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Punitive Relief Is An Open Question In SEC Case

Monday, Jul 23, 2007 --- In SEC v. Jones, Judge Casey of the Southern District of New York dismissed the Securities and Exchange Commission's action seeking civil monetary penalties and an injunction against former Citigroup Asset Management executives Thomas W. Jones and Lewis E. Daidone.

The court found the SEC's action was time-barred by the statute of limitations codified in 28 U.S.C. § 2462 (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).

Section 2462 is a "catch-all" limitations provision, providing 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" (28 U.S.C. § 2462).

The Jones decision is significant because it reminds defense counsel to scrutinize Commission 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 Section 2462.

In addition, the court's rejection of the Commission's argument that Section 2462's limitations period should have been tolled pursuant to the fraudulent concealment doctrine suggests that courts will be unwilling to allow the SEC to readily circumvent Section 2462's bar.

However, Judge Casey's decision left open the question of whether the fraudulent concealment doctrine should be applied in securities fraud cases involving the application of Section 2462's statute of limitations—an issue that has been not been addressed by many courts.

The D.C. Circuit's SEC v. Johnson Decision

Jones comes just over a decade after SEC v. Johnson, in which the Court of Appeals for the District of Columbia held that Section 2462 applied to any SEC administrative proceeding in which the Commission has sought a civil penalty and defined "penalty" as any sanction exceeding what is necessary to protect the public from future violations (SEC v. Johnson, 87 F.3d 484, 488-89 (D.C. Cir. 1996)).

The Court of Appeals held that where equitable relief was punitive in nature in the context of a particular case, or there was insufficient proof that the Commission's requested relief fulfilled a remedial purpose, the five-year limitations period of Section 2462 applied (Johnson, 87 F.3d at 488-89).

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 still be characterized as remedial even if it is not issued pursuant to the traditional injunction standard of restoring the status quo ante (Id. at 488).

At the time, although the decision was 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 Commission administrative proceedings has been dismissed on statute of limitations grounds. For example, in SEC v. Scrushy, the court granted defendant's motion to dismiss the Commission's claim for civil monetary penalties because the defendants' alleged violations occurred outside Section 2462's five-year statute of limitations (No. CV-03-615S, 2005 WL 3279894 at *3 (N.D. Ala. 2005)).

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 (No. CIV-95-1477-A, 1999 WL 33292713 (W.D. Okla. 1999)).

The Commission has dismissed administrative proceedings as time-barred by Section 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 Commission.

(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 that the SEC's Division of Enforcement did not appeal the Administrative Law Judge's finding that the five-year statute of limitations set forth in 28 U.S.C. § 2462 applied to preclude consideration of certain alleged misconduct in considering the SEC's request for an industry bar and monetary penalties); 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)).

Over the course of the ten years that has lapsed since Johnson, however, the courts and the SEC have declined in almost all circumstances to hold that Section 2462 applies to the SEC's traditional forms of remedial relief, including requests for administrative cease-and-desist orders, injunctions, or Commission requests for disgorgement of unlawfully obtained profits.

(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.)

The Jones Decision

In Jones, the SEC sued defendants Jones and Daidone for allegedly aiding and abetting CAM in its violation of Section 206 of the Investment Advisers Act, the statute's general anti-fraud provision, based on their involvement with CAM in an alleged scheme to improperly divert almost $100 million in funds from mutual fund investors (Jones, 2007 WL 632730 at *1).

The Commission pursued civil monetary penalties, a permanent injunction and disgorgement against the defendants (Id. at *5).

In 1999, CAM set-up an in-house transfer agent service whereby Citigroup Trust Bank would assume responsibility from First Data Investment Services Group ("First Data"), 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 (Id. at *3-4).

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 (Id. At *1).

Establishing the transfer agent function in-house required minimal investment by Citigroup Trust Bank and was expected to generate millions of dollars in profits (Id. at *3).

However, the SEC claimed that instead of passing the savings to its mutual funds, Citigroup's divisions improperly usurped the benefits, taking profits of almost $100 million over five years (United States Securities and Exchange Commission's Complaint against Thomas W. Jones and Lewis E. Daidone ¶

99).

The SEC alleged 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 (Jones, 2007 WL 632730 at *4).

As for Jones' and Daidone's involvement, 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" (Id.).

Judge Casey noted that the matter was brought to the SEC's attention in August 2003 when a former Citigroup employee informed the Commission 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" (Id.).

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 over $100 million and a civil penalty of $80 million (Id.).

In August 2005, two years after the Commission learned of CAM's alleged illegal activity, and over five years after the alleged misconduct, the Commission finally sued Jones and Daidone (Id.).

Because the Investment Advisers Act does not contain a statute of limitations period, Judge Casey found that the catch-all statute of limitations contained in Section 2462 applied (Id. at *5).

He held that because the Commission'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 Section 2462's five-year limitations period (Id. at *5).

The Court's Rejection of The Commission's Fraudulent Concealment Argument

In order to circumvent dismissal pursuant to Section 2462's statute of limitations, the SEC argued that the court should toll the statute of limitations pursuant to the fraudulent concealment doctrine (Id).

The court noted that under that doctrine, the Commission must show that (1) defendants concealed the existence of the Commission's cause of action or, in this case, that the fraud alleged was one of non-disclosure and was inherently self-concealing; (2) the Commission did not discover the alleged wrongdoing until some point within five years of commencing its enforcement action; and (3) the Commission'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)).

After examining the record, the court held that the SEC failed to show that defendants' deception was unknowable and thus self-concealing (Id. at *8).

The court stated that the Commission "simply rehashe[d] the underlying allegations of fraud and label[ed] them as self-concealing" (Id.).

Moreover, Judge Casey found that the Commission 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 (Id.).

However, significantly, the court did not dispute that the fraudulent concealment doctrine could act to toll the statute of limitations period in some circumstances.

Although the SEC "fail[ed] to cite a single securities case applying the self-concealing fraud doctrine to toll a statute of limitations," as noted by Judge Casey, other courts in the country have in fact applied it to effectively toll Section 2462's statute of limitations period. (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)).

In SEC v. Cochran, the Commission argued that the five-year statute of limitations contained in U.S.C. § 2462 began to run no earlier than the date on which the Commission discovered certain fraudulently concealed illegal payments the defendants had made (see Cochran, 1999 WL 33292713 at *3).

Defendants argued that the doctrine of fraudulent concealment should only apply where the Commission discovered the underlying facts after the limitations period expired (Id.).

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 (Id.).

The court rejected defendants' position and agreed with the Commission, denying defendants' motion for summary judgment with respect to one set of claims. It 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" (Id. at *5).

With respect to certain other claims in the case for civil monetary penalties, the court held that the Commission was simply unable to produce sufficient proof of independent acts of fraudulent concealment and dismissed those claims pursuant to Section 2462 (Id. at *6).

Punitive Impact Of The Commission's Stale Request For An Injunction

After finding the Commission's penalties request in Jones to be time-barred, Judge Casey examined whether the Commission's request for injunctive relief was on the facts of the case truly remedial or effectively punitive in nature. Judge Casey held that the SEC's request for a permanent injunction prohibiting Jones and Daidone from committing future violations of Section 206 of the Investment Advisers Act was a penalty under Section 2462 and, therefore, was time-barred (Jones, 2007 WL 632730 at *11).

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 (Id. at *9).

The court found that the Commission 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 (Id. at *9-10).

Several years had passed since the defendants' alleged misconduct without incident (Id. at *10).

With respect to collateral consequences, Judge Casey noted that "here, as in many securities cases, the potential collateral consequences of a permanent injunction are quite serious" (Id. (citations omitted)).

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 Id. (citations omitted)).

The severity of such collateral consequences carried, in the court's view, "the sting of punishment" and, therefore, the Commission's requested injunctive relief was punitive and subject to Section 2462's five-year limitations period (Id.).

Conclusion

Jones is significant because its holding that an injunction can serve as a penalty for purposes of Section 2462 serves as a reminder that Section 2462's five-year statute of limitations period is applicable not only to 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 specific case.

(Defense counsel should also consider the Commission's failure to prosecute as a possible basis to seek dismissal of aging claims after a Commission 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 Commission's failure to prosecute the litigation. See Marcia Coyle, SEC delays sink enforcement action, Nat'l L. J. (Apr. 2, 2007). The Commission 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 Section 2462 limitations period had run on the Commission's request for civil penalties. See id.)

The decision is also noteworthy because it highlights an issue only a few courts have addressed concerning whether the fraudulent concealment doctrine should apply in this context and whether Section 2462's limitations period accrues when the violation is discovered or when it occurred, and underscores a judicial reluctance to permit the SEC to readily escape dismissal of stale claims.

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