

Views From Two Trenches: Supreme Court Limits SEC's Ability to Use Internal Proceedings

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In a major victory for the securities defense bar, the U.S. Supreme Court ruled last month that the Securities and Exchange Commission cannot force defendants facing fraud charges into administrative proceedings before the SEC's in-house judges. Though its contours will likely be litigated in the coming years, this ruling has effectively put a stop to the SEC's use of its in-house courts for most litigated enforcement actions. This landmark change in how the SEC can enforce the securities laws is the direct result of years of concerted efforts by the defense bar. Without its home-court advantage, the SEC will have to litigate its cases in federal court—a process that is more complex and resource-intensive. But the SEC has been preparing for this eventuality for years.

We each have followed this controversy avidly, from different perspectives. In 2014, days after Joel Cohen prevailed at trial against the SEC on behalf of hedge fund clients charged with insider trading, the SEC publicly declared its intention to litigate more matters in administrative proceedings. That announcement launched a decade of organized attempts by the defense bar to oppose this shift in strategy, as we discuss below. Meanwhile, during Ladan Stewart's tenure at the SEC, as the industry got increasing traction in the courts for its constitutional challenges to administrative proceedings, the SEC started to build a larger and more formidable litigation unit (including creating its first ever specialized litigation team focusing on crypto and cyber matters, which Ladan led), and brought virtually all of its litigated enforcement actions in federal court. Thus, while the



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SEC v. Jarkesy decision marks a significant milestone for the securities industry, securities defendants litigating against the SEC should be prepared to face a sophisticated opponent that is increasingly able to effectively navigate federal court litigation.

The 'Jarkesy' Ruling

When instituting an enforcement action, the SEC can choose to bring an administrative proceeding, whereby the commission effectively adjudicates the matter itself, or a suit in federal court, where a jury is generally the factfinder. The commission can, and typically does, delegate its role as factfinder in administrative proceedings to administrative law judges (ALJs). Until fairly recently, the SEC could obtain civil penalties only

in federal court (except in cases against entities registered with the SEC, which could be brought administratively). But the 2010 Dodd-Frank Act changed the landscape, allowing the SEC to seek civil penalties in administrative proceedings against all defendants.

It was under this new Dodd-Frank authority that the SEC charged the defendants in *Jarkesy* in an administrative proceeding with violating the “antifraud provisions” of the securities laws. The SEC’s final order levied a civil penalty, among other relief. The defendants appealed, arguing that the SEC had violated their Seventh Amendment right to a trial by jury under the U.S. Constitution. The Fifth Circuit ruled in favor of the defendants on three separate grounds: first, that the in-house proceeding violated their Seventh Amendment right to a jury trial; second, that Congress’ delegation of authority to the SEC violated the nondelégation doctrine; and third, that the insulation of SEC ALJs from executive supervision—with two layers of for-cause removal protections—violated separation of powers principles. The Supreme Court affirmed, but only as to the first point. See *SEC v. Jarkesy*, No. 22-859, slip op. at 7 (2024).

Writing for the majority, Chief Justice John Roberts explained that the SEC’s enforcement action was required to be brought in federal court because the antifraud provisions at issue resemble common law fraud claims typically heard by juries, and because civil penalties are a legal, rather than equitable, remedy that can only be enforced in courts of law. The court concluded by emphasizing that a “defendant facing a fraud suit has the right to be tried by a jury of his peers before a neutral adjudicator.” The language employed by the court strongly suggests that *any agency effort* to pursue punitive relief against a defendant must proceed in federal court, not through an administrative process. Indeed, it is almost certain that *Jarkesy* will have, in the words of Justice Sonia Sotomayor in her dissent, “momentous consequences” beyond the SEC, as more than two dozen federal agencies are authorized to impose civil penalties through administrative proceedings.

While largely expected, this ruling is a major blow to the SEC’s enforcement powers. Coupled with the Supreme Court’s other landmark decision from June

in *Loper Bright Enterprises v. Raimondo* overruling *Chevron* deference to agency determinations, and in light of a series of other recent decisions curtailing the reach of the administrative state, it is increasingly clear that we are in a period of regulatory decline for the SEC.

The Long Road to ‘Jarkesy’

The *Jarkesy* decision is the culmination of a years-long effort by defendants and the defense bar to expose the inherent shortcomings of the SEC’s administrative process which, they have argued, does not adequately protect the rights of defendants. For example, the expedited schedule for in-house proceedings—which can be as short as just a few months—can disadvantage defendants because it shortens their time to prepare an adequate defense. Further, the Federal Rules of Evidence do not apply to administrative proceedings. Instead, ALJs are generally permitted to “receive relevant evidence” under SEC rules and must only “exclude all evidence that is irrelevant, immaterial or unduly repetitious.” 17 C.F.R. 201.320. Accordingly, evidence deemed too unreliable to be permitted in federal court—most notably hearsay evidence—has been admissible in administrative proceedings.

While the defense bar publicly highlighted these disadvantages in a concerted effort to pressure the SEC to change course, it also identified other issues with the in-house administrative process, which led to a series of constitutional attacks that culminated in the ruling in *Jarkesy*. One such challenge was premised on the grounds that the SEC violated the Constitution’s guarantee of equal protection when it sued some defendants in federal court and others administratively. In 2015, after some litigation on this point and a public expression of concern by some members of Congress about fairness and transparency regarding the SEC’s choice of forum, the SEC’s Division of Enforcement released a detailed explanation of its process for choosing between federal court and an administrative proceeding.

Another successful line of attack revolved around the constitutionality of the procedures for appointing and removing ALJs. Before 2018, ALJs were selected by SEC staff, rather than by the commission. Defense

attorneys zeroed in on this aspect of the administrative process, arguing that it violated the Constitution's appointments clause because ALJs qualify as "principal officers" who must be appointed by the president, a court of law, or the head of a department (such as the commission itself). In *Lucia v. SEC*, the Supreme Court agreed, holding that ALJs qualify as principal officers whose appointments must comport with the appointments clause.

In a separate challenge, the defense argued that the congressional statutes that permit termination of principal officers only "for cause" are an unconstitutional violation of separation of powers principles. The Supreme Court again agreed, ruling that because the president must possess the power to remove most principal officers at will, certain protections against "for cause" removal unconstitutionally restrict Executive Branch authority. Although this decision related to a different federal agency (the CFPB), as noted above, the U.S. Court of Appeals for the Fifth Circuit's ruling in *Jarkesy* also concluded that "for cause" removal provisions protecting SEC ALJs are unconstitutional, and that the in-house administrative process violates the nondelegation doctrine. Since the Supreme Court did not reach these issues, the Fifth Circuit's ruling on these two points stands.

This series of legal attacks waged over the past decade significantly advanced the case against the SEC's use of in-house tribunals—culminating, of course, in the long-awaited *Jarkesy* decision.

The SEC's Response and the Path Forward for Securities Defendants

The SEC has seen the writing on the wall for some time now. Long before *Jarkesy*, the Commission started to change its approach to enforcement actions. Following the Supreme Court's 2018 decision in *Lucia*, the SEC has, for the most part, limited its use of administrative proceedings to settled cases. Litigated cases (except for rare cases where the relief sought is not available in federal court) have been generally brought by the SEC in federal court. After *Jarkesy*, this approach will likely be formalized. The

precise scope of the *Jarkesy* ruling remains unclear—open questions include whether the ruling can be limited to fraud cases and if the SEC can continue to bring administratively claims that are not available in federal court. But until these matters are resolved by courts, we can expect the SEC to bring its litigated actions primarily in federal court.

What this means for the agency is that it will have to continue to invest in its litigation resources. Federal court litigation is far more lengthy, complex and burdensome than administrative proceedings. The SEC has significantly bolstered its litigation team in recent years, including by adding a slew of former federal prosecutors with trial experience as well as seasoned civil litigators from leading law firms. The agency has been able to hold its own in numerous lengthy and high-profile litigations in recent years. Of course, as federal court litigation remains the norm, the agency will have to continue grow its litigation roster.

Meanwhile, the defense bar must contend with a more sophisticated—and increasingly aggressive—opponent on the other side of the table. This is true even at the investigative phase, as SEC litigators are routinely getting involved at earlier phases of investigations to advise on litigation risk and strategy. Now, more than ever, securities defendants battling the SEC must be prepared to engage sophisticated and creative legal counsel that can deploy aggressive tactics and novel defenses.

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