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Assessing Whether Jarkesy May Limit FINRA Prosecutions

By **Barry Temkin and Kate DiGeronimo** (August 30, 2024, 4:41 PM EDT)


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On June 27, the U.S. Supreme Court issued its landmark decision in Jarkesy v. U.S. Securities and Exchange Commission, which held that SEC administrative law judges may not adjudicate securities fraud cases seeking civil penalties.[1] Rather, respondents in fraud prosecutions are now entitled to a trial by jury under the Seventh Amendment of the U.S. Constitution.[2]

According to the court, the principal question was "whether the Seventh Amendment entitles a defendant to a jury trial when the SEC seeks civil penalties against him for securities fraud."[3] The court answered the question in the affirmative, holding, "the SEC's antifraud provisions replicate common law fraud, and it is well established that common law claims must be heard by a jury."[4]

Jarkesy is part of a larger trend by which the courts have begun to restrict the powers of regulatory agencies, particularly in the securities industry. Six years earlier, in Lucia v. SEC, the Supreme Court held that, under the appointments clause, SEC ALJs were officers of the U.S. and thus must be appointed by the president, not the SEC staff.[5]

Now that the Supreme Court has spoken on the use of ALJs by the SEC, the question arises as to whether the same principle applies to self-regulatory organizations, specifically the Financial Industry Regulatory Authority.

As discussed below, that issue is raised in a case currently pending before the U.S. Court of Appeals for the District of Columbia Circuit, Alpine Securities Corp. v. FINRA.[6]

And whether a court applies Jarkesy to the facts before it may depend on the nature of the charges brought by FINRA. One reading of the case would be that administrative fraud actions are subject to the same Seventh Amendment issues addressed in Jarkesy. On the other hand, purely regulatory infractions may not require jury trials.

The securities industry has wasted no time in seeking to apply the Seventh Amendment to self-regulatory organization enforcement cases.

On July 10, a complaint was filed against FINRA in the U.S. District Court for the Eastern District of Pennsylvania. That complaint, Blankenship v. FINRA, seeks to apply the Seventh Amendment right to a trial by jury to FINRA.[7]

The Jarkesy Ruling

In Jarkesy, the SEC administratively prosecuted an investment adviser for violations of the federal securities laws, including the Securities Exchange Act and the Investment Advisers Act.[8] An ALJ conducted an administrative hearing, found violations of the securities laws and fined the adviser $300,000.

The Supreme Court held that the right to jury trial attaches to enforcement actions "in the nature of an action at common law" seeking civil monetary penalties for fraud.[9] This is because such penalties arise from the common law tradition, and the federal securities laws derive from the common law definition of "fraud." As the court explained:

> A defendant facing a fraud suit has the right to be tried by a jury of his peers before a neutral adjudicator. Rather than recognize that right, the dissent would permit Congress to concentrate the roles of prosecutor, judge, and jury in the hands of the Executive Branch. That is the very opposite of the separation of powers that the Constitution demands.[10]

The court distinguished between public and private rights. There is an exception in Seventh Amendment jurisprudence for administrative actions seeking to vindicate public rights. For example, past precedents applied the public rights exception to land management, relations with Native Americans, workplace safety and veterans' rights.

The Supreme Court reasoned that an ALJ might be able to adjudicate an administrative action, provided that the claim did not originate from the common law tradition. But because the SEC sought a civil monetary penalty, "this action 'involve[d] a matter[] of private rather than public right.'"[11]

Accordingly, Jarkesy was entitled to a jury trial, and his sanction was vacated.

The Jarkesy decision raises several questions. First, the court focused on the tradition of litigating common law fraud cases before a jury. But is the court's reasoning limited to SEC fraud prosecutions? What if the SEC were to bring a future administrative proceeding for a non-fraud statutory infraction?

For example, assume that the SEC seeks to prosecute a claim for sale of unregistered securities, or statutory disqualification of a registrant. Those claims do not derive from the common law. Would the right to a jury trial attach there?

Second, the court repeatedly emphasized that the SEC was seeking a monetary penalty. But the court did not explain whether an ALJ would be able to adjudicate a case seeking nonmonetary relief, such as an injunction or suspension of a registrant's license.

In addition, self-regulatory organizations, such as FINRA, derive their authority from Congress under the Maloney Act.

FINRA's Division of Enforcement prosecutes all manner of cases against securities industry registrants.[12] These FINRA prosecutions are brought before panels of hearing officers, some of which are FINRA employees. FINRA adjudicatory panels are typically chaired by agency employees.[13] Other hearing officers are independent industry representatives designated as part of FINRA hearing panels.

FINRA hearing officers have a great deal in common with SEC administrative law judges.[14] But, under Jarkesy, SEC ALJs may not constitutionally adjudicate fraud claims. Do the same restrictions apply to FINRA? Are FINRA respondents similarly entitled to jury trials on administrative fraud claims brought by that self-regulatory organization?

FINRA Hearings: Unconstitutional?

These questions are at stake in a pending case, Alpine Securities v. FINRA.[15] The plaintiff in Alpine seeks to enjoin a pending enforcement action brought by FINRA.[16] In July 2023, the D.C. Circuit enjoined FINRA from proceeding with a disciplinary proceeding against the plaintiff registrant.[17]

Alpine Securities Corp. is a registered broker-dealer and a FINRA member. FINRA opened a regulatory enforcement investigation, seeking to bar the firm from the industry for violating a prior consent order.

Alpine sued in the U.S. District Court for the District of Columbia, claiming that FINRA, as a private self-regulatory organization, is not a governmental agency, and that only the executive branch may constitutionally enforce the federal securities laws.

Alpine's argument was based in part on the Supreme Court's 2018 landmark ruling in Lucia v. SEC, which prohibited the use of administrative law judges appointed by the SEC staff in administrative proceedings.[18]

The Supreme Court held in Lucia that administrative law judges may not constitutionally adjudicate hearings because they are officers of the U.S. The ALJ in Lucia was appointed by SEC staff. But only the president, courts of law or heads of departments may constitutionally appoint such officers.

Lucia was a challenge to the method of appointment of ALJs. The ruling in Jarkesy is much broader: It ruled that no ALJ, however appointed, may adjudicate any securities fraud case.[19]

While the district court in Alpine Securities declined to enjoin the FINRA investigation, the court of appeals reversed.[20] In granting the injunction, the D.C. Circuit determined that there was a likelihood of success on the petition.

In a concurring opinion, U.S. Circuit Judge Justin Walker wrote, "Alpine has raised a serious argument that FINRA impermissibly exercises significant executive power."[21] Judge Walker reasoned that FINRA hearing officers who "enforce securities laws and decide parties' rights" are "near carbon copies of ... ALJs."[22] He wrote that the reasoning in Lucia would apply with equal force to FINRA hearing officers.[23]

In other words, if the Constitution required presidential oversight and appointment of an SEC ALJ, then the same logic should apply to a FINRA hearing officer.

As Judge Walker wrote, "It would be odd if the Constitution prohibits Congress from vesting significant executive power in an unappointed and unremovable government administrator but allows Congress to vest such power in an unappointed and unremovable private hearing officer."[24]

However, the Alpine concurrence is not a final adjudication on the merits, nor is it even a majority opinion by the court of appeals.

Further, Jarkesy may not affect the result in the Alpine case pending in the D.C. Circuit. This is because the Jarkesy court was primarily concerned with securities fraud cases deriving from the common law tradition. The respondent in Alpine is charged with violating a prior acceptance, waiver and consent — an administrative order.

FINRA is likely to argue that it is seeking to enforce an administrative public right with no common law antecedent. By this analysis, FINRA is trying to protect the investing public from a flawed or unqualified registrant. FINRA is not seeking the type of civil monetary penalty addressed in Jarkesy.

On the other hand, the plaintiff in Alpine may seek to scrutinize the underlying order to ascertain the conduct proscribed therein. If the underlying conduct beneath the initial order was alleged to be fraud, then perhaps FINRA is also treading on the Seventh Amendment right to jury trial.

Whether FINRA hearings are subject to the Seventh Amendment right to a jury trial may soon be answered in the recently filed case of Blankenship v. FINRA.[25] Filed less than one month after the Jarkesy decision, the plaintiff in Blankenship contends that FINRA's in-house adjudications infringe on the constitutional right to a trial by jury.

In that case, FINRA claims that Allen Blankenship, a registered broker, committed fraud. In response, Blankenship is seeking a preliminary injunction to prevent FINRA's internal adjudication based on the recent Jarkesy holding.

Analysis and Conclusion

The Jarkesy ruling may result in some anomalies. The SEC's docket includes serious fraud cases, such as Ponzi schemes, accounting fraud, misrepresentations and insider trading. It also includes some more technical violations, such as the sale of unregistered securities, misleading marketing materials and proxy solicitation violations.

While all of these enforcement actions are important to the overall federal regulatory scheme, a distinction may be drawn. Arguably, it makes sense to arm the SEC with its most potent tools to combat the most serious violations — i.e., fraud. It seems anomalous, at first blush, to strip the SEC of tools to combat these most serious violations.

But the converse is also true as a matter of constitutional principle. After all, industry respondents are in most need of the protections of a neutral judiciary and a jury of their peers for the most serious cases.

Applying Jarkesy to FINRA prosecutions may prove to be unpredictable. While FINRA is tasked with enforcing federal securities regulations, its jurisdiction is limited to its members.

Additionally, FINRA's docket contains many cases that do not derive from common law fraud.[26] For example, FINRA often prosecutes registrants for making unsuitable recommendations and violating its own regulations — including Regulation Best Interest — for churning, unauthorized trades, front-running, and similar trade practice violations.

FINRA frequently prosecutes its members for violating its ill-defined concept, articulated in its rules, of "high standards of commercial honor and just and equitable principles of trade."[27] These regulatory infractions do not appear, at first blush, to derive from the common law.

On the other hand, a thoughtful registrant could plausibly argue that many FINRA prosecutions derive from the common law. For example, a good argument could be made that Regulation Best Interest derives from a common law fiduciary duty. To the extent such an argument could be made, a court might enjoin a FINRA prosecution on Seventh Amendment grounds.

It is most likely that the effect of Jarkesy on self-regulatory organization investigations will be litigated over time on a case-by-case basis.

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[1] SEC v. Jarkesy, 603 U.S. _ (2024), https://www.supremecourt.gov/opinions/23pdf/22-859_1924.pdf.

[2] See id.

[3] Id.

[4] Id.

[5] Lucia v. SEC, 585 U.S. 237 (2018).

[6] Alpine Securities Corp. v. FINRA, No. 23-5129, 2023 WL 4703307, *3–7 (D.C. Cir. July 5, 2023) (mem.) (per curiam), https://www.cadc.uscourts.gov/internet/orders.nsf/5EBC88B3F77E7F82852589E30054610D/$file/23-5129LDSN2.pdf.

[7] Blankenship v. FINRA, No. 2:24-cv-3003 (E.D. Pa. July 10, 2024), https://dockets.justia.com/docket/pennsylvania/paedce/2:2024cv03003/624182.

[8] SEC v. Jarkesy, 603 U.S. _ (2024), https://www.supremecourt.gov/opinions/23pdf/22-859_1924.pdf.

[9] Id.

[10] Id.

[11] Id.

[12] See FINRA, Division of Enforcement (2024), https://www.finra.org/rules-guidance/enforcement.

[13] See id.

[14] See Alpine Securities Corp. v. FINRA, No. 23-5129, 2023 WL 4703307, *3–7 (D.C. Cir. July 5, 2023) (mem.) (per curiam), https://www.cadc.uscourts.gov/internet/orders.nsf/5EBC88B3F77E7F82852589E30054610D/$file/23-5129LDSN2.pdf.

[15] See Alpine Securities, 2023 WL 4703307, at *3–7.

[16] Id.

[17] Id.

[18] See Alpine Securities, 2023 WL 4703307, at *3–7; Lucia v. SEC, 585 U.S. _ (2018), https://www.supremecourt.gov/opinions/23pdf/22-451_7m58.pdf.

[19] See SEC v. Jarkesy, 603 U.S. _ (2024), https://www.supremecourt.gov/opinions/23pdf/22-859_1924.pdf.

[20] See Alpine Securities, 2023 WL 4703307, at *3–7.

[21] Id.

[22] Id.

[23] Id.

[24] Id.

[25] Blankenship v. FINRA, No. 2:24-cv-3003 (E.D. Pa. July 10, 2024), https://dockets.justia.com/docket/pennsylvania/paedce/2:2024cv03003/624182.

[26] See FINRA, FINRA Disciplinary Actions (2024), https://www.finra.org/rules-guidance/oversight-enforcement/finra-disciplinary-actions-online.

[27] FINRA Rule 2010, https://www.finra.org/rules-guidance/rulebooks/finra-rules/2010.