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SUPREME COURT HOLDS SEC STATUTORY FRAUD CLAIMS MUST BE ADJUDICATED IN COURT VS. ADMINISTRATIVE PROCEEDINGS

KEY HIGHLIGHTS

- The U.S. Supreme Court has held that parties accused of violating federal anti-fraud securities statutes are entitled to a jury trial as opposed to a closed-door proceeding with an administrative law judge.
- The Securities and Exchange Commission is expected to continue pursuing non-fraud actions in administrative proceedings, but fraud claims will need to be filed in federal court.
- Defendants must consider a number of tactical decisions not necessary in administrative proceedings, including how best to use court discovery tools and how to preserve all appellate issues, as well as whether to seek a jury vs. bench trial.
- The decision will likely cause a material change in how the SEC approaches future investigations and litigation.

On June 27, 2024, the U.S. Supreme Court resolved a critical question, whether parties defending fraud claims brought by the government are entitled to have those claims decided by a jury, as opposed to an administrative law judge in a closed-door administrative proceeding. In a 6-3 opinion authored by Chief Justice John Roberts, the Supreme Court held that parties accused of violating the federal anti-fraud securities statutes are entitled to a jury trial. The case is *Securities & Exchange Commission v. George Jarkesy et al.,* Case No. 22-859, 2024 WL 3187811 (U.S. June 27, 2024), and may be accessed here.

Summary: Similar questions have not been addressed in over 30 years, since the Court's opinions in *Tull v. United States*, 481 U.S. 412 (1987) and *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989). Both *Tull* and *Granfinanciera* acknowledged the "public rights exception" to the Seventh Amendment right to a jury trial, which arises where Congress authorizes an executive branch agency to bring claims in administrative forums to enforce public rights created by statute. Yet, in *Tull*, the Court held "actions by the

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Government to recover civil penalties under statutory provisions [] historically have been viewed as one type of action in debt requiring trial by jury." 481 U.S. at 418–19. And in *Granfinanciera*, the Court held that at least one type of statutory fraud claim – a Bankruptcy Code fraudulent transfer claim brought by a trustee – was "more accurately characterized as a private rather than a public right[.]" 492 U.S. at 55. Relying on both *Tull* and *Granfinanciera*, *Jarkesy* narrows the scope of the "public rights exception" and confirms that the right to a jury trial applies to all claims originating from common law, including fraud.

Impact: Going forward, we expect the SEC will continue to pursue non-fraud actions in administrative proceedings. That encompasses a broad range of matters such as compliance with Regulation Best Interest, several Advisers Act case theories (under both the duties of care and loyalty), registration requirements, maintaining and preserving books and records, and more. Fraud claims, however, will need to be filed in federal court. This will require that defendants consider a number of tactical decisions that are not necessary in administrative proceedings. For example, parties will need to determine how to best utilize the discovery tools available in federal court and how to preserve all appellate issues for review. Even the decision of whether to seek a jury trial vs. agreeing to a bench trial will require consideration of the complexity of the defense theories, whether the conduct is particularly egregious, whether the SEC will have a difficult time proving each of its claims' elements based on the available evidence, and whether there will be witness credibility determinations. Looking ahead, *Jarkesy* may also invite challenges to administrative proceedings overseeing claims based on other federal statutes that codify common law claims, or state law versions of the anti-fraud statutes.

BACKGROUND

On March 22, 2013, the SEC filed an administrative proceeding against the defendant and his company, which advised two hedge funds. The SEC alleged that the defendant engaged in fraud by making arbitrary valuations of the funds' holdings which caused their performance figures to be false, marketing the funds using false representations, and breaching his fiduciary duty by not disclosing that certain fees were provided to the CEO of an affiliated broker-dealer. On Jan. 29, 2014, Jarkesy filed suit against the SEC in the U.S. District Court for the District of Columbia, seeking an injunction against the administrative proceeding on grounds that it violated his fundamental constitutional rights, including the right to a jury trial. The District Court found that Congress intended the process of administrative and judicial review to be exclusive and, thus, the court lacked subject matter jurisdiction to hear the defendant's constitutional claims before there was a final decision in the administrative action. The U.S. Court of Appeals for the District of Columbia Circuit agreed and affirmed the District Court on Sept. 29, 2015. *Jarkesy v.*

S.E.C., 803 F.3d 9 (D.C. Cir. 2015).

Meanwhile, the SEC administrative proceeding went to hearing in February 2014. The administrative law judge ordered the defendant to pay a civil penalty of $450,000 and disgorgement of $1,278,597. The defendant appealed the decision to the Commission. By opinion and order on Sept. 4, 2020, the Commission barred the defendant from any future investment-related activities and ordered him to pay a $300,000 civil penalty and $684,935.35 in disgorgement.

Jarkesy appealed the outcome of the SEC's administrative proceeding to the Fifth Circuit Court of Appeals, making several constitutional arguments. By opinion dated May 18, 2022, the Fifth Circuit vacated the SEC's decision on grounds that (1) SEC administrative actions violate individuals' right to a jury trial guaranteed by the Seventh Amendment; (2) Congress unconstitutionally delegated legislative power to the SEC when it gave the agency the power to assign disputes to administrative adjudication (as opposed to court) without providing any intelligible principle to guide that delegated power; and (3) the statutory protections against removing SEC ALJs violated the Constitution as they possibly prevent the President from faithfully executing the law. Thereafter, the U.S. Supreme Court granted *certiorari* review on June 30, 2023, and heard oral argument on Nov. 29, 2023.

FURTHER ANALYSIS: THE JARKESY OPINION

Citing the analyses in *Tull* and *Granfinanciera*, the *Jarkesy* Court considered two questions. First, whether claims based on alleged violations of the securities anti-fraud statutes triggered the right to a jury trial. Second, whether the public rights exception applied and allowed Congress to authorize the SEC to adjudicate those claims in its administrative forum without a jury.

With respect to the first question, the Court found several reasons why the right to a jury applied. The Seventh Amendment right to a jury applies to all common law claims that do not invoke a court's equity or admiralty jurisdiction. That includes statutory claims which are "legal in nature."

In determining whether the SEC's statutory fraud claim was legal or equitable, the Court reviewed the nature of the penalty the regulator was seeking. Citing *Tull*, *Jarkesy* stated "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." The Court reviewed the statutory factors in 15 U.S.C. § 78u-2(c), which governs whether the SEC may obtain a civil monetary penalty, and found that they "concern culpability, deterrence, and recidivism." Further, the size of the penalty was closely connected to how culpable the conduct was pursuant to the three "tiers" of civil penalties authorized by 15 U.S.C. § 78u-2(b). Finally, the Court noted that the SEC was not required to return any civil

penalty funds to the underlying victims, and the target of both common law fraud and statutory fraud was the same conduct, i.e., mispresenting or concealing material facts.

With respect to the second question and whether the “public rights exception” applied, the Court viewed this aspect of the decision as a separation of powers issue; that the “judicial Power of the United States cannot be shared with the other branches.” Therefore, the default principle is “matters concerning private rights may not be removed from Article III courts.” The Court reviewed the cases involving public rights – statutory actions involving collection of revenue, immigration restrictions, tariffs on foreign goods, and others – and noted that those cases involved government rights that “flowed from century-old rules” concerning sovereign authority while *Jarkesy* involved claims of fraud.

Emphasizing the separation of powers, the Court quoted *Stern v. Marshall*: “Article III could neither serve its purpose in the system of checks and balances nor preserve the integrity of judicial decision making if the other branches of the Federal Government could confer the Government's ‘judicial Power’ on entities outside Article III.” 564 U.S. 462, 484 (2011). Because the anti-fraud statutes authorized the SEC to obtain civil penalties and targeted the same conduct as common law fraud, the Court found that the SEC’s fraud action against Jarkesy involved private, and not public, rights. Jarkesy was entitled to have a jury of his peers decide the statutory fraud claims brought against him and his company by the SEC.

In a result that limits the effect of the *Jarkesy* decision, the Court did not address the other issues the Fifth Circuit relied upon – relating to the appropriate delegation of legislative power and the removal protections for administrative law judges – to affirm that court’s decision to vacate the SEC’s administrative order entered against Jarkesy.

CONCLUSION

As of the date of this advisory, the SEC has not issued a press release or statement from the Chair on the *Jarkesy* decision. We expect, however, that the decision will cause a material change in how the regulator approaches future investigations and litigation.

To be sure, administrative courts are now no longer acceptable forums for cases involving alleged violations of the federal anti-fraud statutes.[1] Such cases must now be brought in federal court, where defendants will be able to utilize broader discovery tools under the Federal Rules of Civil Procedure and have a wholly independent adjudicator in the form of an Article III federal judge.

If you have any questions about the *Jarkesy* decision or how it may impact any

investigations or proceedings involving your company, please reach out to your regular Armstrong Teasdale lawyer or one of the listed authors.

[1] Those statutes would include Section 17(a) of the Securities Act (15 U.S.C. § 77q), Section 10(b) of the Securities Exchange Act (15 U.S.C. § 78j), and Section 206 of the Investment Advisers Act (15 U.S.C. § 80b-6).