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SEC ENFORCEMENT MATTERS

How the SEC May Circumvent the Five-Year Statute of Limitations on Disgorgement Under *Kokesh v. SEC*

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On June 5, 2017, the U.S. Supreme Court ruled in *Kokesh v. SEC* that the disgorgement remedy available to the SEC is restricted by a five-year statute of limitations. See "*Implications for Fund Managers of the Supreme Court's Ruling in Kokesh v. SEC*" (Jun. 15, 2017). The decision was widely seen as a victory for entities that are subject to the enforcement arm of the SEC. The total monetary liability for advisers alleged to have engaged in securities violations may be dramatically reduced due to *Kokesh*. Advisers also have greater certainty that they will not be punished for violations that occurred outside the five-year limitations period.

It is unlikely, however, that the Commission's Division of Enforcement will take the *Kokesh* decision lying down, and it may adopt strategies to mitigate the impact of the Court's decision on its ability to seek penalties and disgorgement from advisers. This article discusses some of the legal tools available to the SEC to circumvent *Kokesh* now that disgorgement is not the open-ended and unlimited remedy it had previously been.

SEC Disgorgement

Since the 1970s, the SEC has sought to require defendants in enforcement actions to "disgorge" their ill-gotten gains as an equitable remedy. In an insider trading case, for example, the SEC typically seeks an order requiring the defendant to disgorge profits, or losses avoided, as a result of the alleged improper trading. For years, disgorgement has been a powerful enforcement tool for the SEC. Indeed, in 2015 alone, it was reported that the Division of Enforcement obtained more than $3 billion in disgorgement payments.

That amount is the result of the Division of Enforcement's longstanding practice to seek disgorgement beyond the limitations period set forth in 28 U.S.C. §2462. Section 2462 provides that a five-year statute of limitations applies to any government action for the enforcement of any "civil fine, penalty, or forfeiture." In 2013, the Supreme Court made clear that §2462's limitations period applies when the SEC seeks statutory civil monetary penalties.[1] Until Kokesh, however, courts were divided over the related question of whether the five-year statute of limitations applies to claims for disgorgement.

The U.S. Court of Appeals for the D.C. Circuit ruled that §2462 does not apply to disgorgement because "disgorgement orders are not penalties, at least so long as the disgorged amount is causally related to the wrongdoing."[2] The U.S. Court of Appeals for the First Circuit had reached a similar conclusion.[3] The Eleventh Circuit, on the other hand, concluded that disgorgement and forfeiture substantively overlapped and thus disgorgements were effectively forfeitures subject to §2462's five-year statute of limitations.

The Kokesh Case

To resolve this circuit split, the U.S. Supreme Court granted certiorari in *Kokesh v. SEC*. In 2009, the SEC brought an enforcement action in federal court in New Mexico against investment adviser Charles Kokesh. The Commission alleged that, between 1995 and 2006, Kokesh misappropriated $34.9 million from two business development companies. Following a jury trial in which Kokesh was found liable, the SEC sought, among other things, fines and disgorgement of ill-gotten gains.

The district court held that §2462 precluded any civil monetary penalties for Kokesh's misappropriation that had occurred five years before the date the SEC filed its complaint. Thus, the court limited the liability for fines to misconduct occurring after 2004, which amounted to $2.4 million. In line with the Court of Appeals for the D.C. and First Circuits, however, the district court held that the SEC's request for disgorgement was not a penalty within the meaning of §2462; thus, no limitations period applied. As a result, the district court ordered Kokesh to pay $34.9 million in disgorgement, $29.9 million of which related to conduct outside the five-year statute of limitations. On appeal, the Tenth Circuit affirmed the district court's holding.

Reversing the Tenth Circuit, the Supreme Court unanimously held that disgorgement is a penalty within the meaning of §2462 thus subject to its five-year limitations period. Penalties, the Court said, often reflect two basic qualities: (1) they are imposed to redress public wrongs, rather than individual wrongs; and (2) they are imposed for the primary purposes of punishment and deterrence, not compensation of the victim. Disgorgement, the Court held, embodies both qualities.

Violations of the securities laws are public wrongs, the Court explained, not least because the SEC may pursue enforcement actions even against the victims' wishes. The SEC, the Court said, acts in the public interest. Disgorgement also serves deterrent and punitive purposes, the Court noted. This is illustrated by the fact that disgorged profits are frequently paid to the court, rather than the victims. Courts ordering disgorgement may also require an individual to pay more than he or she personally gained from the alleged misconduct. In those cases, the Court said, "disgorgement does not simply restore the status quo; it leaves the defendant worse off."

The Ruling's Impact

The *Kokesh* decision has important implications. The Court's opinion clearly limits the potential financial liability of entities subject to SEC enforcement actions. The opinion makes clear that conduct occurring more than five years prior to the date the SEC files a complaint cannot be the subject of disgorgement, resulting in a significant reduction of liability in cases involving conduct beyond the five-year statute of limitations.

Relatedly, the Court's decision may have weakened the Enforcement Staff's position in settlement discussions. Following Kokesh, it will be more difficult for the SEC to leverage the prospect of enormous disgorgement amounts based on historical conduct. Thus, for claims that accrue outside the five-year limitations period, advisers may have a stronger hand in negotiating more favorable resolutions.

Notwithstanding that *Kokesh* weakens the impact of disgorgement, that remedy will likely remain a staple in SEC enforcement actions. Unlike civil penalties, which can be imposed on a defendant only in relation to that individual's own ill-gotten gain, defendants are jointly and severally liable for disgorgement. By requesting disgorgement in cases involving multiple defendants, the SEC can seek from any single defendant the full amount of the ill-gotten gain received by all defendants within the limitations period.

While *Kokesh* therefore restores some parity between the amount a court can disgorge from a defendant in a securities case and the size of the penalty the court may impose, disgorgement can still dwarf the maximum possible penalty in cases where a single defendant is held jointly and severally liable for disgorgement of the total ill-gotten gain. As a result, the SEC remains incentivized to pursue disgorgement alongside civil monetary penalties and other statutory remedies.

This risk is particularly acute for advisers and other regulated entities that almost certainly will have deeper pockets than any individuals named as co-defendants in an enforcement action.

Anticipated SEC Strategies

In response to the *Kokesh* decision, the SEC's Enforcement Staff can be expected to explore how it might extend the limitations clock. The following are several potential strategies the SEC may adopt to mitigate the impact of *Kokesh* and allow the agency to maximize the amount of disgorgement available in an enforcement action.

Tolling Agreements

Tolling agreements will likely feature more prominently in SEC investigations. Voluntarily entered into between the SEC and a potential target of an investigation, tolling agreements pause the limitations clock for the certain period of time specified in the agreement and allow the SEC to continue its investigation and bring enforcement actions that otherwise would be time-barred. Given that disgorgement is now subject to a five-year statute of limitations, it can be expected that the SEC will demand tolling agreements more frequently and at earlier stages in its investigations.

Whether to agree to the SEC's request for a tolling agreement can often present a difficult choice for the target of an SEC investigation. Agreeing to toll the limitations period simply provides the Division of Enforcement with additional time to build a case, but it may also offer an opportunity for an adviser to obtain valuable cooperation credit and explain to the SEC why an enforcement action is unwarranted. Conversely, by refusing to toll the limitations period, the adviser may successfully run out the clock on the SEC without charges being filed or, after Kokesh, limit the SEC's ability to seek disgorgement. Declining a request for a tolling agreement, however, may also cause the adviser to lose cooperation credit and, in a worst-case scenario, force the SEC to file charges prematurely. These factors need to be considered on a case-by-case basis.

Methods to Suspend or Extend the Statute of Limitations

Beyond an uptick in the use of tolling agreements, the Court's decision will likely spark an increased reliance by the Enforcement Staff on various doctrines that suspend the statute of limitations clock or extend the limitations period.

Discovery Rule

The SEC, for example, might argue that the so-called "discovery rule" governs the date on which the claim accrues for statute-of-limitations purposes and determines the date on which the limitations clock begins to run. Under the discovery rule, a claim does not accrue – and the limitations period does not begin to run – until the SEC discovers, or should have discovered, the securities violation.

In *Gabelli v. SEC*, the Supreme Court explicitly refused to apply the discovery rule in determining the date on which the claim accrued under §2462. Gabelli involved a case seeking civil penalties, however, and the Court's reasoning noted that civil penalties are not intended "to ensure that the injured receive recompense." Thus, applying the discovery rule to an action for civil penalties, the Court concluded, would not serve the discovery rule's usual justification of "preserv[ing] the claims of victims who do not know they are injured."

Without question, the Court in *Kokesh* recognized that disgorgement serves some of the same punitive functions as civil penalties; indeed, that recognition was the basis for the Court's holding that §2462 applies to disgorgement. The Court in *Kokesh* also recognized, however, that unlike penalties, disgorgement "serves compensatory goals in some cases." Thus, the Court's reasoning in *Kokesh* and *Gabelli* leaves some room for the SEC to claim that, although the discovery rule does not apply to civil penalty remedies, it should apply to disgorgement. If the Commission can make that argument successfully, it may be able to circumvent *Kokesh's* limitations on disgorgement.

Equitable Tolling

The SEC may pursue other avenues to blunt the impact of Kokesh. It might attempt to invoke the doctrine of equitable tolling to evade a statute of limitations defense where the limitations period has lapsed. Unlike the discovery rule, equitable tolling does not govern when the claim accrues. Rather, it tempers the harshness of a statute of limitations where principles of equity make a rigid application of the statute unfair – for example, where the defendant has misled the plaintiff or where the plaintiff has been precluded from asserting his rights in some extraordinary way. *Kokesh* might drive the Enforcement Staff to invoke this doctrine.

Continuing Violations

The SEC might also focus its investigations on identifying continuing violations of the securities laws. Where a defendant's unlawful conduct is a continuing violation, the statute of limitations does not begin to run until the unlawful conduct ceases. By invoking the continuing violation doctrine, the SEC could recover penalties and disgorgement for unlawful conduct that, when viewed in isolation, would otherwise fall outside the statute of limitations. Following Kokesh, advisers that are targets of enforcement activity can expect the SEC to take an aggressive view of what qualifies as a continuing violation.

Conclusion

To be clear, the *Kokesh* decision is a watershed moment for securities enforcement. One of the sharpest arrows in the SEC's enforcement quiver has been blunted. Although it can be expected that the Enforcement Staff will try to re-sharpen it – by, for example, invoking the above doctrines that could expand or extend the limitations period – how vigorously it attempts to do so and how far the courts let the SEC go toward that end remains to be seen.

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[1] *Gabelli v. SEC*, 568 U.S. 442 (2013).
[2] *Riordan v. SEC*, 627 F.3d 1230, 1234 (D.C. Cir. 2010).
[3] *SEC v. Tambone*, 550 F.3d 106, 148 (1st Cir. 2008).

