facts, a life-tenured, salary protected Article III judge presides and the Federal Rules of Evidence apply whereas, when the enforcement action is brought before an in-house ALJ, the SEC itself adjudicates the matter as the ALJ is employed by the SEC, the SEC's Division of Enforcement prosecutes the case, the SEC resolves all discovery disputes and the SEC's Rules of Practice apply which are significantly different than the Federal Rules of Evidence.[9] It also noted that the full Comission itself will review any appeal and then, and only then, may the case be appealed to a federal court of appeals.[10] On appeal, the reviewing court "must" treat the agency's factual findings as "conclusive" even if such evidence could not have been admitted in federal court.[11]

The Supreme Court then noted the significant changes made by the Dodd-Frank Act, in particular, which gave the SEC the right to seek civil penalties now in hearings both before an SEC ALJ as well as in federal court whereas, prior to the Dodd-Frank Act, the SEC could only seek civil penalties in federal court.[12]

In particular, the Supreme Court analyzed a fundamental question, that is, whether the Seventh Amendment entitles a defendant in an SEC enforcement action in which the SEC sought civil penalties to a jury trial.[13] The Supreme Court clearly held: "it does."[14] It then analyzed whether the "public rights exception" set forth in Article III jurisdiction applies to an SEC enforcement actions; "it does not."[15] The Supreme Court concluded that the exception does not apply here because the fraud claims brought by the SEC against the respondents in this case "does not fall within any of the distinctive areas involving governmental prerogatives" as noted in Article III.[16]

The Supreme Court then devoted significant pages to the purpose of the right to a jury trial under the Seventh Amendment and why the "public rights" exception does not apply to securities fraud cases.[17]

The majority opinion written by Chief Justice Roberts focused primarily on the Seventh Amendment's right to a jury trial. In a concurring opinion written by Justice Gorsuch and joined by Justice Thomas, Justice Gorsuch noted that other constitutional provisions applied as well. Namely, Justice Gorsuch noted that the Due Process clause of the Fifth Amendment and Article III of the Constitution, entitling individuals to an independent judge, should also be applied to limit how the government may go about depriving an individual of "life, liberty or property."[18] Justice Gorsuch noted regarding the changes made by the Dodd-Frank Act:

> "To be sure, the Commissioners opted, as they often do, to send Mr. Jarkesy's case in the first instance to an 'administrative law judge,' (citing 17 CFR § 201.110(2023), but the title 'judge' in

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> this context is not quite what it might seem. Yes, ALJs enjoy some measure of independence as a matter of regulation and statute from the lawyers who pursue charges on behalf of the agency. Yet, they remain servants of the same master - the very agency tasked with prosecuting individuals like Mr. Jarkesy."[19]

Justice Gorsuch then noted:

> "Going in, then, the odds were stacked against Mr. Jarkesy. The numbers confirm as much: According to one report, during the period under study, the SEC won aout 90% of its contested in-house proceedings compared to 69% of its cases in court."[20]

> "How did all this play out in Mr. Jarkesy's case? Accompanying its charges, the SEC disclosed 700 gigabytes of data—equivalent to between 15 and 25 million pages of information it had collected. . .. .over Mr. Jarkesy's protests that it would take 'two lawyers or paralegals working twelve-hour days over four decades to review."[21]

In a dissenting opinion written by Justice Sotomayor that was joined by Justices Kagan and Jackson, Justice Sotomayor noted that Congress had intended for agencies, like the SEC, to be permitted to use their own ALJs.[22] In supporting the "public rights exception" in Article III, Justice Sotomayor then noted:

> "It (Congress) has enacted more than 200 statutes authorizing dozens of agencies to impose civil penalties for violations of statutory obligations. Congress had no reason to anticipate the chaos today's majority would unleash after all these years."[23]

Justice Sotomayor then listed more than two dozen agencies that can impose civil penalties in administrative proceeings, all of which were enacted by Congress.[24]

IMPACT OF THE *JARKESY* CASE ON PAST, CURRENT AND FUTURE SEC, CFTC AND SRO ENFORCEMENT ACTIONS

There is no doubt that agencies, like the SEC, must now bring any civil enforcement proceeding in which it is seeking civil penalties in federal court, eliminating its use of in-house ALJs. I am not sure that this adversely impacts current and future SEC enforcement actions as the SEC has recently been filing most of its enforcement actions in federal court. Similarly, the CFTC has not used ALJs for many years, so this case will have little to no impact on current and future CFTC enforcement actions. Query, it will be interesting to see if any past SEC enforcement actions that were adjudicated by an SEC ALJ will file a motion to dismiss any such cases.

The *Jarkesy* decision will also impact the time to resolve contested SEC enforcement actions as federal courts often take much more time to finalize any actions brought by the SEC than those adjudicated by an ALJ.

Query, it will be interesting to see if SEC and CFTC disgorgement cases will be impacted and, if so, how, by the *Jarkesy* case. These do not directly involve civil penalties but seek instead restitution of any profits made by the respective respondent.[25] Similarly, as noted below by the recent *Loper Bright* decision, will enforcement actions brought by the SEC and the CFTC involving crypto/digital assets and their trading platforms be challenged by the absence of the *Chevron* deference until any new federal legislation granting them jurisdiction over crypto/digital assets?

It will also be interested to see if any enforce-

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ment actions brought by a self-regulatory organization ("SRO"), such as FINRA, NFA or any securities or derivatives exchange, will be impacted by the *Jarkesy* case. There is a pending action before the D.C. Court of Appeals in which a broker-dealer, Alpine Securities, has challenged FINRA's right to bring an enforcement action before one of its hearing officers.[26]

'The questions before the D.C. Court of Appeals are:

1. If FINRA is deemed to be a private entity, can it also be deemed to be "part of the government" for constitutional purposes?
2. Is FINRA a state actor subject to constitutional constraints, or not?
3. Are FINRA's actions in an enforcement case "attributable to" the government?
4. How would arbitrations brought, pursuant to the FINRA Code of Arbitration, be impacted if Alpine Securities is successful in its claims?
5. How will the D.C. Court of Appeals view the role of self-regulation?
6. Should SRO enforcement/business conduct hearings, which utilize a combination of industry members and public representatives for the respective panel, rather than hearing officers, be treated differently than a SEC enforcement action adjudicated by an ALJ?[27]
7. All SROs are mandatory membership organizations whereby the member agrees in advance to the SRO's grievance proceeding. Does this mandatory membership requirement create a difference from the principles set forth in the *Jarkesy* decision?[28]

IMPACT OF *LOPER BRIGHT* ON FUTURE AGENCY ENFORCEMENT ACTIONS

One day after the Jarkesy decision,, on June 28, 2024, the Supreme Court issued its decision in the *Loper Bright* case which effectively unwound the *Chevron* deference that has been granted to agencies' interpretations of its rulemakings for over 40 years.[29] While the courts will no longer be allowed to defer to the expertise of the respective agency, it will be interesting to see how the *Loper Bright* case might impact future SEC and CFTC enforcement actions that do not involve basic anti-fraud claims as SEC Rule 10b-5 is generic in nature just like the CFTC's anti-fraud regualtions.

CONCLUSION

As noted above, administrative proceedings which seek civil penalties are now DOA. Respondents, that do not seek settlements, are clearly now entitled to a jury trial.

ENDNOTES:

[1]*Securities and Exchange Commission v. Jarkesy et al.,* No. 22-859 (SC - June 27, 2024). Cite as *Securities and Exchange Commission v. Jarkesy*, 144 S. Ct. 2117 (2024). See also *Lucia v. Securities and Exchange Commission*, 585 U.S. 237, 138 S. Ct. 2044, 201 L. Ed. 2d 464, Fed. Sec. L. Rep. (CCH) P 100205 (2018) wherein the Supreme Court held that the SEC's ALJs were inferior federal officers that needed to be appointed by the President,.. or Heads of Departments. Following *Lucia,* the SEC empowered all of its ALJs. See SEC Press Release 2017-215, SEC Ratifies Appointment of Adminsitarive

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Law Judges (Nov. 30, 2017).

[2]Slip Opinion of *Jarkesy* at p.1.

[3]*Ibid*.

[4]*Ibid*.

[5]Slip Opinion at p.5. See also *Jarkesy v. Securities and Exchange Commission*, 34 F.4th 446, Fed. Sec. L. Rep. (CCH) P 101401 (5th Cir. 2022), cert. granted, 143 S. Ct. 2688, 216 L. Ed. 2d 1255 (2023) and cert. denied, 143 S. Ct. 2690, 216 L. Ed. 2d 1256 (2023).

[6]Slip Opinion at p.2. See also 15 U.S.C.A. § 77q(a), 15 U.S.C.A. § 78(j)(b), 15 U.S.C.A. § 80b-6(4) and 17 C.F.R. § 240.10b-5.

[7]Slip Opinion at p.3.,

[8]*Ibid*.

[9]*Ibid*.

[10]*Ibid*.

[11]*Ibid*. (emphasis added).

[12]Slip Opinion at p.4. See also Dodd-Frank Wall Street Reform and Consumer Protection Act, 124 Stat. 1376 and 1862-1864, and H.R. Rep. No. 111-687, p.78n (2010)

[13]Slip Opinion at p. 6.

[14]*Ibid*.

[15]*Ibid*.

[16]Slip Opinion at p.7.

[17]Slip Opinion at pp. 7-27.

[18]See Concurring Opinion of Justice Gorsuch at p.1.

[19]Gorsuch Concurring Opinion at p.2.

[20]Gorsuch Concurring Opinion at p.3.

[21]*Ibid.*

[22]See Dissenting Opinion of Justice Sotomayor at p.1.

[23]*Ibid.*

[24]Dissenting Opinion of Sotomayor at pp. 34-35.

[25]See "Ask the Professor: Will the Recent Second Circuit Decision in *SEC v. Govil* Adversely Impact Future SEC Disgorgement Cases—or Not?," 44 Fut. Deriv. L. Rep. (June 2024) and "Ask the Professor—How Did the Fifth Circuit Interpret the "Investor Benefit' Requirement Governing Disgorgements in *Blackburn?,'* 41 Fut. Deriv. L. Rep. (December 2021).

[26]See *Alpine Securities Corporation et al. v. Financial Industry Regulatory Authority, Inc.* No. 23-5129 (DC Cir.).

[27]The panels that hear most Business Conduct Committees are comprised of both industry members of the respective SRO and public representatives, with the public representative typically being the chair of the respective panel.

[28]See Brief of Amici Curiae National Futures Association, CME Group Inc. and CBOE Global Markets Inc. filed with the DC Court of Appeals in the *Alpine Securities* case (November 3, 2023).

[29]See *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244 (2024) which overruled *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 104 S. Ct. 2778, 81 L. Ed. 2d 694, 21 Env't. Rep. Cas. (BNA) 1049, 14 Envtl. L. Rep. 20507 (1984).

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