CLIENT MEMORANDUM

Supreme Court Holding that SEC Disgorgement is Subject to Five-Year Limitations Period Portends Significant Consequences for SEC, CFTC and FERC Enforcement Regimes

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In a unanimous and groundbreaking decision authored by Justice Sonia Sotomayor, the U.S. Supreme Court on June 5, 2017 held in *Kokesh v. SEC*, No. 16-529 (U.S. June 5, 2017) that the five-year statute of limitations under 28 U.S.C. § 2462 applies to claims for disgorgement imposed as a sanction for violating the federal securities laws. The ruling, which overturned a Tenth Circuit opinion and resolved disagreement among the Circuits over whether disgorgement claims in Securities and Exchange Commission (SEC) proceedings are subject to the five-year limitation period of § 2462, requires the SEC to commence a disgorgement claim within five years of the date the claim accrued. *Kokesh v. SEC*, No. 16-529, slip op. at 11 (U.S. June 5, 2017). Holding that disgorgement in the securities-enforcement context is a "penalty" within the meaning of § 2462, the Supreme Court delivered a loss to the SEC both in the context of the case and more broadly to its enforcement program. The ruling directly contradicts the SEC's longstanding policy that § 2462 does not apply to SEC claims for disgorgement, and thus carries potentially significant consequences for current SEC enforcement investigations and actions involving potential disgorgement claims that are outside or partially outside the five-year limitations period.

The SEC brought the action at issue against Charles Kokesh in 2009 in federal district court, alleging that between 1995 and 2009 he, through his two investment-adviser firms, misappropriated $34.9 million from four of his firms' advisees. After a five-day jury trial in which he was found liable, the district court imposed civil monetary penalties and disgorgement. In imposing sanctions, the district court restricted the civil penalties by § 2462's five-year limitations period but imposed disgorgement and pre-judgment interest for the entire period back to 1995. The Tenth Circuit affirmed the district court's application of the limitations period. By imposing the five-year limitations period on the disgorgement claim in the case, the Supreme Court reduced the SEC's disgorgement claim by $29.9 million, from $34.9 million to $5 million, and will significantly reduce the $18.1 million prejudgment interest calculation tied to the original disgorgement figure.

Enforcement actions by the SEC, and also the Commodity Futures Trading Commission (CFTC) and Federal Energy Regulatory Commission (FERC), are subject to the five-year statute of limitations applicable to any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise." *Id.* at 1 (quoting 28 U.S.C. § 2462).[1] Having previously determined that this five-year limitations period applies when the SEC seeks statutory monetary penalties, *Gabelli v. SEC*, 568 U.S. 442, 454 (2013), the Court addressed in *Kokesh* whether § 2462 applies when the SEC seeks disgorgement.[2] *Kokesh*, No. 16-529 at 3. The Court held that it does because SEC disgorgement is a "penalty."

The Court applied two principles to resolve the question and reach its holding. First, the Court assessed "whether the wrong sought to be redressed is a wrong to the public, or a wrong to the individual." *Id.* at 6 (citation omitted). Penalties are punishments for offenses against the laws of the State, the Court said. The Court reasoned that "[t]he violation for which [SEC disgorgement] is sought is committed against the United States rather than an aggrieved individual—this is why, for example, a securities-enforcement action may proceed even if victims do not support or are not parties to the prosecution." *Id.* at 7.

Second, the Court observed that "a pecuniary sanction operates as a penalty only if it is sought 'for the purpose of punishment, and to deter others from offending in like manner'—as opposed to compensating a victim for his loss." *Id.* (citation omitted). The Court cited a number of SEC cases in which disgorgement was explicitly imposed as a deterrent and explained that "[s]anctions imposed for the purpose of deterring infractions are inherently punitive because

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[1] S*ee FERC v. Barclays Bank*, 105 F. Supp. 3d 1121, 1130-33 (E.D. Cal. 2015) (applying § 2462 in FERC enforcement context); *CFTC v. Fin. Robotics*, No. H-11-2446, 2013 WL 3280038, at 4 (S.D. Tex. June 27, 2013) (CFTC arguing that fraud by misappropriation claim was timely because § 2462 applies to such claims, which claims, the court observed, are similar to "suits brought by the S.E.C. under the Securities Exchange Act" to which §2462 applies); *Prohibition of Energy Market Manipulation*, 114 FERC ¶ 61,047 P 63 (Jan. 19, 2006) (stating that FERC "will adhere to the five-year statute of limitations [referring to §2462] where we seek civil penalties").

[2] We analyzed the Court's decision in *Gabelli* in a separate Client Memorandum on March 1, 2013, which is available here.

'deterrence is not a legitimate nonpunitive governmental objective.'" *Id.* at 8 (quoting *Bell v. Wolfish*, 441 U.S. 520, 539, n.20 (1979)).[3]

In addition, the Court addressed the SEC's position that disgorgement is inherently remedial, not punitive, in nature in that it lessens the effect of a violation by restoring the status quo. The Court was not convinced that disgorgement, as it had been applied in the SEC enforcement context, restores the status quo. Rather, the Court observed, SEC disgorgement "sometimes exceeds the profits gained as a result of the violation." For example, the Court wrote, an insider trader may be ordered to disgorge the gains of tippees. As another example, SEC disgorgement "sometimes is ordered without consideration of a defendant's expenses that reduced the amount of illegal profit. In such cases, disgorgement does not simply restore the status quo; it leaves the defendant worse off." *Kokesh*, No. 16-529 at 10 (citations omitted). For these primary reasons, the Court found SEC disgorgement to be a penalty under § 2462.

The *Kokesh* decision dealt a significant blow to the SEC's enforcement program, and is likely to lead to further challenges by defendants arguing that § 2462 applies to other SEC remedies such as associational bars. The ruling will impact federal enforcement programs more generally, in the following ways:

- It will pressure the SEC, and other federal independent agencies like the CFTC and FERC, to increase the speed of investigations and settlement negotiations, and decrease time to litigation.
- The SEC, CFTC and FERC will likely seek tolling agreements more frequently to address the running of applicable periods.
- The SEC examination staff may be more limited in its look-back to historical practices generally, particularly in industries such as private equity where industry-wide and best practices relating to disclosure have developed only within the past five years.
- Other affected agencies and even the SEC itself may make greater efforts to advance disgorgement claims that are more limited and genuinely remedial based on the Court's analysis in *Kokesh*. Given the SEC's aggressive stance on disgorgement in the past, the CFTC and FERC may have more success in limiting their disgorgement claims and avoiding the five-year statute of limitations.

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[3] The Court added that SEC disgorgement is also not compensatory because disgorged profits are paid to the district court and it is within the court's discretion to determine how and to whom the money will be distributed.

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