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Client Alert

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The Supreme Court Unanimously Curbs SEC's Power to Obtain Disgorgement

By Mary P. Hansen and Mira E. Baylson

The Supreme Court of the United States released its unanimous opinion in *Kokesh v. Securities and Exchange Commission* on June 5, 2017, establishing that SEC disgorgement constitutes a "penalty" under federal law and, therefore, is subject to a five-year statute of limitations. In short, the Court determined that the SEC can no longer impose disgorgement fees without regard to a statute of limitations.

The petitioner, Charles Kokesh ("Kokesh"), was the owner of two registered investment advisers. Between 1995 and 2006, the SEC alleged he misappropriated $34.9 million from certain business development companies managed by those investment advisers. The SEC pursued a civil enforcement action against him in 2009, and a jury found that he violated the antifraud provisions of the Securities Exchange Act, the Investment Advisers Act and the Investment Company Act. The U.S. District Court for the District of New Mexico ordered Kokesh to pay disgorgement of $34,927,329, which represented the full amount he had misappropriated since 1995. The District Court, and then the 10th Circuit, concluded that the disgorgement was not a penalty subject to a statute of limitations because it was remedial, rather than punitive.

The issue before the Court, therefore, was whether the SEC's ability to obtain disgorgement is subject to a five-year statute of limitations for "the enforcement of any civil fine, penalty, or forfeiture." The SEC makes frequent use of disgorgement and took in more than $3 billion in disgorgement in 2015 alone. Of that money, some went to victims and some to the U.S. Treasury. Complicating the issue was that Congress never authorized the SEC to have the power to order such disgorgement. Rather it had just been a policy of the SEC for at least 30 years to seek disgorgement as an equitable remedy in administrative proceedings and federal court actions. Disgorgement, however, was never authorized by statute.

In *Kokesh*, the Court determined that SEC disgorgement "bears all the hallmarks of a penalty" and therefore should be subject to the five-year statute of limitations for three main reasons:

> (1) "SEC disgorgement is imposed by courts as a consequence for violation" of public laws, i.e., for violations committed against the United States rather than an "aggrieved individual";
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> (2) "SEC disgorgement is imposed for punitive purposes" such as deterrence, similar to other types of penalties; and
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> (3) SEC disgorgement is *not* compensatory and is often paid directly to the court, which has the discretion to decide where the disgorged funds should be distributed—there is no statutory command that such funds be paid to victims of the defendant's criminal activities.

The Court concluded that because "[i]t is imposed as a consequence of violating a public law and it is intended to deter, not to compensate," the five-year statute of limitations applies when the SEC seeks disgorgement.

The Court also was clear in a footnote that "nothing 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." This footnote harkens back to comments made by the Justices during oral argument, which touched upon the lack of statutory authority for the SEC to seek disgorgement. It could well be that the Supreme Court is indicating its interest in reviewing a case that tests the authority of the SEC to request disgorgement, in which case *Kokesh* is a harbinger of things to come.

The Court's ruling is a blow to the SEC's longstanding practice to seek disgorgement regardless of whether the alleged misconduct falls outside the five-year statute of limitations. Accordingly, the ruling will impact all of the SEC's investigations, as well as its charging and settlement decisions. For example, the SEC will likely feel pressure to increase the speed with which it makes charging decisions in investigations, and question whether to open investigations where the suspected misconduct is already outside, or close to the end, of the five-year statute of limitations.

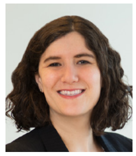
Importantly, while this case involved a registered investment adviser, the decision applies to all individuals and entities involved in SEC investigations and actions. Defense counsel and their clients can expect to receive more frequent, and earlier, requests for tolling agreements as the SEC begins to integrate the *Kokesh* opinion into its practices and procedures. As disgorgement tends to be a significant factor in SEC settlements, and almost always accounts for a larger part of the monetary settlement than civil penalties, defense counsel must carefully consider whether to advise clients to agree to requests for tolling agreements going forward.

Should you have any questions about this alert, please contact one of the authors listed below or the Drinker Biddle lawyer with whom you regularly work.

Litigation Group

Primary Contacts

Mary P. Hansen
Partner
Philadelphia
(215) 988-3317
mary.hansen@dbr.com



Mira E. Baylson
Associate
Philadelphia
(215) 988-2677
mira.baylson@dbr.com