

U.S. Supreme Court Significantly Limits SEC's Power to Recover Disgorgement

IN SHORT

The Situation: Federal circuit courts had issued divergent rulings as to whether the SEC's disgorgement measures constituted a punitive or a remedial action.

The Development: The U.S. Supreme Court held, in *Kokesh v. SEC*, that disgorgement acts as a penalty and is therefore subject to a five-year statute of limitations.

Looking Ahead: The decision appears to severely limit the SEC's use of one of its most prominent enforcement mechanisms, but the SEC could revise its strategies to accommodate the new restrictions.

On June 5, 2017, in an unanimous ruling in *Kokesh v. SEC*, No. 16-529, the United States Supreme Court significantly limited the breadth of the Securities and Exchange Commission's primary enforcement tool. The Court held that disgorgement, like the SEC's other financial sanctions, is subject to the five-year statute of limitations of 28 U.S.C. § 2462 since it operates as a penalty. The Court's decision settles a federal circuit court split on the issue and puts an end to the SEC's ability to recover disgorgement based on conduct that occurred more than five years before a claim accrued. Notably, the Court also suggested in a footnote in the opinion that the very use of disgorgement in SEC actions may be up for debate.

Background

The five-year statute of limitations under Section 2462 applies to "an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture." In 2013, the Supreme Court similarly limited the SEC's enforcement powers when in *Gabelli v. SEC*, 133 S. Ct. 1216 (2013), it held that Section 2462 applies when the SEC seeks statutory monetary penalties. The Court, however, left open the question of whether it applies to disgorgement. Since *Gabelli*, circuit courts have split on this issue. In *SEC v. Graham*, 823 F.3d 1357 (11th Cir. 2016), the Eleventh Circuit held that disgorgement is a forfeiture subject to Section 2462. In *Kokesh*, the Tenth Circuit disagreed, holding that disgorgement is remedial, not punitive, and thus is not a forfeiture subject to Section 2462. The First and D.C. Circuits also have rejected the application of Section 2462 to disgorgement.



Notably, the Court suggested that the very use of disgorgement in SEC actions may be up for debate.



The Supreme Court's Decision

In *Kokesh*, the Supreme Court reversed the Tenth Circuit's ruling, holding that disgorgement constitutes a penalty and, as such, is subject to Section 2462's five-year statute of limitations. Writing for the unanimous Court, Justice Sonia Sotomayor said disgorgement "bears all the hallmarks of a penalty: It is imposed as a consequence of violating a public law and it is intended to deter, not to compensate." In rejecting the SEC's position that "disgorgement is not punitive but 'remedial' in that it 'lessen[s] the effects of a violation by 'restor[ing] the status quo,'" the Court referenced prior cases where the amount of disgorgement exceeded the defendant's ill-gotten gains, thereby leaving the defendant worse off. The Court also called into question, though did not decide, the legitimacy of the SEC's use of disgorgement, writing in a footnote that

"[n]othing in this opinion should be interpreted as an opinion on whether courts possess the authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context."

Implications

First, companies and individuals facing SEC enforcement actions based on conduct occurring more than five years before the claims accrued have a firm basis to resist disgorgement for conduct beyond that period. On the flip side, however, defendants may expect the SEC to seek higher penalty amounts since it no longer can seek as much in disgorgement.

Second, companies and individuals may expect the SEC to push harder for documents and testimony and to move more quickly in issuing Wells notices. The SEC also may expedite its requests for tolling agreements to suspend or waive the statute of limitations. Alternatively, the SEC may try to avoid these issues altogether by claiming the alleged misconduct was a single and ongoing act, rather than separate and discrete acts, that continued into the statutory period.

Third, the Court's footnote questioning the legitimacy of disgorgement, quoted above—in addition to the Court's acknowledgement that the SEC has applied disgorgement contrary to the basic rules set out in the Restatement (Third) of Restitution and Unjust Enrichment § 51—suggests its continuing discomfort with the SEC's view that expenses attributable to the conduct that earned the ill-gotten gain are not deductible when computing the disgorgement amount. The Court seems to encourage challenges to the SEC's approach to disgorgement computation in the context of enforcement proceedings. As such, *Kokesh* may not be the last challenge to the SEC's disgorgement authority.

Fourth, the characterization of disgorgement as a penalty may revive arguments that in parallel civil and criminal cases, a Department of Justice criminal fine may bar by double jeopardy an SEC disgorgement remedy, under the test set forth in *Hudson v. United States*, 522 U.S. 93 (1997). This could have important consequences for the many investigations under the Foreign Corrupt Practices Act, as well as other federal securities laws, that are commonly resolved by parallel negotiated settlements with the Department of Justice and SEC.

FOUR KEY TAKEAWAYS

1. The *Kokesh v. SEC* decision puts an end to the SEC's ability to recover disgorgement based on conduct that occurred more than five years before a claim accrued.
2. As a result, however, defendants might experience the SEC asking for inflated penalties, since it no longer can seek as much in disgorgement.
3. In another possible reaction, the SEC could speed up the issuing of Wells notices and expedite its requests for tolling agreements to suspend or waive the statute of limitations.
4. The SEC also may try to avoid statute of limitations obstacles completely by alleging the misconduct was a single and ongoing act—rather than separate and discrete occurrences—that continued into the statutory period.

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