

CLIENT ALERT

# The *Jarkesy* Decision and the Future of Administrative Proceedings

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On June 27, 2024, in *Securities Exchange Commission v. Jarkesy*,<sup>1</sup> the Supreme Court of the United States held in a 6-3 decision that (i) the Seventh Amendment entitles a defendant to a jury trial when the Securities and Exchange Commission (the “SEC”) seeks civil penalties for securities fraud, unless the “public rights” exception<sup>2</sup> applies, and (ii) in this matter the “public rights” exception did not apply as the action brought against Mr. Jarkesy involved a private right rather than a public right.<sup>3</sup>

## **Background**

Congress has granted the SEC authority to bring actions to enforce the federal securities laws, including the Securities Exchange Act of 1934 (the “Exchange Act”),<sup>4</sup> through its own administrative adjudication process in lieu of an Article III

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<sup>1</sup> *Securities and Exchange Commission v. Jarkesy*, No. 22-859, slip.op. (S. Ct., June 27, 2024).

<sup>2</sup> Under this exception, Congress may assign the matter for a decision to an agency without a jury, if such matter historically could have been determined by the executive and legislative branches of the federal government. *Jarkesy* at 6.

<sup>3</sup> *Jarkesy* at 6-7.

<sup>4</sup> 15 U.S.C §§ 78 *et seq.*

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court.<sup>5</sup> Specifically, Congress authorized the SEC to use its administrative courts to bring securities fraud cases and seek monetary penalties against registered and non-registered entities.<sup>6</sup>

At the SEC, the Commissioners decide whether to bring an action in the SEC's administrative courts or in an Article III court. When the SEC elects to bring an action in its administrative court, the case is heard by an administrative law judge ("ALJ") employed by the SEC. The ALJ may only be removed by the SEC "for good cause" as established and determined by the Merit Systems Protection Board (the "MSPB"), another independent federal agency.<sup>7</sup> Much like a federal district court judge, the ALJ may hold a hearing, make factual and legal determinations, and issue a decision.<sup>8</sup> The parties may then appeal to the SEC.<sup>9</sup> After a final order is entered, the parties may seek further review in the federal courts of appeal.<sup>10</sup>

Some litigants and commentators have raised due process concerns about the SEC's administrative adjudications.<sup>11</sup> Some question whether the ALJs are truly independent and emphasize that the SEC is responsible for both making the decision to bring a case and deciding the initial appeal. Others note that litigation in the SEC's administrative courts is subject to the SEC's Rules of Practice rather than the Federal Rules of Evidence. Commentators also have expressed concerns that the costs of the administrative proceedings may encourage parties to settle before a federal appeal takes place, diminishing the safeguard provided by that review.<sup>12</sup> In the majority opinion in *Jarkesy*, the Supreme Court noted

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<sup>5</sup> An Article III court is one established pursuant to Article III of the U.S. Constitution, which establishes that "[t]he judicial power of the United States, shall be vested in one Supreme Court, and in such inferior courts as the Congress may from time to time, ordain and establish," and those courts' "judicial power shall extend to all cases, in law and equity, arising under this Constitution, the laws of the United States, and treaties made" as well as under several other circumstances. U.S. Const., Art. III §§ 1, 2. A presidentially appointed judge presides over these courts.

<sup>6</sup> 15 U.S.C. §§ 77h-1(g), 78u-2(a), 80a-9(d), 80b-3(i).

<sup>7</sup> 5 U.S.C. §§ 7521(a), 1202(d). Members of the MSPB are also only removable by the President for inefficiency, neglect of duty or malfeasance in office.

<sup>8</sup> 16 CFR §§ 3.21-3.56 (2021); 17 CFR §§ 201.221-201.360 (2021).

<sup>9</sup> 16 CFR §§ 3.52-53; 17 CFR §§ 201.411(a).

<sup>10</sup> 15 U.S.C. § 78y(a)(1)(3), 5 U.S.C. § 45(c).

<sup>11</sup> See *Supreme Court 9, Administrative State 0*, WALL STREET JOURNAL (Apr. 14, 2023), <https://www.wsj.com/articles/supreme-court-axon-v-ftc-sec-v-cochran-administrative-state-federal-court-elena-kagan-43f6b20>; *Constitutional Thunder Out of the Fifth Circuit*, WALL STREET JOURNAL (May 22, 2022) (arguing that the SEC acts as "prosecutor, judge, and jury" in administrative adjudications), [https://www.wsj.com/articles/constitutional-fifth-circuit-court-appeals-securities-and-exchange-commission-sec-jarkesy-administrative-state-supreme-court-constitutional-11653236377?mod=article\\_inline](https://www.wsj.com/articles/constitutional-fifth-circuit-court-appeals-securities-and-exchange-commission-sec-jarkesy-administrative-state-supreme-court-constitutional-11653236377?mod=article_inline); The Honorable Jed S. Rakoff, Judge, Southern District of New York, PLI Securities Regulation Institute Keynote Address: Is the S.E.C. Becoming a Law unto Itself? (Nov. 5, 2014).

<sup>12</sup> See e.g., Jennifer L. Mascott & Daniella Efrat, *Adjudication With a Stacked Deck*, YALE J. REG. (Notice & Comment Blog, Feb. 18, 2022), <https://www.yalejreg.com/nc/symposium-decisional-independence-05/>.

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certain of the differences between a proceeding before an ALJ versus before an Article III judge,<sup>13</sup> and in the concurring opinion Justice Gorsuch noted the higher success rates for the SEC in administrative proceedings (90% of contested in-house proceedings versus 69% of its cases in federal court).<sup>14</sup>

Prior to its decision in *Jarkesy*, the Supreme Court had previously raised substantial separation-of-powers concerns related to administrative adjudication in recent years, focusing on issues of appointment and removal protection. First, in *Free Enterprise Fund v. PCAOB*, the Supreme Court held that a statutory scheme that insulated inferior federal officers from presidential oversight via two layers of “for-cause” removal protection violated the President’s power under Article II, Section III (the “Take Care Clause”) of the U.S. Constitution to supervise the Executive Branch.<sup>15</sup> Then, in *Lucia v. SEC*, the Supreme Court found that the SEC’s ALJs were inferior federal officers that needed to be appointed by “the President, Courts of Law or Heads of Departments” (and, in practice, had not been).<sup>16</sup>

Although the SEC remedied the appointments issue by reappointing ALJs in the constitutionally required fashion, the determination in *Lucia* that the SEC ALJs were inferior officers also implicated the constitutionality of their multilayered removal protections under *Free Enterprise Fund*.<sup>17</sup> The Supreme Court, however, did not reach the removal-protection issue in *Lucia*, meaning that the legality of SEC administrative adjudications remained an open question after the case was decided. Moreover, under the Administrative Procedure Act, the multilayered removal protections that protect the SEC ALJs also apply to all of the ALJs in the Executive Branch, including those at the Federal Trade Commission, the Federal Energy Regulatory Commission, the Department of Health and Human Services, and the Social Security Administration.<sup>18</sup>

On May 18, 2022, in *Jarkesy v. S.E.C.*, a divided Fifth Circuit panel vacated the SEC’s affirmation of an SEC ALJ’s determination that *Jarkesy and Patriot28, LLC* committed securities fraud.<sup>19</sup> The panel found that (1) the in-house adjudication of the case violated petitioners’ Seventh Amendment right to a jury trial, (2) Congress unconstitutionally delegated legislative power to the SEC by authorizing it to determine whether to bring these types of cases in an Article III court or before an ALJ, and (3) the ALJ removal protections violate the Take Care Clause.

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<sup>13</sup> For example, the ALJ determines the scope and form of permissible evidence, may admit hearsay and other testimony that would be inadmissible in federal court, and is the factfinder, and on appeal a reviewing court must treat the factual findings as conclusive if sufficiently supported by the record. *Jarkesy* at 3.

<sup>14</sup> *Jarkesy* at 3 (Gorsuch, N., concurring).

<sup>15</sup> 561 U.S. 477, 481 (2010).

<sup>16</sup> 138 S. Ct. 2044, 2041 (2018); see also U.S. Const. Art. II, § 2, Cl. 2.

<sup>17</sup> Press Release, SEC Ratifies Appointment of Administrative Law Judges (Nov. 30, 2017), <https://www.sec.gov/news/press-release/2017-215>.

<sup>18</sup> 5 U.S.C. §§ 3105, 7521(a), 1202(d).

<sup>19</sup> *Jarkesy v. SEC*, No. 20-61007, slip op. (5th Cir., May 18, 2022).

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Right to a Jury Trial. The Fifth Circuit panel concluded that the SEC’s decision to bring the case in front of an ALJ, rather than an Article III court, deprived Petitioners of their “fundamental” right to a jury trial under the Seventh Amendment.<sup>20</sup>

Non-Delegation Doctrine. The Fifth Circuit panel also held that the Dodd-Frank Wall Street Reform and Consumer Protection Act unconstitutionally delegated legislative power to the SEC by granting the SEC unfettered discretion in determining whether to bring securities fraud actions for monetary penalties in Article III courts or in the SEC’s administrative courts.<sup>21</sup>

Article I, Section I of the U.S. Constitution provides that “all legislative Powers herein granted shall be vested in a Congress of the United States. . . .”<sup>22</sup> Under Supreme Court precedent, Congress may only grant an agency regulatory power if it provides an “intelligible principle,” or a guiding condition that an agency must follow when promulgating rules or otherwise exercising quasi-legislative power.<sup>23</sup> This requirement that Congress moderate grants of delegated legislative authority is often referred to as the non-delegation doctrine.

Multilayer Removal Protection. The Fifth Circuit panel held that SEC ALJs are unduly protected from Presidential oversight by multiple layers of “for-cause” removal protection, in violation of the Take Care Clause, as interpreted by the Supreme Court in *Free Enterprise Fund v. PCAOB*.<sup>24</sup>

For-cause removal protections for “officers of the United States” subject to the Appointments Clause of Article II of the U.S. Constitution present constitutional issues due to the inherent conflict between Congress’s Article I legislative power to create and define the jurisdiction of regulatory agencies and the President’s Take Care Clause executive power to supervise the Executive Branch. Two Supreme Court cases, *Myers v. United States*,<sup>25</sup> and *Humphrey’s Executor v. United States*,<sup>26</sup> established a rule to balance congressional and executive power.<sup>27</sup> Congress cannot restrict the President’s power to remove the principal officers of purely executive agencies, like the Department of State or the Department of Defense.<sup>28</sup> In contrast, for-cause removal protections for the principal officers of quasi-legislative, quasi-judicial agencies Congress created, including the SEC, are constitutionally permissible.<sup>29</sup>

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<sup>20</sup> *Jarkesy* (5<sup>th</sup> Cir.) at 9.

<sup>21</sup> *Jarkesy* (5<sup>th</sup> Cir.) at 25.

<sup>22</sup> U.S. Const. Art. 1, § 1.

<sup>23</sup> See *J.W. Hampton Jr. & Co. v. United States*, 276 U.S. 394, 409 (1928).

<sup>24</sup> 561 U.S. 477 (2010).

<sup>25</sup> 272 U.S. 52 (1926).

<sup>26</sup> 295 U.S. 602 (1935).

<sup>27</sup> *Free Enterprise Fund*, 561 U.S. at 493 (discussing the *Myers* and *Humphrey’s Executor* holdings).

<sup>28</sup> *Myers*, 272 U.S. at 164.

<sup>29</sup> *Humphrey’s Executor v. United States*, 295 U.S. at 627-629.

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In *Free Enterprise Fund*, the Supreme Court considered how the *Myers* and *Humphrey's Executor* cases applied to inferior officers insulated by two layers of for-cause removal protection. Specifically, the SEC Commissioners could only remove members of the Public Company Accounting Oversight Board (the "PCAOB")<sup>30</sup> for cause, and the President could only remove the SEC Commissioners themselves for cause. The Supreme Court first decided that both the SEC Commissioners and the PCAOB Board Members were inferior officers under the Appointments Clause, and then held that multiple layers of for-cause removal violated the Take Care Clause's vesting of executive power in the President.<sup>31</sup> The multilevel scheme, as opposed to the single level of protection at issue in *Humphrey's Executor*, was unconstitutional because "the President cannot remove an officer who enjoys more than one level of good-cause protection, even if the President determines that the officer is neglecting his duties or discharging them improperly."<sup>32</sup>

The Fifth Circuit panel in *Jarkesy* employed similar logic as the Supreme Court in *Free Enterprise Fund* in establishing that the removal restrictions for SEC ALJs violated the Take Care Clause of the U.S. Constitution. First, the Fifth Circuit panel noted that, per *Lucia*, SEC ALJs are inferior officers under the Appointments Clause.<sup>33</sup> The Fifth Circuit panel then emphasized that SEC ALJs can be removed by the SEC "only for good cause established and determined by the Merit Systems Protection Board on the record after opportunity for hearing before the Board," and the SEC Commissioners can only be removed for cause.<sup>34</sup> The Fifth Circuit panel in *Jarkesy* concluded that these multiple layers of removal protection for inferior officers under the Appointments Clause are unconstitutional.<sup>35</sup>

Appeals. In October 2022, the Fifth Circuit denied the SEC's petition for rehearing en banc. A petition by the SEC for a writ of certiorari was granted by the Supreme Court on June 30, 2023 and oral argument was held on November 29, 2023.

### The Supreme Court Decision

In deciding *Jarkesy*, the Supreme Court focused on the Seventh Amendment which guarantees the right of jury trial in suits at common law. The Court's opinion concludes that the right is not limited to only the common law forms of action recognized when the Seventh Amendment was ratified but instead includes all claims that are "legal in nature." To determine whether a suit is "legal in nature," a court must consider whether the cause of action resembles common law causes of action and whether the remedy is the sort that was traditionally obtained in a court of law. The Supreme Court

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<sup>30</sup> The Sarbanes-Oxley Act of 2002 created the PCAOB to oversee the audits of public companies.

<sup>31</sup> *Free Enterprise Fund*, 561 U.S. at 486–87.

<sup>32</sup> *Free Enterprise Fund*, 561 U.S. at 481 (concluding that the President cannot "take Care that the Laws be faithfully executed" if he cannot oversee the faithfulness of the officers who execute them).

<sup>33</sup> *Jarkesy* (5<sup>th</sup> Cir.) at 27.

<sup>34</sup> *Jarkesy* (5<sup>th</sup> Cir.) at 27. The Fifth Circuit panel further noted that MSBP members themselves can only be removed by the President for cause, meaning that the SEC ALJs may be insulated from removal by three layers of for-cause protection.

<sup>35</sup> *Jarkesy* (5<sup>th</sup> Cir.) at 28.

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found that the SEC's antifraud provisions replicate common law fraud. As to the remedy, the SEC sought civil penalties and the Supreme Court held that these penalties were "legal in nature" as they are designed to punish or deter the wrongdoer (rather than restore the status quo). The Supreme Court thus determined that the Seventh Amendment entitles a defendant to a jury trial when the SEC seeks civil penalties against the defendant for securities fraud.<sup>36</sup>

The Supreme Court next considered whether the "public rights" exception to Article III jurisdiction was applicable. This exception has been held to permit Congress to assign certain matters to administrative agencies for adjudication even though such proceedings would not afford the right to a jury trial. These matters historically could have been determined exclusively by the executive and legislative branches, and include the collection of revenue, customs law, immigration law, relations with Indian tribes, and granting of public benefits. The Supreme Court held that the exception did not apply in this instance because the matter did not "fall within any of the distinctive areas involving governmental prerogatives where the Court has concluded that a matter may be resolved outside of an Article III court, without a jury."<sup>37</sup>

In reaching its decision, the Supreme Court pointed to the 1989 *Granfinanciera* decision,<sup>38</sup> and noted that the principles identified in that case largely resolve the *Jarkesy* case. *Granfinanciera* involved a statutory action for fraudulent conveyance and in 1984 Congress authorized non-Article III bankruptcy judges to hear these type of matters without a jury. Actions for fraudulent conveyance were well known at common law and the Supreme Court in *Granfinanciera* held that the "public rights" exception was not applicable to this designation to a non-Article III judge.<sup>39</sup>

The Supreme Court in *Jarkesy* did not reach the non-delegation or removal issues.

In a concurring opinion joined by Justice Thomas, Justice Gorsuch noted that while he agreed that the SEC's use of an in-house hearing to seek civil penalties violates the Seventh Amendment right to a jury trial, Article III of the U.S. Constitution and the Due Process Clause of the Fifth Amendment each also requires the result reached by the Supreme Court in *Jarkesy*. Article III entitles individuals to an independent judge who will preside over the trial, while due process promises that any trial will be held in accord with certain time-honored principles. As to Article III, Justice Gorsuch found that as the matter before the Supreme Court is the subject of a suit at common law, the responsibility for deciding it rests with an Article III judge in an Article III court. As to due process, Justice Gorsuch concluded that as the penalty sought by the SEC would deprive Mr. Jarkesy of property, due process protections thus require the "regular course of trial proceedings with their usual protections," not an ad hoc adjudication before the same agency responsible for prosecuting the law.<sup>40</sup>

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<sup>36</sup> *Jarkesy* at 8-11.

<sup>37</sup> *Jarkesy* at 13-17.

<sup>38</sup> *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33.

<sup>39</sup> *Jarkesy* at 19-21.

<sup>40</sup> *Jarkesy* at 11-12 (Gorsuch, N., concurring).

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Justices Kagan, Jackson and Sotomayor dissented. In the dissenting opinion, Justice Sotomayor argued that Congress has the right to assign a governmental civil penalty claim to an administrative agency for initial adjudication, subject to judicial review, and that the Supreme Court's decision upends longstanding precedent as reflected in the *Atlas Roofing* decision<sup>41</sup> and the established practice of its coequal partners in the tripartite system of government.<sup>42</sup> In response, the majority concluded that *Atlas Roofing* did not apply to *Jarkesy*, as the cases relied upon in *Atlas Roofing* applied the "public rights" exception to actions that were not suits at common law and, conversely, the statutory claim in *Jarkesy* is in the nature of a common law suit.<sup>43</sup>

### The Future

We would expect that the impact of the *Jarkesy* decision for administrative adjudications throughout the Executive Branch of the federal government would be limited, except to the extent that the matters determined by the agency ALJs resemble common law causes of action and the remedy is the sort that was traditionally obtained in a court of law (such as civil penalties). It is our understanding that the SEC has already ceased bringing matters seeking civil penalties before ALJs and that the Commodities Future Trading Commission currently has no ALJs.

In addition, while the SEC has only a handful of ALJs and could instead file the vast majority of its cases in federal courts instead of administrative tribunals,<sup>44</sup> other federal agencies employ many more ALJs. For example, the Social Security Administration employs about 1,400 ALJs that hold hearings on benefits disputes, the Department of Health and Human Services has approximately 60 ALJs to conduct hearings on coverage and claim issues, and the Federal Energy Regulatory Commission employs 12 ALJs that oversee gas and electric market manipulation cases.<sup>45</sup> However, the *Jarkesy* opinion notes that a traditional "public rights" exception to the Seventh Amendment requirement for a jury trial is for matters involving public benefits.<sup>46</sup> Thus, it would seem that the ordinary course administrative proceedings at the Social Security Administration and the Department of Health and Human Services would not be affected by this decision.

In the dissenting opinion, Justice Sotomayor notes that there are at least two dozen agencies that can impose civil penalties in administrative proceedings, though it is unclear how many ALJs are actually employed by these agencies or

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<sup>41</sup> *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n*, 430 U.S. 442.

<sup>42</sup> *Jarkesy* at 32-36 (Sotomayor, S., dissenting).

<sup>43</sup> *Jarkesy* at 22-26.

<sup>44</sup> However, certain types of proceedings are currently required to be brought by the SEC before an ALJ. In addition, the SEC brings many settled enforcement proceedings before its ALJs; this allows the parties the convenience of avoiding having to file such matters in federal court.

<sup>45</sup> Social Security Administration, Program Provisions and SSA Administrative Data (Annual Statistical Supplement, 2020) <https://www.ssa.gov/policy/docs/statcomps/supplement/2020/2f8-2f11.html> (last visited November 8, 2023); Department of Health and Human Services, <https://www.hhs.gov/about/agencies/dab/different/appeals-at-dab/appeals-to-alj/index.html> (last visited Nov. 8, 2023); FERC Office of Administrative Law Judges Org. Chart, <https://www.ferc.gov/office-administrative-law-judges-oalj> (last visited Nov. 8, 2023).

<sup>46</sup> *Jarkesy* at 17.



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how frequently any such ALJs deal with matters involving civil penalties.<sup>47</sup> Certain of these agencies, such as the Federal Energy Regulatory Commission, can only pursue civil penalties in agency enforcement proceedings; these agencies will need a new Congressional authorization in order to pursue civil penalties in federal court, if applicable.<sup>48</sup>

The Supreme Court did not reach the removal issues relied on in part by the Fifth Circuit panel for its decision. Thus, any party to an administrative hearing would still have a good-faith argument that the removal protection of the ALJ is unconstitutional and thus the decision of the ALJ must be vacated; this argument can be made regardless of whether the matter decided by the ALJ resembles a common law cause of action or the remedy sought.

If you have any questions regarding this client alert, please contact any of the Willkie attorneys listed below or the Willkie attorney with whom you regularly work.

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<sup>47</sup> These agencies include the Department of Agriculture, the Department of Justice, the Consumer Financial Protection Bureau, the Federal Energy Regulatory Commission, the Department of Education, the Occupational Safety and Health Review Commission, the Federal Mine Safety and Health Review Commission, the Department of Treasury, the Environmental Protection Agency, the Department of Housing and Urban Development, the Federal Maritime Commission, the Federal Communications Commission, the Postal Service, the Federal Railroad Administration and the Department of Transportation, among others. *Jarkesy* at 34-35 (Sotomayor, S., dissenting).

<sup>48</sup> *Jarkesy* at 35 (Sotomayor, S., dissenting).