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Supreme Court imposes five-year limitation on SEC disgorgement, and invites future challenges to the SEC's authority to use the disgorgement remedy at all

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The Supreme Court recently held in *Kokesh v. SEC*, No. 16-529 (June 5, 2017), that Securities and Exchange Commission (SEC) disgorgement orders are subject to a five-year statute of limitations. The Court in a unanimous decision held that disgorgement in SEC enforcement proceedings is a “penalty” under 28 U.S.C. § 2462 such that any disgorgement actions must be commenced within five years of the date the SEC’s claim accrues. Additionally, while the issue before the Court was only whether disgorgement constitutes a penalty for statute of limitations purposes, comments in the opinion and questions during oral argument—particularly one question from Justice Gorsuch—appear to invite future challenges to the SEC’s authority to seek disgorgement in enforcement proceedings.

How did the use of disgorgement evolve?

Generally, disgorgement is the act of giving up something, such as illegally obtained profits, on demand or by legal compulsion.

The Supreme Court chronicled the evolution of disgorgement in SEC enforcement proceedings, finding that, at the inception of the agency, the only stated remedy available was an injunction. As a result, in the 1970s, the SEC urged courts to order disgorgement of defendants’ profits derived from securities violations under a court’s inherent equity powers. In 1990, Congress provided the SEC with the ability to seek monetary civil penalties—yet the SEC continued to seek disgorgement in addition to its newly available monetary remedy.

Then, just a few years ago, in *Gabelli v. SEC*, 568 U.S. 442 (2013), the Supreme Court held that the SEC’s monetary civil penalties were subject to the five-year statute of limitations set forth in 28 U.S.C. § 2462. Claims seeking monetary penalties for conduct arising beyond five years were barred. However, the SEC decided to narrowly interpret the *Gabelli* decision, and continued to seek disgorgement beyond the five-year limit for monetary civil penalties.

The creation of a circuit court split

In 2009, the SEC initiated an enforcement action in federal court against Charles Kokesch, an owner of two investment advisor firms, for allegedly misappropriating \$34.9 million from companies his firms advised between 1995 and 2009. After a 5-day trial, a jury in New Mexico found Kokesch guilty of securities violations. The New Mexico District Court ordered that Kokesch pay to the SEC \$34.9 million in disgorgement, even though \$29.9 million of that amount resulted from conduct outside of the five-year limitations period, holding that § 2462 did not apply to SEC disgorgement remedies. On appeal, the Tenth Circuit Court of Appeals affirmed the lower court's holding that disgorgement is not a "penalty" subject to the statute of limitations, splitting with a prior decision from the Eleventh Circuit Court of Appeals to the contrary. The Supreme Court granted certiorari to resolve the circuit split.

View from the Supreme Court: disgorgement is a penalty

Section 2462 provides a five-year limitation for "an action, suit or proceeding for the enforcement of any civil fine, penalty or forfeiture." The question before the Court was whether SEC disgorgement falls within this definition.

The unanimous Supreme Court held in *Kokesch* that disgorgement is a "penalty" and, thus, the limitation of § 2462 applies. In holding that disgorgement is a penalty, the Supreme Court looked to the purpose of disgorgement. The Court found that disgorgement (1) is intended to remedy a wrong against the public (as opposed to an individual victim), and (2) is imposed for punitive and deterrent purposes. Additionally, the Court noted that disgorgement does not necessarily restore the status quo, despite argument to the contrary by the SEC, because disgorgement orders sometimes do not take into account a defendant's expenses related to the activity, essentially holding the defendant accountable for gross proceeds instead of net. For these reasons, the Court viewed the SEC's use of disgorgement as a penalty as that term is intended in § 2462.

Is there a future for the SEC's use of disgorgement?

Perhaps more problematic for the SEC than the imposition of the five-year limitation on disgorgement was what appears to us as a clear invitation from the Supreme Court for future challenges to the SEC's authority to impose disgorgement *in any action*. At oral argument, on just his second day of hearing arguments at the Court, Justice Gorsuch made a pointed comment to SEC counsel about the SEC's lack of express authority to seek disgorgement, stating: "[T]here's no statute governing [disgorgement]. We're just making it up."¹ This remark was reiterated in Justice Sotomayor's opinion for the unanimous court in a footnote that we interpret as an effort to clarify that the court was not ruling on whether courts have the authority to order disgorgement in SEC enforcement proceedings. (Slip Op. at 5 n.3).

We continue to watch developments relative to SEC authority to seek action against certain conduct and to assess certain penalties and remedies. In the meantime, the *Kokesch* decision limits the SEC disgorgement to conduct going back five years, bringing that remedy in line with the SEC's monetary civil penalties.

¹ *Kokesch*, No. 16-529, Transcript of Oral Argument on April 18, 2017, available at https://www.supremecourt.gov/oral_arguments/argument_transcripts/2016/16-529_21p3.pdf

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