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The SEC's Continuing Struggle With Stale Claims

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On Feb. 26, 2007, Southern District of New York Judge Richard Conway Casey dismissed the Securities and Exchange Commission's action seeking civil monetary penalties and an injunction against former Citigroup Asset Management (CAM) executives Thomas W. Jones and Lewis E. Daidone. Casey found the SEC's action was time-barred by the statute of limitations codified in 28 U.S.C. §2462.[1]

Section 2462 is a "catch-all" limitations provision, which states 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."[2] Casey's decision illustrates the continuing difficulty confronting the SEC in pursuing non-recurrent securities law violations in certain cases, and the importance to defense counsel of considering the applicability of §2462 when representing individuals or entities in SEC investigations involving isolated and aging conduct.

THE D.C. CIRCUIT'S 'SEC V. JOHNSON' DECISION

SEC v. Jones comes just about a decade after *SEC v. Johnson*, in which the U.S. Court of Appeals for the D.C. Circuit held that §2462 applied to any SEC administrative proceeding in which the SEC has sought a civil penalty and defined "penalty" as any sanction exceeding what is necessary to protect the public from future violations.[3] The D.C. Circuit held that where equitable relief was punitive in nature in the context of a particular case, or there was insufficient proof that the SEC's requested relief fulfilled a remedial purpose, the five-year limitations period of §2462 applied.[4]

Johnson similarly held that an equitable remedy, such as an injunction, which is primarily aimed at preventing future harm to the public, rather than punishing a particular defendant, may be characterized as remedial though it is not directly tied to the traditional injunction standard of restoring the status quo ante.[5] At the time, although the decision was certainly newsworthy, the repercussions of Johnson were not fully known.

TIME-BARRED SEC ACTIONS FOLLOWING 'JOHNSON'

In the wake of *Johnson*, punitive relief sought in both SEC federal court injunctive actions and SEC administrative proceedings has been dismissed on statute of limitations grounds.

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For example, in *SEC v. Scrushy*, the court granted defendant's motion to dismiss the SEC's claim for civil monetary penalties because the defendants' alleged violations occurred outside §2462's five-year statute of limitations.[6] And, in *SEC v. Cochran*, an anti-fraud injunction action arising out of two "advance refunding" municipal bond offerings, the SEC's requested relief included civil monetary penalties which the court dismissed in part on summary judgment, finding that the relief was time-barred.[7]

In terms of administrative proceedings, the SEC has dismissed proceedings as time-barred by §2462 where the Division of Enforcement sought civil penalties and various industry bars precluding securities industry professionals from associating with securities firms, or attorneys and accountants from practicing before the SEC.[8] Over the course of the 10 years that has lapsed since *Johnson*, however, the courts and the SEC have declined in almost all circumstances to hold that §2462 applies to the SEC's traditional forms of remedial relief, including requests for administrative cease-and-desist orders, injunctions or SEC requests for disgorgement of unlawfully obtained profits.[9]

THE 'JONES' DECISION

The recent *Jones* decision is significant because it allows defense counsel to scrutinize SEC requests for traditionally remedial relief like injunctions or cease-and-desist orders in cases where, given the passage of time and lack of continuing misconduct by the defendant, or the respondent in an administrative proceeding, such relief would not serve the remedial purpose of protecting the public from future harm, but would simply act to punish. A sufficiently punitive impact would, under *Jones*, be subject to §2462. Equally instructive is the court's discussion of its rejection of the SEC's argument that §2462's limitations period should have been tolled pursuant to the fraudulent concealment doctrine.

In *Jones*, the SEC sued defendants Jones and Daidone for allegedly aiding and abetting CAM in its violation of §206 of the Investment Advisers Act, the statute's general anti-fraud provision, based on their involvement with CAM in a purported scheme to improperly divert almost $100 million in funds from mutual fund investors.[10] The SEC sought civil monetary penalties, a permanent injunction and disgorgement against the defendants.[11]

In 1999, CAM established an in-house transfer agent service whereby Citigroup Trust Bank would assume responsibility from First Data Investment Services Group, a processing services provider, for all customer service functions and maintain overall responsibility for the transfer agent function, and retained First Data as the sub-transfer agent to perform transaction processing and all other customary functions of a transfer agent.[12]

A transfer agent is responsible for securities transaction processing, shareholder accounting, customer service and certain technology applications and operations, essentially maintaining shareholder records and issuing or canceling stock certificates when shares are bought or sold.[13] Bringing the transfer agent function in-house required minimal investment by Citigroup Trust Bank and was expected to generate millions of dollars in profits.[14]

The SEC alleged, however, that, rather than pass the savings to its mutual funds, Citigroup's divisions improperly usurped the benefits, taking profits of almost $100 million over five years.[15] The SEC asserted that defendants did not accurately inform the mutual funds' boards regarding how much Citigroup expected to make from the arrangement with First Data, nor the true reason for choosing First Data to serve as sub-transfer agent, which was to obtain reciprocal business.[16]

As for Jones' and Daidone's role, the SEC alleged that Daidone primarily prepared, and Jones reviewed, the mutual fund board materials, which "did not disclose CAM's leveraging the Funds' [transfer agent] business to obtain reciprocal business and revenue guarantees benefiting only Citigroup."[17]

The *Jones* court noted that the matter was brought to the SEC's attention in August 2003 when a former Citigroup employee informed the SEC that the transfer agent arrangement was "probably not in the best interest of the shareholders of the funds because there were profits that were being taken that should have been passed on as savings to the shareholders of the funds as opposed to profits of the corporation."[18]

In May 2005, the SEC issued an administrative order censuring Smith Barney Fund Management and Citigroup Global Markets for CAM's activities and ordered disgorgement of more than $100 million and a civil penalty of $80 million.[19] In August 2005, two years after the SEC learned of CAM's alleged illegal activity, and more than five years after the alleged misconduct, the SEC sued Jones and Daidone.[20]

THE COURT'S REJECTION OF THE SEC'S FRAUDULENT CONCEALMENT ARGUMENT

The Investment Advisers Act does not contain a statute of limitations period and, therefore, Casey found that the catch-all statute of limitations contained in §2462 applied.[21] Casey first held that because the SEC's request for civil monetary penalties against Jones and Daidone was obviously a penalty, and the underlying acts at issue took place in the summer of 1999 -- more than five years before the SEC filed its complaint in August 2005 -- the SEC's penalties request was barred by §2462's five-year limitations period.[22]

The SEC argued that the court should toll the statute of limitations pursuant to the fraudulent concealment doctrine.[23] Casey did not dispute that the fraudulent concealment doctrine could act to toll the statute of limitations period, but, after examining the record, held that the SEC failed to show that defendants' deception was unknowable and thus self-concealing.[24]

The court stated that the SEC "simply rehashe[d] the underlying allegations of fraud and label[ed] them as self-concealing."[25] Moreover, Casey found that the SEC was alerted to defendants' activity by a whistleblower in 2003 and had access to memoranda and other documents concerning the same conduct well before the statute of limitations had run.[26]

Incidentally, Casey noted that the SEC "fail[ed] to cite a single securities case applying the self-concealing fraud doctrine to toll a statute of limitations."[27] There does, however, appear to be at least one case in which the SEC successfully did so.[28]

In *Cochran*, the SEC argued that the five-year statute of limitations contained in 28 U.S.C. §2462 began to run no earlier than the date on which the SEC discovered certain fraudulently concealed illegal payments the defendants had made.[29] Defendants argued that the doctrine of fraudulent concealment should only apply where the SEC discovered the underlying facts after the limitations period expired.[30]

Defendants asserted that the SEC should be precluded from obtaining the benefit of the fraudulent concealment doctrine because it discovered the cause of action within the five-year limitations period, but failed to file a claim until after the limitations period had run.[31] The court rejected defendants' position and agreed with the SEC, denying defendants' motion for summary judgment with respect to one set of claims.

The court reasoned that to hold otherwise and accept defendants' argument that the doctrine of fraudulent concealment should only apply where the underlying facts were uncovered after the expiration of the five-year limitations period would, in effect, allow the wrongdoer "to benefit in the form of a shorter limitations period."[32] With respect to certain other claims, however, in the case for civil monetary penalties, the court held that the SEC was simply unable to produce sufficient proof of independent acts of fraudulent concealment and dismissed those claims pursuant to §2462.[33]

PUNITIVE IMPACT OF THE SEC'S STALE REQUEST FOR AN INJUNCTION

After finding the SEC's penalties request in Jones to be time-barred, Casey examined whether the SEC's request for injunctive relief was on the facts of the case truly remedial or effectively punitive in nature. Casey held that the SEC's request for a permanent injunction prohibiting Jones and Daidone from committing future violations of §206 of the Investment Advisers Act was a penalty under §2462 and, therefore, was time-barred.[34]

In concluding that the SEC's requested injunction was a penalty, and not a remedial measure, the court examined the defendants' likelihood of committing similar alleged violations in the future, and the possible collateral consequences of enjoining them.[35]

The court found that the SEC offered no proof, apart from defendants' past alleged wrongdoing, to suggest any cognizable danger of recurrent violations, nor sufficiently demonstrated that the defendants engaged in a pattern of securities law violations.[36] Several years had passed since the defendants' alleged misconduct without incident.[37]

With respect to collateral consequences, Casey noted that "here, as in many securities cases, the potential collateral consequences of a permanent injunction are quite serious."[38] Indeed, the court stated that the practical effect of any permanent injunction would be to "stigmatize Defendants in the investment community," "significantly impair their ability to pursue a career," and, furthermore, "provide the authority for the Commission to seek to permanently bar defendants from the investment adviser industry."[39]

The severity of such collateral consequences carried, in the court's view, "the sting of punishment" and, therefore, the SEC's requested injunctive relief was punitive and subject to §2462's five-year limitations period.[40]

CONCLUSION

The recent *Jones* decision indicates that the SEC continues to struggle with the catch-all statute of limitations in 28 U.S.C. §2462. Its holding that an injunction can serve as a penalty for purposes of §2462 permits defense counsel to consider §2462's impact not just on SEC monetary penalty requests, but in any SEC enforcement action where a defendant's or respondent's isolated conduct years in the past might render traditionally remedial SEC relief punitive in nature when applied to the facts of a particular case.[41]

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1. *SEC v. Jones*, No. 05 Civ. 7044, 2007 WL 632730 at *5-11 (S.D.N.Y. Feb. 26, 2007). The court also granted summary judgment and dismissed the SEC's request for disgorgement, holding that it "was not supported by sufficient facts." *Jones*, 2007 WL 632730 at *12.
2. 28 U.S.C. §2462.
3. 87 F.3d 484, 488-89 (D.C. Cir. 1996).
4. *Johnson*, 87 F.3d at 488-89.
5. Id. at 488.
6. No. CV-03-615S, 2005 WL 3279894 at *3 (N.D. Ala. 2005).
7. No. CIV-95-1477-A, 1999 WL 33292713 (W.D. Okla. 1999).
8. *See, e.g., In re Feeley & Wilcox Asset Mgmt. Corp.*, Securities Act Release No. 8249, Exchange Act Release No. 48162, Advisers Act Release No. 2143, 80 S.E.C. Docket 1730 (July 10, 2003) (noting five-year statute of limitations set forth in 28 U.S.C. §2462 applied in determining whether a bar from association with a broker or dealer or investment adviser was appropriate); In re Blizzard, Initial Decision Release No. 229, 80 S.E.C. Docket 1464 (June 13, 2003) (holding that requested three to five year industry bar and civil penalty were time-barred by 28 U.S.C. §2462).
9. *In re Moskowitz*, Exchange Act Release No. 45609, 77 S.E.C. Docket 446, (March 21, 2002) ("Cease-and desist proceedings are remedial in nature and not subject to Section 2462"); *In re Blizzard*, Initial Decision Release No. 229, 80 S.E.C. Docket 1464 (June 13, 2003) (holding that "a prospective cease-and-desist order that a Respondent not violate the securities laws in the future is not a penalty" and therefore not barred by 28 U.S.C. §2462); *In re Coxon*, Securities Act Release No. 8271, Exchange Act Release No. 48385, Investment Advisers Act Release No. 2161, Investment Company Act Release No. 26165, 80 S.E.C. Docket 2586 (August 21, 2003) ("Because a cease-and-desist order is forward-looking, we believe that Section 2462 does not apply to actions for a cease-and-desist order.")
10. *Jones*, 2007 WL 632730 at *1.
11. *Id.* at *5.
12. *Id.* at *3-4.
13. *Id.* at *1.
14. *Id.* at *3.
15. United States Securities and Exchange Commission's Complaint against Thomas W. Jones and Lewis E. Daidone 99.
16. *Jones*, 2007 WL 632730 at *4.
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.* at *5.
22. *Id.* at *5.
23. *Id.* The court noted that under that doctrine, the SEC must show that: (1) defendants concealed the existence of the SEC's cause of action or, in this case, that the fraud alleged was one of non-disclosure and was inherently self-concealing; (2) the SEC did not discover the alleged wrongdoing until some point within five years of commencing its enforcement action; and (3) the SEC's continuing ignorance was not attributable to lack of diligence on its part. Id. (citing *New York v. Henrickson Bros., Inc.*, 840 F.2d 1065, 1083 (2d Cir. 1988)).
24. *Id.* at *8.
25. *Id.*
26. *Id.*
27. *Id.*
28. *See SEC v. Cochran*, No. CIV-95-1477-A, 1999 WL 33292713 (D. Okla. 1999) (rejecting defendants' motion for summary judgment based on the statute of limitations with regard to one transaction, but granting summary judgment based on the statute of limitations as applied to another transaction), *rev'd on other grounds*, 214 F.3d 1261 (10th Cir. 2000).
29. *See Cochran*, 1999 WL 33292713 at *3.
30. *Id.*
31. *Id.*
32. *Id.* at *5.
33. *Id.* at *6.
34. *Jones*, 2007 WL 632730 at *11.
35. *Id.* at *9.
36. *Id.* at *9-10.
37. *Id.* at *10.
38. *Id.* (citations omitted).
39. *Id.* (citations omitted).
40. *Id.*
41. Defense counsel should also consider the SEC's failure to prosecute as a possible basis to seek dismissal of aging claims after an SEC complaint has been filed. In a recent decision in *SEC v. PacketPort.com, Inc.*, No. 3:05CV1747, a federal district judge in Connecticut dismissed a $9 million dollar enforcement action involving an alleged "pump and dump" stock scheme because of the SEC's failure to prosecute the litigation. See Marcia Coyle, "SEC delays sink enforcement action," Nat'l L. J. (Apr. 2, 2007). The SEC initiated its investigation in December 1999 -- two days after the alleged scheme took place -- but did not file the lawsuit until almost six years later, including three and a half years after it had served a Wells Notice, and nine months after the §2462 limitations period had run on the SEC's request for civil penalties. *See id.*