Hedge Fund Law Report hflawreport.com

Mar. 28, 2024

SEC Enforcement Matters

Common Law Fraud and SEC *v. Jarkesy*: The Key Issue Underlying the Questions Presented

By Eric R. Nitz and Kenneth Notter, *MoloLamken LLP*

In SEC *v. Jarkesy*, the U.S. Supreme Court (Court) is poised to determine the constitutionality of the SEC's practice of enforcing the securities laws through administrative proceedings. How the Court will answer that question is unclear, but whatever the Court decides will have far-reaching implications. Beyond the obvious repercussions for SEC proceedings and the administrative state generally, the case also offers the Court a chance to weigh in on another significant question: What are the contours of common law fraud?

This article discusses the proceedings before the Court, how the Court appears likely to rule and the implications the Court's decision may have on SEC enforcement efforts – and fraud actions generally – against private fund managers.

See "Agency Power and Adjudication: The Government Seeks Supreme Court Review of *Jarkesy v. SEC*" (Jun. 8, 2023).

The Road to the Court

SEC Proceedings Generally

The SEC has two paths to enforce federal securities laws. It can either:

1. file a civil lawsuit in federal court; or
2. institute administrative enforcement proceedings before the Commission.

In the first option, a federal district court judge – appointed under Article III of the Constitution – presides over the case. The defendant and the SEC would have to follow the ordinary Federal Rules of Civil Procedure and Federal Rules of Evidence. And, critically, the defendant would have a right to a jury trial and to appeal any final judgment directly to the court of appeals.

In contrast, administrative proceedings are not conducted by a federal judge nominated by the President and confirmed by the Senate. Rather, an administrative law judge (ALJ) – an SEC employee who may be removed only "for cause" – oversees the proceedings according to the SEC's Rules of Practice and prepares an initial decision with findings of fact and conclusions of law. A defendant can appeal that decision to the full Commission for a final order and then petition the court of appeals to review that final order.

The SEC chooses whether to file a civil suit in federal court or initiate administrative enforcement proceedings – not the defendant.

The Fifth Circuit's Decision in *Jarkesy*

In 2013, the SEC initiated enforcement proceedings against hedge fund manager George Jarkesy, Jr. for alleged violations of federal securities laws. Although the SEC could have pursued the same allegations in federal court, it opted to proceed with an administrative action before an ALJ, who found that Jarkesy had violated the securities laws and imposed a $300,000 civil penalty and $685,000 in disgorgement. The full Commission affirmed the ALJ's decision.

In May 2022, a divided panel of the Fifth Circuit, however, held that the administrative enforcement proceedings against Jarkesy violated the Constitution in three ways:

1. administrative proceedings before an ALJ violated Jarkesy's Seventh Amendment right to a jury trial;
2. Congress unconstitutionally delegated its legislative authority by giving the SEC complete discretion to pick whether to bring enforcement actions in federal court or before an ALJ; and
3. the statutory for-cause removal requirements for ALJs violated the Constitution.

On the first issue, the Fifth Circuit ruled that both the substantive cause of action (securities fraud) and the remedies the SEC sought (monetary penalties) were similar enough to common law fraud to trigger the Seventh Amendment's guarantee of a jury trial for all "suits at common law." The court rejected the SEC's argument that the Seventh Amendment did not apply because the case involved "public rights" created by Congress separate and apart from existing common-law causes of action.

Judge W. Eugene Davis disagreed. He asserted that an SEC enforcement proceeding involves public rights because it is brought by the government in its sovereign capacity to vindicate public interests. In such a proceeding, Jarkesy had no Seventh Amendment right to a jury trial.

The Fifth Circuit also concluded that Congress had unconstitutionally delegated legislative authority by granting the SEC unconstrained discretion to determine the forum for enforcement proceedings. Article I of the Constitution vests Congress – and only Congress – with legislative power. Under separation of powers principles, Congress cannot delegate that legislative authority to the Executive or the Judiciary. The Fifth Circuit concluded that the decision to bring an enforcement case before an agency adjudicator, rather than in court, constituted legislative authority and that the unconstrained discretion the SEC exercised in that regard violated the non-delegation doctrine. Judge Davis again dissented.

Finally, the Fifth Circuit found that the statutory removal requirements for SEC ALJs violated Article II of the Constitution. Because Article II vests the President with authority for appointing officers of the United States, and because the power to remove is ancillary to the power to appoint, Congress violates the Constitution when it excessively restricts the President's removal authority. Concluding that SEC ALJs were officers, the Fifth Circuit held that removal restrictions for the ALJs violated the Constitution. On that question, too, Judge Davis dissented.

The Fifth Circuit rejected the government's petition for rehearing *en banc* by the full court. Although six judges would have granted rehearing, ten voted against doing so.

For more on *Jarkesy*, see "A Jury of Your Peers: Fifth Circuit Ruling in *Jarkesy v.* SEC Broadly Expands the Right to a Jury Trial for SEC Actions" (Jul. 21, 2022); and "Fifth Circuit Decision Could Hamstring SEC Enforcement Abilities" (Jun. 9, 2022).

Jarkesy at the Court

The Government's Petition

The government petitioned for certiorari, and the Court granted the petition, agreeing to hear three questions:

1. Did Congress violate the Seventh Amendment by allowing the SEC to adjudicate enforcement actions before ALJs?
2. Did Congress impermissibly delegate its legislative power by allowing the SEC to decide whether to proceed through agency adjudication or in federal court?
3. Did Congress improperly grant for-cause removal protection to ALJs when the agency head also has for-cause removal protection?

The Parties' Briefs

Addressing the Seventh Amendment question first, the government argued that the Court's decision in *Atlas Roofing Co. v. Occupational Safety & Health Review Commission* resolves the jury-trial right question here. According to the government, the Court must first consider whether the dispute is one that Congress can permissibly assign to a non-Article III adjudicator. If so, that resolves the Seventh Amendment question concerning the right to a jury trial: When Congress can appropriately assign a dispute to a non-Article III adjudicator, the parties have no right to a jury trial even if Congress also opens an Article III forum to the parties.

Put differently, the question of whether a jury-trial right attaches only arises when the dispute is one that must be resolved by an Article III court. The text of the Seventh Amendment supports that interpretation, the government argued, because its terms apply only to "suits at common law."

Under *Atlas Roofing*, the government asserted, Congress could appropriately assign SEC enforcement proceedings to a non-Article III adjudicator because the securities laws created "new statutory obligations" enforceable through "civil penalties." According to the government, that resolves the Seventh Amendment question.

Turning to the non-delegation question, the government argued that "enforcement discretion" is a "core executive power." The choice of forum falls within that power: "[T]here is no constitutional difference between the power to decide *whether* to bring an enforcement proceeding and the power to choose *where* to bring it," the government asserted.

Finally, the government argued that the SEC's ALJs are not impermissibly insulated from removal. Distinguishing the Court's prior decision in *Free Enterprise Fund v. PCAOB*, the government noted that SEC ALJs are adjudicators, not policymakers. Adjudicators require "decisional independence," so Congress has "more leeway" to impose conditions on their removal.

In response, Jarkesy defended the Fifth Circuit's decision. Emphasizing the jury's role and function in English history, Jarkesy argued that the Seventh Amendment required a jury trial in securities enforcement actions. SEC enforcement actions, he argued, involve the "core" right of private property and encompass common law claims traditionally resolved by a jury. The government's reliance on *Atlas Roofing*'s public-rights doctrine was therefore flawed. Additionally, more recent Court decisions have limited or overruled *Atlas Roofing*.

The assignment of claims to a non-Article III forum violated non-delegation principles, Jarkesy argued. The decision to assign a claim to a non-Article III adjudicator is a "core legislative power," and Congress's decision to vest such authority in the SEC – without any constraints – ran afoul of the Constitution.

Finally, Jarkesy challenged the government's assertion that Congress enjoys enhanced flexibility when imposing conditions on the removal of adjudicators. According to Jarkesy, the Court has recognized only two narrow exceptions to the rule that Congress may not restrict the President's removal authority:

1. when the agency does not "wield substantial executive power"; or
2. when the officer at issue is an "inferior officer with narrowly defined duties."

SEC ALJs do not fall within either exception, Jarkesy concluded.

The Oral Argument

The hours-long oral argument before the Court focused exclusively on the Seventh Amendment jury trial question. The parties and the Justices extensively discussed the Court's Seventh

Amendment cases following *Atlas Roofing* and debated whether those cases overruled or, at least, narrowed that decision.

The extent to which SEC enforcement proceedings reflected common law fraud also became a topic of extensive discussion. The government conceded that Congress could not "take[] common law fraud and hand[] it from the courts to an agency." The Justices seemed to agree.

However, the parties and the Justices hotly disputed whether Congress had, in fact, done that here. The key distinguishing element appeared to be the extent to which both common law fraud and the securities violations at issue in this case required a showing of actual harm. Jarkesy's counsel, for example, argued that the elements of the securities violations at issue here matched the elements of common law fraud. The government countered that this case involved elements that were "very different" from the elements of common law fraud, in part because the government in a securities case need not prove damages or harm arising from the fraud.

Some Justices appeared sympathetic to the government's view that the SEC's administrative enforcement scheme fell squarely within the scope of the Court's prior holding in *Atlas Roofing*. Justice Ketanji Brown Jackson suggested that, under *Atlas Roofing*, Congress could assign a claim to a non-Article III tribunal when it creates a new right but not when the action involved a common law claim. She thus pressed the parties on the issue of whether the securities fraud statute created a new right or whether it repurposed a common law claim.

Other Justices seemed skeptical of the argument that the SEC's securities fraud claim differed from common law fraud. Justice Neil M. Gorsuch's questioning, for example, highlighted parallels between the elements of securities fraud and common law fraud. Still other Justices seemed worried about the practical implications of a broad ruling that might require a jury trial in any action involving private property rights.

Implications of the Court's Decision

A ruling for Jarkesy could reshape the administrative enforcement landscape across the federal government. Dozens of agencies impose civil penalties through administrative proceedings. Thus, an opinion invalidating the SEC's administrative enforcement system may cast doubt on other in-house administrative enforcement systems at those other agencies.

Removing the option to proceed before an ALJ may change which cases the SEC and other agencies pursue. Civil litigation in federal court typically takes more time and resources than administrative proceedings. Given resource constraints, the SEC might prioritize more serious cases, while declining cases the agency would have otherwise pursued in an administrative forum. It also may change which remedies the SEC and other agencies seek, compelling them to move away from monetary penalties and toward equitable remedies.

See "What Remedies and Relief Can Fund Managers Expect in SEC Enforcement Actions?" (Jan. 10, 2019).

Conversely, if the Court reverses the Fifth Circuit's decision, the SEC and other agencies may choose to use administrative enforcement proceedings more often. And Congress may use the SEC's system as a model for any future statutes empowering an agency to adjudicate enforcement actions.

See "SEC and CFTC 2023 Enforcement Results: Robust Enforcement Activity and Significant Monetary Sanctions" (Jan. 18, 2024).

A Chance to Clarify Common Law Fraud

Beyond the implications for administrative enforcement proceedings, *Jarkesy* presents an opportunity for the Court to clarify the boundaries of common law fraud. Although common law fraud has been around for centuries, its exact contours are still debated. Last year, for example, the parties in *Ciminelli v. United States* sparred before the Court over whether common law fraud required damage to the victim.

In *Jarkesy*, the Court may clarify its understanding of the elements of common law fraud. If the Court decides the Seventh Amendment question by considering the extent to which the securities claims track the elements of common law fraud, it must necessarily define the elements of common law fraud. That will necessitate an answer to the question of whether common law fraud requires actual harm because that element, in particular, marked a key area of disagreement between Jarkesy and the government.

Implications for Fund Managers

The Court's decision in *Jarkesy* could have far-reaching implications for fund managers. If the Court conclusively affirms the SEC's ability to adjudicate securities claims before ALJs, the status quo would not only be preserved but also Congress's willingness and ability to assign other types of regulatory and enforcement actions to a non-Article III adjudicator might be enhanced.

On the other hand, a decision striking down the SEC's administrative adjudication of the enforcement action against Jarkesy would inject substantial uncertainty into the ability of the SEC (and other regulators) to resolve enforcement actions through administrative proceedings – particularly if the Court adopts an analysis that compares the elements of the alleged regulatory violation to the elements of an analogous claim at common law. In that circumstance, future cases challenging the adjudication of specific regulatory claims would almost certainly follow and have to be resolved on a case-by-case basis.

A decision clarifying the scope of common law fraud would have even broader implications. If the Court concludes that common law fraud did not require actual harm to a property interest, that decision could remove a significant hurdle to bringing fraud claims at common law, although damages might be little more than nominal in a situation involving fraudulent conduct that lacks actual harm.

Such a decision would have broad impact in criminal cases, however. The Court has recognized that the mail and wire fraud statutes draw upon the common law meaning of fraud by punishing “schemes” to defraud. A decision holding that actual harm is unnecessary at common law could dramatically expand the scope of criminal liability for mail and wire fraud (and related statutes). In contrast, a decision holding that actual harm is required would maintain current limits on the application of those crimes to circumstances in which the scheme contemplates causing a victim cognizable harm.

For a look at another impactful Court decision, see “Supreme Court Scales Back SEC’s Disgorgement Remedy in *Liu v. SEC*” (Jul. 16, 2020).

Eric Nitz is a partner at MoloLamken LLP, *where he represents clients in white collar investigations and regulatory enforcement; complex civil litigation; and appellate litigation, briefing appeals in appellate courts across the country and in the Supreme Court.*

Ken Notter is an associate at MoloLamken LLP, *where he focuses on white collar criminal matters and complex commercial disputes.*