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SEC ENFORCEMENT

Two attorneys at Patterson Belknap discuss the U.S. Supreme Court's recent decision holding that limits the power of the Securities and Exchange Commission to seek disgorgement. The authors examine the circuit split that led to the high court taking up the case, and explain the importance of the ruling.

Supreme Court Unanimously Holds SEC Disgorgement Is Subject to Five-Year Limitations Period

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On June 5, 2017, in *Kokesh v. SEC* (No. 16-529, 2017 BL 187939), the U.S. Supreme Court made clear that disgorgement, like other penalties in civil enforcement actions by the Securities and Exchange Commission (SEC), is subject to the five-year statute of limitations found in 28 U.S.C. § 2462. The unanimous decision resolves a circuit split in which the majority of the courts to consider the issue held that disgorgement was neither a penalty nor a forfeiture and as such was not governed by the limitations period. This is a major win for securities litigants and puts pressure on the SEC to speed up their investigations rather than to depend on the existence of a particular form of relief that does not have a statute of limitations.

Background

Charles Kokesh was found by a jury to have violated federal securities laws when he filed false and misleading SEC reports and proxy statements in order to conceal his embezzlement of $34.9 million dollars from several business development companies between 1995 and 2009. The District Court imposed a judgment that included both civil monetary penalties and disgorgement, limiting the civil penalties to the five-year period prior to the date the complaint was filed. This is consistent with *Gabelli v. SEC*, 568 U.S. 442 (2013), in which the Supreme Court recognized that the five-year statute of limitations applies when the SEC seeks statutory monetary penalties. The district court refused, however, to impose a similar limitation on the disgorgement order, even though the majority of Kokesh's profits—$29.9 million out of a total of $34.9 million in profits—

resulted from violations occurring outside of the five-year limitations period. The U.S. Court of Appeals for the Tenth Circuit affirmed on appeal, holding that disgorgement is neither a penalty nor a forfeiture, and thus is not subject to the five-year statute of limitations. *SEC v. Kokesh*, 834 F.3d 1158 (10th Cir. 2016).

The Split Amongst the Circuits

The question of whether there is an applicable statute of limitations for a disgorgement action is governed by 28 U.S.C. § 2462, which provides that ''an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued.'' Prior to the Tenth Circuit's ruling below, both the First and D.C. Circuits had similarly held that the five-year limitations period did not apply to SEC disgorgement actions. *SEC v. Tambone*, 550 F.3d 106 (1st Cir. 2008); *Riordan v. SEC*, 627 F.3d 1230 (D.C. Cir. 2010). Only the Eleventh Circuit had concluded that disgorgement was a forfeiture and that the limitations period therefore applied. *SEC v. Graham*, 823 F.3d 1357, 1363 (11th Cir. 2016). The Supreme Court granted certiorari to resolve the circuit split and address the question of whether SEC disgorgement actions are subject to Section 2462's five-year statute of limitations.

The Supreme Court Rules That The Five-Year Limitations Period Applies

Justice Sonia Sotomayor, writing for a unanimous court, reversed. Her opinion first provided a summary of what constitutes a ''penalty'' within the meaning of Section 2462—''a punishment, whether corporal or pecuniary, imposed and enforced by the State, for a crime or offense against its laws.'' *Kokesh*, 2017 BL 187939 at *4. This standard gives rise to a two-pronged inquiry to determine if an order to pay money is a ''penalty'' or something else:

(1) ''whether the wrong sought to be redressed is a wrong to the public, or a wrong to the individual'' and

(2) whether the sanction in question operates ''for the purpose of punishment, and to deter others from offending in a like manner.'' *Id.*

Unless the liability is imposed to redress a private injury and is solely compensatory, it is a ''penalty'' and is subject to the five-year limitations period.

Applying this standard to disgorgement, the Court easily concluded that disgorgement constitutes a penalty within the meaning of Section 2462 and held that any SEC enforcement action must be commenced within five years of the date the disgorgement claim accrued.

First, the Court observed that in an SEC disgorgement action, the violation for which disgorgement is sought—securities fraud—is committed against the U.S., rather than a private individual. The SEC does not require permission from the victims of securities fraud to pursue an enforcement action, and may proceed without naming the victims as parties to the action. The government largely conceded this point in its brief, stating that the SEC ''acts in the public interest, to remedy harm to the public at large'' when it pursues enforcement actions. *Id.* at *6.

Turning to the second prong of the penalty inquiry, the Court found that SEC disgorgement is imposed for punitive purposes. The Court noted that in one of the first cases to award such disgorgement, the famous *Texas Gulf Sulfur* insider trading case, the district court emphasized that disgorgement was necessary to ''protect the investing public by providing an effective deterrent to future violations.'' *Id.* (citing *SEC v. Texas Gulf Sulfur Co.*, 312 F. Supp. 77, 92 (S.D.N.Y. 1970)). Since then, courts have repeatedly explained that deterrence is the primary purpose of SEC disgorgement. The Supreme Court observed that sanctions imposed for their deterrent effect are inherently punitive in nature.

The Court also cited the fact that SEC disgorgement is not always compensatory in further support of its conclusion that disgorgement is punitive. Disgorged profits are paid to the district court, rather than directly to the victims of the fraud, and there is no statutory requirement that these funds be transferred to the victims. Rather, district courts have the discretion to instead award these funds to the U.S. Treasury. As such, the Court found that SEC disgorgement ''bears all the hallmarks of a penalty: It is imposed as a consequence of violating a public law and is intended to deter, not to compensate.'' *Id.* at *7.

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Finally, the Court rejected the government's argument that SEC disgorgement is remedial, rather than punitive, because it restores the status quo. The Court disputed that disgorgement returns the defendant to the place he would have been absent the fraud because courts sometimes award disgorgement in an amount that exceeds the profits gained from the scheme. For example, in insider trading cases, courts can include in a disgorgement order the benefit gained by third parties who traded on the confidential information. Similarly, courts sometimes award disgorgement without reducing profits by the amount of the defendant's expenses incurred in executing the fraud. As such, SEC disgorgement occasionally leaves a defendant worse off than he would have been but for the alleged violations. As the Court explained, the fact that disgorgement is sometimes compensatory does not alter this conclusion because sanctions can serve more than one purpose. So long as SEC disgorgement pursues a deterrent purpose in addition to its compensatory effect, it is a penalty, and is thus subject to the five-year limitations period.

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Importance of Decision

This is an important decision for two reasons. First, it ends the anomalous treatment of disgorgement as having a different statute of limitations than other types of SEC civil financial penalties. Why should the SEC be able to evade the five-year statute of limitations for bringing an action for penalties by recharacterizing the relief sought as disgorgement as opposed to something else? In this action, $30 million of the $35 million award came from conduct outside the relevant limitations period. Second, it should be a further prompt to speed up SEC investigations or at least to let subjects of those investigations make a meaningful decision about whether to toll the statute of limitations. These investigations often take years to resolve, stretching out the burden on businesses and individuals and exacerbating the legal expenses involved in such investigations.

Looking ahead, the Court also raised in footnote three the question of whether there should even be such a thing as disgorgement, writing that ''[n]othing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC proceedings or on whether courts have properly applied disgorgement principles in this context.'' This was also the subject of debate at argument, where Justice Anthony M. Kennedy asked ''[i]s it clear that the district court has statutory authority to do this?'' (Tr. 7). Justice Sotomayor also referred to the exercise of the disgorgement power as ''unusual,'' given that the only applicable statutory authority arises from Title 15 U.S.C. § 78u, which allows district courts to grant ''any equitable relief that may be appropriate or necessary for the benefit of investors.'' (Tr. 9).

So we now begin the wait for the next challenge concerning SEC disgorgement actions: Should disgorgement actions be permitted at all?