

## US Supreme Court: Disgorgement Is a Penalty, Limiting SEC's Reach

***Rejecting the Tenth Circuit Kokesh decision, the holding that the five-year limitations period applies to SEC disgorgement claims will dramatically affect enforcement actions.***

### Key Points:

- The Supreme Court decision will have a significant impact on the SEC's ability to conduct investigations that take many years, because the statute of limitations may eliminate disgorgement claims as the investigation continues.
- Both the SEC and those under investigation will have an additional factor to consider in deciding when and how to use tolling agreements.

The United States Supreme Court unanimously held that the five-year limitations period in 28 U.S.C. § 2462 applies to disgorgement claims the Securities and Exchange Commission (SEC) seek in enforcement actions. In resolving a circuit split, the Court determined that the remedy of disgorgement is a "penalty," and thus falls within the five-year limitations period for any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise."

In issuing its ruling, the Court clarified the purpose of disgorgement for both the SEC and those companies and individuals facing claims for disgorgement in enforcement actions. The decision critically impacts defendants because it impairs the SEC's ability to extract monetary payments for violations that took place for many years, which in turn, will substantially affect the amount of penalties that defendants are required to pay. Indeed, in 2015, the SEC extracted US\$3 billion in disgorgement payments, compared to just US\$1.2 billion in monetary penalties.<sup>1</sup> Disgorgement collections also have increased 60% since 2011, in contrast to the 25% increase in penalties.<sup>2</sup>

In addition to the obvious monetary impacts, the decision likely will have collateral implications on the strategy decisions of both the SEC and those facing an enforcement action. Most directly, the SEC now may be forced to decide earlier in an investigation whether to recommend enforcement proceedings or to rely more on requesting tolling agreements from those under investigation. Those under investigation for past conduct may now have less incentive to agree to tolling if the consequence is a greater disgorgement penalty. The SEC will also need to reconsider its approach to enforcement in areas such as private equity, as the agency has brought actions based on alleged disclosure defects in governing documents executed many years prior to the enforcement action.

## The *Kokesh* Litigation

Charles Kokesh owned two investment advisory firms that provided investment advice to business development companies. In 2009, the SEC filed a civil enforcement action alleging that, between 1995 and 2006, Kokesh misappropriated US\$34.9 million from the business development companies through his investment advisory firms. The SEC sought civil monetary penalties, disgorgement, and an injunction barring Kokesh from violating securities laws in the future.

Based on the improper distributions, the jury found that Kokesh had violated the Investment Company Act of 1940; the Investment Advisers Act of 1940; and the Securities Exchange Act of 1934. After the jury's verdict, the SEC moved for entry of judgment and asked the district court to impose a civil monetary penalty of US\$5 million and disgorgement of US\$34.9 million.

Regarding the civil monetary penalties, the district court held that the five-year limitations period in 28 U.S.C. § 2462 precluded any claim that first accrued before October 27, 2004 — five years before the SEC's complaint. As a result, the court ordered Kokesh to pay a civil penalty of US\$2,354,593, which represented "the amount of funds that [Kokesh] himself received during the limitations period."<sup>3</sup>

The district court held that the limitations period in 28 U.S.C. § 2462 did not apply to the SEC's claim for disgorgement because disgorgement is not a "penalty" within the meaning of the statute.<sup>4</sup> The district court thus entered a disgorgement judgment in the full amount of US\$34.9 million, even though the SEC admitted that US\$29.9 million was the result of violations that had occurred before October 27, 2004. The court also required Kokesh to pay an additional US\$18.1 million in prejudgment interest.

The Court of Appeals for the Tenth Circuit affirmed, agreeing that disgorgement is not a penalty. The Tenth Circuit reasoned that disgorgement does not inflict punishment, but rather is "remedial."<sup>5</sup> In addition, although the court acknowledged that disgorgement serves a deterrent purpose, it concluded that disgorgement does not amount to punishment because disgorgement simply deprives the "wrongdoer of the benefits of the wrongdoing."<sup>6</sup> The Tenth Circuit also held that disgorgement is not a forfeiture.<sup>7</sup>

## The Supreme Court's Decision

The Supreme Court rejected the Tenth Circuit's holding that disgorgement is not a penalty under § 2462 and outlined two determining principles for whether a sanction constitutes a penalty. First, the Court stated that the question turns in part on "whether the wrong sought to be redressed is a wrong to the public, or a wrong to the individual."<sup>8</sup> Second, the Court explained that a sanction is a penalty 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."<sup>9</sup>

Applying these principles, the Court reasoned that disgorgement is a penalty because courts impose disgorgement as a consequence for violating "public laws" — *i.e.*, the remedy is sought for a violation committed against the US, not against an aggrieved individual.<sup>10</sup> In addition, the Court explained that SEC disgorgement is imposed for punitive purposes. The Court reasoned that the primary purpose of disgorgement is deterrence, and deterrence is "inherently punitive" because disgorgement is not a legitimate nonpunitive governmental objective.<sup>11</sup> Finally, the Court emphasized that SEC disgorgement is not compensatory. Disgorged profits are paid to the district court, which has the discretion to determine how the money should be distributed. The Court highlighted that courts ordered disgorgement as a remedy, regardless of whether the disgorged funds even would be paid to investors as restitution.<sup>12</sup>

The Court also explicitly rejected the government's argument that SEC disgorgement is not punitive, but "remedial." The Court explained that in the SEC context, disgorgement is punitive because it sometimes exceeds the profits gained as a result of the violation. Therefore, disgorgement does not necessarily restore the status quo, but can instead put the defendant in a worse position.<sup>13</sup>

The result of the decision was significant for *Kokesh* because it eliminated approximately nine years of disgorgement claims — the case was filed in 2009, and the district court had imposed disgorgement going back to 1994.

## Looking Ahead

The SEC typically uses disgorgement as a hammer in cases it believes it can show "ill-gotten" gain. These cases primarily arise in situations of insider trading, securities offerings, misappropriation, and improper or excessive fees. As the Court pointed out, however, the SEC has often conflated disgorgement with restitution, and the funds are neither returned to those who allegedly were harmed or the punishment is not tied to a defendant's gain. Most notably, this practice occurs in insider trading cases in which the tippee is forced to pay disgorgement based on the tippee's profits.<sup>14</sup>

Another important implication from the decision is the Court's footnote that "[n]othing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context."<sup>15</sup> When read in the context of the Court's assessment of disgorgement as a penalty, the Court identified a possible future challenge to the SEC's right to impose disgorgement, as the Court held that disgorgement, like a civil penalty, is punitive.

In light of the Court's focus on the SEC's express statutory authorization to seek civil penalties, and the Court's note that the same statutes do not expressly empower the SEC to seek disgorgement, defendants likely will challenge the SEC's authority to seek disgorgement as a remedy. In addition, the Court's determination that disgorgement is a penalty may spur defendants to challenge whether the SEC's other remedies — such as a censure or a bar — are likewise penalties subject to § 2462.

## Conclusion

The *Kokesh* decision likely will cause the SEC to reconsider its approach to cases that hinge on disclosure defendants made in documents provided to investors many years prior to an SEC exam or enforcement action. For example, the SEC has brought a number of enforcement actions against large private equity fund managers based on allegedly defective disclosures in fund documents provided to investors at the inception of the fund. However, fund documents drafted after Dodd-Frank's 2012 effective date typically include more specific disclosures regarding conflicts of interest. The evolution in fund documents toward greater specificity, coupled with the strict enforcement of the five-year statute of limitations may reduce the number of SEC enforcement actions focused on private equity.

This decision also may be a bellwether, signaling the Court's willingness to further curtail the SEC's exercise of its powers. For example, the Court may ultimately decide to resolve the circuit split over whether the SEC's use of administrative courts is constitutional.

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<sup>1</sup> SEC, Select SEC and Market Data, Fiscal 2015, at 2, <https://www.sec.gov/reportspubs/select-sec-and-market-data/secstats2015.pdf> (SEC 2015 Data).

<sup>2</sup> Compare SEC 2015 Data at 2 with SEC, Select SEC and Market Data, Fiscal 2011, at 2, <https://www.sec.gov/reportspubs/select-sec-and-market-data/secstats2011.pdf>.

<sup>3</sup> *SEC v. Kokesh*, 2015 WL 11142470, at \*5 (D.N.M. Mar. 30, 2015).

<sup>4</sup> *Id.* at \*9-10.

<sup>5</sup> *SEC v. Kokesh*, 834 F.3d 1158, 1164 (10th Cir. 2016).

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* at 1165-66.

<sup>8</sup> Op. at 6 (quoting *Huntington v. Attrill*, 146 U.S. 657, 668 (1892)).

<sup>9</sup> *Id.* (quoting *Huntington*, 146 U.S. at 668).

<sup>10</sup> *Id.* at 7.

<sup>11</sup> *Id.* at 8.

<sup>12</sup> *Id.* at 8-9.

<sup>13</sup> *Id.* at 9-10. Interestingly, the Court did not discuss the other argument advanced by Kokesh's counsel and that the Eleventh Circuit had relied upon in finding that the limitation period applied to § 2462 — that disgorgement is a forfeiture.

<sup>14</sup> *Id.* at 10.

<sup>15</sup> Op. at 5, n.3.