

June 7, 2017

## Supreme Court Applies Five-Year Statute of Limitations to SEC Disgorgement Claims in *Kokesh v. SEC*

### I. Introduction

On June 5, 2017, after years of industry debate and litigation, the Supreme Court put to rest a billion dollar question: can the Securities and Exchange Commission (“SEC” or the “Commission”) seek disgorgement beyond the general five-year statute of limitations period that constrains much of its other enforcement activity? In *Kokesh v. SEC*, 581 U.S. — (2017) (No. 16-529), a unanimous Court held that disgorgement orders are in fact time-barred under 28 U.S.C. § 2462 (“Section 2462”), a statute governing claims brought by the SEC and many other federal agencies. In doing so, the Court granted a significant victory to market participants and disarmed an increasingly powerful tool in the Commission’s vast enforcement arsenal. We also note that the decision will have several consequential impacts in terms of the scope of future investigations and a few other areas.

### II. Background

Section 2462 provides for a five-year statute of limitations period for “the enforcement of any civil fine, penalty, or forfeiture” by the Commission. This catch-all statute is intended to provide a measure of certainty to market participants regarding their potential exposure in enforcement actions brought by the government. Consistent with this goal, in a landmark decision dating back to 2013, *Gabelli v. SEC*, the Supreme Court held that the SEC could collect penalties under Section 2462 for five years from the date that the alleged violation *occurred* – and not, as the government argued – once the alleged violation was or should have been *discovered*. *Gabelli* represented a monumental victory for the defense bar, keeping alive in practice the theoretical protections offered by Section 2462. Yet the decision left unresolved the full scope of the statute – namely, whether the limitations period set forth in Section 2462 applied to other enforcement tools on which the statute was silent.

To this end, the reach of Section 2462 with respect to disgorgement has long been an open question as to whether disgorgement constitutes a type of “civil fine, penalty, or forfeiture” so as to fall under its purview. Until *Kokesh*, district and appellate courts historically held that disgorgement is an equitable remedy used to prevent unjust enrichment – not a punishment – and was thus outside the realm of Section 2462.

### III. *Kokesh*

*Kokesh* challenged the Commission’s ability to impose disgorgement for conduct that took place beyond the five-year limitations period set forth in Section 2462. The case arose out of an enforcement action against Charles Kokesh, the owner of two investment advisory firms, for the misappropriation of \$34.9 million in corporate funds between 1995 and 2006. Following a guilty verdict at trial, the district court imposed monetary penalties of \$2.4 million and disgorgement of \$34.9 million (plus \$18.1 million in prejudgment interest) in “ill-gotten gains” against Kokesh. Kokesh unsuccessfully challenged the \$34.9 million disgorgement order as time-barred under Section 2462 at the district court level. On appeal, the Tenth Circuit upheld the district court’s determination that disgorgement was not subject to the five-year statute of limitations set forth in Section 2462. Kokesh appealed to the Supreme Court.

In a unanimous decision, the Supreme Court held that disgorgement constitutes a penalty under Section 2462 and is therefore subject to the five-year statute of limitations period. The Court reasoned that disgorgement shares fundamental characteristics that constitute the definition of a “penalty.” Ultimately, as the Court explained, “SEC

disgorgement thus 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 Court concluded that disgorgement falls squarely within the purview of Section 2462.

#### IV. Implications of the Court’s Decision in *Kokesh*

The Commission must now contend with a specific cap on the scope of profits it may seek in connection with a potential securities violation. This is especially significant because, of all of the SEC’s enforcement tools, disgorgement orders arguably have the most damaging and lasting impact on the viability of a company’s or principal’s finances. This limitation on disgorgement will also have a significant impact on how penalties are calculated, as in many instances the staff pressured parties to accept “discounted” penalties by threatening to impose penalties equal to the full disgorgement amount. In addition, another significant issue associated with the SEC’s belief that disgorgement was not subject to any statute of limitations was the breadth of investigations reaching back without regard to time and seeking data related to events that happened well more than five years into the past. The additional costs of responding to inquiries associated with old facts are substantial but impossible to quantify as those numbers rarely are calculated or disclosed.

There are three additional interesting aspects to the decision beyond the main finding. First, the court in a footnote states that it is not addressing the question of whether the SEC has the actual authority to impose disgorgement in the first place, thereby implying that this practice itself may be subject to future challenge. Second, the court through its discussion of SEC disgorgement practices seems to support the SEC seeking disgorgement from one individual based on profits obtained from another participant in the scheme versus just the individual’s own gain. Third, the fact that the opinion arguably dictates that disgorgement in a criminal proceeding should be subject to *Apprendi* principles – meaning that the issues and fact underlying an order of disgorgement should be provided to a jury to consider whether the government has established them beyond a reasonable doubt versus for consideration in a sentencing phase where the lower preponderance of the evidence standard is used.

If you have any questions, or would like to discuss the above or any related matter, please contact the Ropes & Gray attorney with whom you regularly work.