SUPREME COURT REJECTS APPLICATION OF FRAUD DISCOVERY RULE TO SEC ENFORCEMENT ACTIONS SEEKING CIVIL PENALTIES

In a unanimous decision authored by Chief Justice Roberts, the U.S. Supreme Court on February 27, 2013 held that the fraud discovery rule, which can extend the time plaintiffs have to sue for fraud-related actions, does not apply to U.S. Securities and Exchange Commission enforcement actions that seek to impose civil penalties. *Gabelli v. SEC*, No. 11-1274, slip op. at 11 (U.S. Feb. 27, 2013). The ruling, overturning a Second Circuit decision and delivering a disappointing result for the SEC, held that the statute of limitations for penalty actions begins to run when the alleged fraud occurs, not when the fraud is discovered or reasonably could have been discovered. The decision increases the stakes of the SEC's failure to file suit within five years of a fraud, and may increase the speed at which the SEC investigates and brings enforcement actions, an area where the agency has faced significant criticism in the past. In addition, the ruling may prompt statute of limitations challenges to the SEC's enforcement remedies beyond civil penalties.

The SEC brought the action at issue in *Gabelli* against the portfolio manager of a mutual fund and the Chief Operating Officer of the fund's investment adviser. The Complaint alleged that, between 1999 and 2002, the defendants allowed a fund investor to engage in "market timing" in the fund and then misrepresented that fact to the fund's investors. Although the SEC began its investigation in the fall of 2003, it did not file suit until April 2008.

The five-year statute of limitations in 28 U.S.C. § 2462, at issue in the *Gabelli* case, applies to all federal actions seeking a penalty, fine, or forfeiture. The defendants moved to dismiss the SEC's claim for penalties on the ground that the statute of limitations had expired. The district court agreed and dismissed the case. The Second Circuit reversed, accepting the SEC's argument that because the underlying violations sounded in fraud, the "discovery rule" applied and the statute of limitations did not begin to run until the claim was discovered or could have been discovered with reasonable diligence.

The Supreme Court reversed the Second Circuit, holding that, for SEC enforcement actions seeking civil penalties, the five-year statute of limitations found in § 2462 begins to run when the defendant's allegedly fraudulent conduct occurs, not when the fraud is discovered or reasonably could have been discovered. The Court distinguished the SEC from private plaintiffs, stating that "[u]nlike the private party who has no reason to suspect fraud, the SEC's very purpose is to root it out, and it has many legal tools at hand to aid in that pursuit. . . . [T]he SEC as enforcer is a far cry from the defrauded victim the discovery rule evolved to protect." *Gabelli*, No. 11-1274 at 8. The Court also explained that the purpose of the fraud discovery rule is to ensure that victims are compensated, not to enable government agencies to seek penalties, which are intended to punish defendants.

In an analysis that may provide a basis for challenges to other SEC remedies, such as officer and director bars, the Court noted that grafting the fraud discovery rule onto § 2462 would leave defendants exposed to government enforcement action not only for five years following their potential misdeeds, but for an additional uncertain period into the future. But there are some notable limitations to the Court's ruling. At oral argument, both Gabelli and the SEC agreed that the five-year limitation period does not apply to equitable remedies such as disgorgement or injunctive relief, and the Supreme Court did not address actions for these other remedies in its decision. To apply § 2462 to SEC remedies other than civil penalties, such as officer and director bars, requires a court to find that such relief would be punitive, and thus a "fine, penalty, or forfeiture" under the statute. *See, e.g.*, *SEC v. Bartek*, 484 F. App'x 949, 957 (5th Cir. 2012) (holding that a permanent injunction and an officer and director bar were punitive in nature and therefore subject to the five-year statute of limitations found in § 2462); *Johnson v. SEC*, 87 F.3d 484, 491-92 (D.C. Cir. 1996) (finding the SEC's censure and a six-month suspension of a securities industry supervisor punitive within the meaning of § 2462 and vacating the sanctions based on expiration of the five-year statute of limitations).

The *Gabelli* decision is likely to impact federal enforcement programs in the following ways:

- The decision will pressure the SEC to increase the speed of its investigations, settlement negotiations, and time to litigation. Although the Division of Enforcement will continue to use tolling agreements, the decision will pressure the Staff to move more quickly.

- The decision will reinforce the importance of various internal referrals to the SEC's Division of Enforcement, including examinations of investment advisers and broker-dealers as well as whistleblower complaints. As a consequence, the Division of Enforcement's coordination with the SEC's Office of Compliance Inspections and Examinations may increase and whistleblower complaints may be considered more carefully.

- The ruling may generate challenges to other SEC remedies, such as officer and director bars, seeking to characterize them as "penalties" within the meaning of the Court's ruling.

- The ruling may similarly impact other federal civil enforcement agencies that have penalty powers.

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