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PERSPECTIVES

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UNITED STATES SUPREME COURT HOLDS SEC DISGORGEMENT ORDERS SUBJECT TO FIVE-YEAR STATUTE OF LIMITATIONS

On Monday, June 5, 2017, a unanimous Supreme Court held that the ability of the Securities and Exchange Commission ("SEC") to seek disgorgement in connection with a violation of federal securities law is subject to a five-year statute of limitations, reversing a decision from the United States Court of Appeals for the Tenth Circuit, and rejecting the SEC's argument that disgorgement is an equitable remedy not subject to any statute of limitations. *Kokesh v. SEC*, No. 16-529 (June 5, 2017). Writing for the Court, Justice Sotomayor analyzed the function of SEC disgorgement, concluding that it "bears all the hallmarks of a penalty" and was therefore subject to the five-year statute of limitations under 28 U.S.C. § 2462 ("Section 2462"). In so doing, the Supreme Court resolved an outstanding circuit split as to whether the statute of limitations applies to disgorgement, answering that question with a definitive 'yes.'

The petitioner in *Kokesh* was the owner of multiple investment advisory firms. In late 2009, the SEC began an enforcement action against him, alleging that he had, through his firms, misappropriated $34.9 million between 1995 and 2009. A jury found him liable for multiple violations of the federal securities laws after a five-day trial. Following the jury verdict, at the SEC's request, the United States District Court for the District of New Mexico ordered disgorgement of $34.9 million, plus an additional $18.1 million in prejudgment interest. Of the disgorgement amount, $29.9 million related to conduct that occurred more than five years prior to commencement of the SEC's action. However, the District Court had concluded that the five-year statute of limitations embedded in Section 2462 did not apply to the SEC's request for a $34.9 million disgorgement judgment. Section 2462 provides a five-year statute of limitations for "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise," but the District Court concluded that Section 2462 did not apply because disgorgement was not a "penalty" or "forfeiture" within the meaning of the statute. Instead, the District Court agreed with the SEC that disgorgement — which is not rooted in any statute empowering the SEC but, rather, is based on common law — is an equitable remedy meant to deprive wrongdoers of ill-gotten gains.

On direct appeal, the Tenth Circuit agreed with the District Court that disgorgement is not a penalty or forfeiture within the meaning of Section 2462. In so doing, the Tenth Circuit was in agreement with the First Circuit and the D.C. Circuit. *See SEC v. Tambone*, 550 F.3d 106 (1st Cir. 2008); *Riordan v. SEC*, 627 F.3d 1230 (D.C. Cir. 2010). The Eleventh Circuit, however, held the opposite in 2016. In *SEC v. Graham*, the Eleventh Circuit concluded that Section 2462 does apply to disgorgement, categorizing it as a type of forfeiture. *SEC v. Graham*, 823 F.3d 1357, 1364 (11th Cir. 2016). This set the stage for the Supreme Court to resolve the open question.[1]

The Supreme Court's analysis began with a discussion of the word "penalty," as set forth in Section 2462. Justice Sotomayor wrote that the term "penalty" refers to a "punishment, whether corporal or pecuniary, imposed and enforced by the State, for a crime or offen[s]e against its laws." In contrast to a "compensatory remedy for a private wrong," penalties are punishments for offenses against the State itself. For example, a money judgment against a defendant, paid entirely to a private plaintiff to compensate the plaintiff for the defendant's wrongdoing, was not a "penalty."

Justice Sotomayor concluded that the "foregoing principles readily demonstrate[ ] that SEC disgorgement constitutes a penalty within the meaning of § 2462." She cited three principal reasons for this conclusion. First, SEC disgorgement seeks to redress a violation of "public laws," because the violation is "committed against the United States rather than an aggrieved individual." Second, SEC disgorgement is designed to enhance deterrence and is thus punitive. Justice Sotomayor quoted from S*EC v. Texas Gulf Sulphur Co.*, where the court "emphasized the need 'to deprive the defendants of their profits in order to . . . protect the investing public by providing an effective deterrent to future violations'." 312 F. Supp. 77, 91 (S.D.N.Y. 1970), *aff'd in part and rev'd in part*, 446 F. 2d 1301 (2d Cir. 1971). Third, and finally, she observed that SEC disgorgement does not play a compensatory function, as "disgorged profits are paid to the district court," who then exercises its discretion to decide how the money will be distributed. Although Justice Sotomayor acknowledged that in some instances disgorged funds go to private plaintiffs for their losses (such as under the SEC's "Fair Funds" program), the default is for disgorged funds to be paid to into the United States Treasury.

Justice Sotomayor rejected the Government's argument that disgorgement is "remedial," "returning the defendant to the place he would have occupied had he not broken the law." While disgorgement acts as a compensatory measure in some circumstances, Judge Sotomayor noted that in other circumstances that plainly is not the case. She noted that the SEC disgorgement "sometimes exceeds the profits gained as a result of the violation," for example, when an insider trader is ordered to disgorge his unlawful gains, as well as the benefit to third parties as a result of the wrongdoer's conduct. Rather than restoring the *status quo*, disgorgement "leaves the defendant worse off," demonstrating that it is a "punitive, rather than a remedial, sanction."

This case provides certainty in an important area of SEC enforcement. It will also have a concrete impact on the cases the SEC can bring. While the SEC may seek to bring cases promptly, it does not always succeed in doing that. Sometimes the SEC does not learn of potential infractions until some years after the fact, and other times it takes years for the SEC to investigate more complicated fact patterns. In such cases, the SEC already often seeks tolling agreements to mitigate the impact of any statute of limitations; it seems likely in light of the *Kokesh* decision that the SEC will begin to seek such agreements earlier and more reflexively going forward.

+ Footnotes

[1] The Supreme Court previously reserved the question of whether § 2462 applies to claims for disgorgement in *Gabelli v. SEC*. 133 S. Ct. 1216 (2013). In *Gabelli*, the Supreme Court held that monetary penalties were subject to the five-year statute of limitations.

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