Congress may restore SEC's disgorgement power

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Congress is considering legislation that would clarify and significantly expand the Securities and Exchange Commission's disgorgement powers, two years after the Supreme Court curtailed them in ruling that they were penalties subject to a five-year statute of limitations.[1] The decision in *Kokesh v. SEC* dealt a significant blow to the agency's enforcement division, which had relied heavily on unfettered disgorgement powers as a means of deterrence. Now, with older ill-gotten gains unreachable, the SEC has reportedly left close to a billion dollars on the table in the first year following the ruling.

A House of Representatives Committee has passed a legislative fix that would go a long way to restoring the SEC's disgorgement powers — and clarifying their legitimacy— but the prospects for passage in the wider House and Senate remain uncertain.

Kokesh v. SEC

Courts have allowed the SEC to seek disgorgement as an equitable remedy since the 1970s, despite the fact that it has no explicit statutory powers to do so, and have considered that remedy to be outside the scope of the five-year statute of limitations for civil penalties specified in 18 U.S.C. § 2462. So when the SEC brought an enforcement action against Charles Kokesh for allegedly misappropriating client funds from his investment adviser companies, the agency sought and obtained disgorgement going back more than five years before the lawsuit was filed. In fact, approximately $30 million of the $35 million disgorgement ordered by the trial court fell outside that five-year window.

The Supreme Court in *Kokesh* unanimously held that disgorgement under SEC enforcement actions constituted a "penalty" subject to 18 U.S.C. § 2462, and accordingly, the statute's five-year statute of limitations applied. The Court said that "SEC disgorgement sometimes exceeds the profits gained as a result of the violation," rejecting the SEC's argument that disgorgement was "remedial" rather than punitive. The Court concluded that SEC disgorgement "bears all the hallmarks of a penalty: It is imposed as a consequence of violating a public law and it is intended to deter, not to compensate."

The Impact of Kokesh Two Years Later

Kokesh has had a very real impact on the SEC's enforcement powers. The enforcement division's 2018 annual report estimated that *Kokesh* may have caused "the Commission to forgo up to approximately

[1] *Kokesh v. S.E.C.*, 137 S. Ct. 1635, 1639 (2017).

$900 million in disgorgement" in 2018 alone.[2] An earlier Supreme Court case holding that the five-year clock begins to run at the moment the violation occurs — and not when the agency discovers it — amplified the limitation.[3] That means that the SEC has to discover a violation, investigate it, and bring charges all within the five-year window.

In *Kokesh*'s wake, defendants have challenged the very nature of the SEC's ability to seek disgorgement, seizing on a footnote in which the Supreme Court explicitly stated that it was not addressing "whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context." The Supreme Court recently agreed to hear a case arguing that very point.[4]

Defendants are also using *Kokesh* to attack other SEC remedies, with mixed results. In *SEC v. Gentile*, defendants in a penny-stock manipulation scheme argued that the SEC was not entitled to various injunctions because they were punitive in nature and, therefore, subject to the five-year statute of limitations imposed under *Kokesh*.[5] The United States Court of Appeals for the Third Circuit disagreed, holding that the injunctive relief was designed to prevent future misconduct and, thus, were not penalties governed by §2462. Similarly, a broker challenged a Financial Industry Regulatory Authority order expelling him from the securities industry, arguing that the disciplinary action was "punitive" under *Kokesh*. The SEC rejected that argument and upheld FINRA's disciplinary order, reasoning that FINRA's lifetime bans are permissibly prophylactic and not necessarily punitive.[6]

[A separate article by Buckley attorneys discussed what *Kokesh* and *Gentile* could mean for time-barred conduct.]

The Legislative Fix Is In

Is a legislative fix on the horizon? Reps. Ben McAdams, a Democrat from Utah, and Bill Huizenga, a Republican from Michigan, in September introduced a bill designed to overturn *Kokesh*.[7] It would amend the Securities Exchange Act of 1934 by specifically authorizing the SEC to seek disgorgement and restitution, putting to rest the threshold question of whether the SEC has the authority to seek disgorgement — potentially before the Supreme Court even has a chance to address the issue next spring.

[2] SEC, Division of Enforcement, 2018 Annual Report at 12, available at https://www.sec.gov/files/enforcement-annual-report-2018.pdf.

[3] *Gabelli v. SEC*, 568 U.S. 442, 454 (2013).

[4] *SEC v. Liu*, 754 F. App'x 505 (9th Cir. 2018), *cert. granted*, *Liu v. SEC*, No. 18-1501, 2019 WL 5659111 (U.S. Nov. 1, 2019).

[5] 939 F.3d 549, 553 (3d Cir. 2019).

[6] John M.E. Saad, Exchange Act Release No. 86751, File No. 3-13678r, at 3, available at https://www.sec.gov/litigation/opinions/2019/34-86751.pdf.

[7] To amend the Securities Exchange Act of 1934 to allow the Securities and Exchange Commission to seek and Federal courts to grant disgorgement of unjust enrichment, and for other purposes, H.R. 4344, 116th Cong. (2019), *available at* https://financialservices.house.gov/uploadedfiles/bills-116-hr -m001209-amdt-10.pdf.

The bill specifically blunts *Kokesh* by stating that such "additional relief" shall not be construed as a "civil fine, penalty or forfeiture subject to [§ 2462]," and instead sets a 14-year statute of limitations — the exact length of time of Charles Kokesh's misappropriation scheme.

Despite heavy pressure from the securities industry,[8] the House Financial Services Committee passed the bill by a bipartisan vote of 49-5 on Sept. 20.[9] The bill is likely to find support in the Senate, where Sens. Mark Warner, a Democrat from Virginia, and John Kennedy, a Republican from Louisiana, introduced similar legislation earlier this year (albeit with a 10-year limitations period instead of 14 years).[10]

Both bills have far to go before they become law, especially in a deeply divided Congress heading into an election year, but the bipartisan focus suggests that *Kokesh*'s days may themselves be limited.

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[8] SIFMA Statement in Opposition to H.R. __ "To amend the Securities Exchange Act of 1934 to allow the Securities and exchange Commission to seek and Federal courts to grant restitution to investors and disgorgement of unjust enrichment," Markup of Legislation in the Committee on Financial Services U.S. House of Representatives (Sept. 16, 2019), available at https://www.sifma.org/wp-content/uploads/2019/09/19-09-16-SIFMA-Letter-on-Kokesh-Legislation.pdf.

[9] Press Release, Committee Passes 12 Bills to Benefit Consumers, Investors and Vulnerable Families (Sept. 20, 2019), available at https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=404362.

[10] Press Release, Warner & Kennedy Introduce Bill to Help Investors Harmed by Fraud (Mar. 14, 2019), https://www.warner.senate.gov/public/index.cfm/2019/3/warner-kennedy-introduce-bill-to-help-investors-harmed-by-fraud.