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Litigation & Arbitration Group Client Alert: United States Supreme Court Concludes SEC Disgorgement Is a "Penalty" Subject To Five-Year Limitations Period

Last week, the United States Supreme Court limited the US Securities and Exchange Commission's (SEC) power to seek disgorgement for violations of federal securities law, holding that "[d]isgorgement in the securities-enforcement context is a 'penalty' within the meaning of [28 U.S.C.] § 2462, and so disgorgement actions must be commenced within five years of the date the claim accrues." *Kokesh v. SEC*, No. 16-529, slip op. 1. The *Kokesh* decision follows an earlier case in which the Supreme Court used Section 2462 to limit SEC claims for civil money penalties. *Gabelli v. SEC*, 568 U.S. 442 (2013). Section 2462 provides that "an action . . . for the enforcement of any civil fine, penalty, or forfeiture . . . shall not be entertained unless commenced within five years from the date when the claim first accrued." 28 U.S.C. § 2462.

While the decision is not likely to impact the majority of SEC enforcement matters, which usually target conduct within the limitations period, it could limit the SEC's ability to recover ill-gotten gains in long-running or late-discovered frauds, including in certain insider trading and investor fraud cases as well as ones brought under the Foreign Corrupt Practices Act (FCPA) where overseas evidence has been difficult or time-consuming to obtain. Thus, although the decision's consequences may be felt in only a relatively small number of SEC matters, it may disproportionately affect those that are high-profile or otherwise impactful.

BACKGROUND TO THE DECISION

When Congress created the SEC in 1934, the only remedy available to the SEC in a judicial enforcement action was injunctive relief. Beginning in the late 1960s and early 1970s, the SEC began pursuing awards of disgorgement, urging courts to impose the remedy as an exercise of their "inherent equity power to grant relief ancillary to an injunction." *SEC v. Texas Gulf Sulphur Co.,* 312 F. Supp. 77, 91 (S.D.N.Y. 1970), *aff'd in part and rev'd in part*, 446 F. 2d 1301 (2d Cir. 1971). Courts ordered disgorgement

in SEC enforcement proceedings in order to "deprive . . . defendants of their profits in order to remove any monetary reward for violating" securities laws and to "protect the investing public by providing an effective deterrent to future violations." *Kokesh* slip op. 3 (quoting *Texas Gulf Sulphur*, 312 F. Supp. at 92).

In 1990, Congress authorized the SEC to seek civil monetary penalties up to the "gross amount of pecuniary gain," or potentially more using a per-violation calculation method. *See* 15 U.S.C. §§ 77t(d)(2), 78u(d)(2).

The stage for *Kokesh* was set in *Gabelli v. SEC*, 568 U.S. 442 (2013), in which the Supreme Court held that the five-year clock for the SEC to commence enforcement actions for civil penalties begins to run when the violation occurred, not when it is discovered. Before *Gabelli*, the SEC had more latitude regarding the conduct for which a penalty could be sought. *Gabelli*, however, left open the question of whether disgorgement was subject to the five-year time bar.

KOKESH V. SECURITIES AND EXCHANGE COMMISSION

In 2009, the SEC brought an enforcement action against defendant Charles Kokesh, alleging that Kokesh, through the investment-adviser firms he owned, misappropriated nearly $35 million from clients between 1995 and 2009. The SEC sought civil monetary penalties, disgorgement, and injunctive relief barring Kokesh from committing future securities law violations.

The district court ordered Kokesh to pay civil penalties, totaling $2,354,593, subject to a five-year statute of limitations period under § 2462. With respect to disgorgement, the district court found that no limitations period applied. The court ordered disgorgement of $34.9 million, which represented all funds illegally obtained from 1995 to 2006, plus $18.1 million in prejudgment interest. The Tenth Circuit affirmed, holding that the SEC's disgorgement remedy was not a penalty and thus was insulated from the limitations period of § 2462.

In a unanimous opinion authored by Justice Sonia Sotomayor, the Supreme Court reversed. The Supreme Court reasoned that disgorgement constitutes a penalty within the meaning of § 2462 for the following reasons:

(i) Disgorgement is imposed by the courts as a consequence of violating public laws, *i.e.*, "the violation for which the remedy is sought is committed against the United States rather than an aggrieved individual." *Kokesh*, No. 16-529, slip op. 7-8.

(ii) Disgorgement is imposed for punitive purposes. The Court found that the primary purpose of disgorgement is to "deter violations of the securities laws by depriving violators of their ill-gotten gains." *Id.* at 8.

(iii) The Court also noted that in many cases, SEC disgorgement is not compensatory; rather, "courts have ordered disgorgement regardless of whether the disgorged funds will be paid to [harmed] investors as restitution." *Id.* at 9.

Thus, the Court found that SEC disgorgement "bears all the hallmarks of a penalty." *Id.* The Supreme Court held that because disgorgement operates as a penalty under § 2462, "any claim for disgorgement in an SEC enforcement action must be commenced within five years of the date the claim accrued." *Id.* at 11.

Finally, the Supreme Court observed in a footnote that the decision was not to be interpreted as an opinion on "whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context." *Id.* at 5 n.3.

IMPLICATIONS

While the full the implications of *Kokesh* remain to be seen, three observations are worth noting.

First, *Kokesh* may change the calculus of parties who are asked to enter into tolling agreements with the SEC, especially in matters that go back several years or are close to expiring under the statute of limitations.

Second, in long-running or late-discovered frauds, *Kokesh* may give the SEC an incentive to make a criminal referral to the US Department of Justice (DOJ) earlier or more often than would otherwise have been the case. In those circumstances, the SEC could be concerned about an inability to obtain disgorgement of all of a defendant's ill-gotten gains, whereas criminal forfeiture, which is not subject to a statute of limitations, might be viewed as a more effective remedy to reach back in time to the earlier conduct. Although most of the SEC's enforcement matters likely involve shorter-term or more discrete conduct which is charged in a timely fashion, it is sometimes the most difficult, and the largest, cases which are hard to uncover and difficult to investigate, creating the potential for them to fall within the ambit of *Kokesh*.

In particular, the ruling may impact the SEC's approach to FCPA cases, where evidence from foreign countries can be difficult and time-consuming to obtain, and which are

often investigated in parallel with the criminal authorities. Unlike the SEC, the DOJ may in certain cases be able to rely on conspiracy charges to allow it to reach conduct that would otherwise fall outside of the five-year statute of limitations period. To the extent that *Kokesh* limits the SEC from obtaining disgorgement related to conduct that pre-dates the limitations period, it could affect settlement discussions where the SEC and DOJ are proceeding in parallel, or discourage the SEC from proceeding at all if the conduct is not discovered, or monetary recovery cannot be obtained, until close to the expiration of the limitations period or in circumstances where the bulk of the conduct in question predates the limitations period.

Third, the availability of disgorgement as an equitable remedy in the SEC's judicial enforcement actions may be subject to legal challenge in the future. Indeed, the Court may have invited such a challenge with footnote three, which arguably signaled unease with the lawfulness of disgorgement as a remedy available to the SEC.

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