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In *Kokesh v. SEC*, the U.S. Supreme Court held that disgorgement orders are subject to the five-year limitations period governing claims brought by the SEC. The ruling granted a significant victory to market participants and disarmed an increasingly powerful tool in the SEC's vast enforcement arsenal, attorneys from Ropes & Gray say. They also caution, however, that the opinion may simply force the SEC into using more creative enforcement tools.

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



By R. Daniel O'Connor, Helen Gugel and Jessica Soricelli

I. Introduction

After years of industry debate and litigation, the U.S. Supreme Court has finally 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*, a unanimous Supreme 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.

II. Background

Section 2462 provides 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, 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*. *See Gabelli v. SEC* (reasoning that Section 2462 seeks to avoid ''leav[ing] defendants exposed to Government enforcement action . . . for an . . . uncertain period into the future'' and that it ''would be utterly repugnant to the genius of our laws if actions for penalties could be brought at any distance of time.'') (internal quotation marks omitted).

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. *See generally* R. Daniel O'Connor, Helen Gugel, and Jessica Soricelli, *SEC Enforcement Landscape Post-*Gabelli.

The reach of Section 2462 with respect to disgorgement has long been an open question. Although the statute does not expressly refer to disgorgement, much litigation has ensued about whether disgorgement constitutes a type of ''civil fine, penalty, or forfeiture'' so as to fall under its purview.

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Market participants have repeatedly sought to curtail the Commission's ability to collect profits beyond the five year statute of limitations period by arguing that the Commission uses disgorgement as a punitive measure akin to the ''penalty'' or ''forfeiture'' contemplated by the statute. For example, they note that disgorged profits are often turned over to the government, rather than to the victims of the alleged misconduct, making the remedy not wholly remedial in nature. Instead, such profits are—at least in part—meant to punish wrongdoers and thus constitute a ''penalty'' under Section 2462. *See, e.g.*, Brief for Petitioner, *Kokesh*; *Riordan v. SEC* (''It could be argued that disgorgement is a kind of forfeiture covered by § 2462, at least where the sanctioned party is disgorging profits not to make the wronged party whole, but to fill the Federal Government's coffers.''); Brief for Donald R. Miller, Jr., in his Capacity as the Independent Executor of the Will and Estate of Charles J. Wyly, Jr., as Amicus Curiae Supporting Petitioner, [hereinafter ''*Wyly* Brief''], *Kokesh* (citing *Gabelli* and arguing that disgorgement is akin to a penalty where the recovery ''make[s] whole no victims and ha[s] no otherwise compensatory purpose.'').

In addition, market participants have posited that disgorgement orders represent a mandate to turn money over to the government due to a violation of law and thus fall squarely within the definition of ''forfeiture'' for purposes of the statute. *See, e.g.*, Brief for Petitioner, *Kokesh* (arguing that, under the statute, forfeiture is used as ''an umbrella term covering any order to turn over money to the government . . . as a result of a legal transgression - in personam or in rem, remedial or punitive.''); Memorandum of Law In Support of Relief Defendants' Motion to Dismiss Certain Claims in the Second Amended Complaint at 7 [hereinafter ''*Ahmed* Memo''], *SEC v. Ahmed* (urging the court to ''find that the term 'forfeiture' in Section 2462 is not limited to any specific statutory provision using that label, and can be deemed to include claims labeled as seeking 'disgorgement' where such claims essentially seek the same form of relief''); Memorandum of Points and Authorities in Support of Defendant Steven A. Newman's Motion to Dismiss First, Second, Sixth and Seventh Causes of Action in Plaintiff's Amended Complaint and, in the Alternative, Motion to Strike Portions of Amended Complaint at 44-45 [hereinafter ''Newman Memo''] *SEC v. Saltsman* (arguing that disgorgement constitutes a forfeiture under Section 2462).

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Beyond these substantive arguments, market participants have often invoked the policy considerations underlying statutes of limitations, generally, and emphasized that form should not trump substance in considering the reach of Section 2462. *See, e.g.*, *Ahmed* Memo (arguing that ''the societal need for certainty embodied in statutes of limitations'' trumps any ''labels'' used to describe similar remedies); *See also* Newman Memo (citing SEC v. Graham for the position that the fact that Section 2462 does not contain the word ''disgorgement'' should not allow the SEC to evade the statute's five year limitations period).

On the other hand, the government has frequently argued that disgorgement does not constitute a penalty or forfeiture under Section 2462 because it is an equitable remedy used to prevent unjust enrichment. Whereas penalties or forfeiture seek to ''deprive the defendant of money to which he has a lawful entitlement,'' the government has proffered, disgorgement seeks to restore a status quo that was upset by the defendant's wrongdoing. *See, e.g.*, Brief for the Respondent, *Kokesh*. The government has argued that disgorgement is therefore an equitable remedy not subject to the limitations placed on the penal—or punitive—remedies listed in Section 2462. The government has also stated that disgorgement is not a forfeiture because forfeiture similarly ''refers to something punitive'' *id.*; *see also* Plaintiff United States Securities And Exchange Commission's Response in Opposition to Relief Defendants' Motion to Dismiss Certain Claims in the Second Amended Complaint, *Ahmed* (positing that forfeiture is a punitive remedy used to recover ''property the defendant *lawfully* required'' while disgorgement is ''limited to *ill-gotten gains*.'') (emphasis in original).

District and appellate courts have historically favored the government's position, repeatedly holding that disgorgement is an equitable remedy used to prevent unjust enrichment—not a punishment—and was thus outside the realm of Section 2462. *See e.g.*, *Zacharias v. SEC* (noting that ''[t]he primary purpose of disgorgement is not to refund others for losses suffered but

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rather to deprive the wrongdoer of his ill-gotten gain.'') (internal quotation marks and citations omitted); *SEC v. Straub* (holding that ''Section 2462 . . . applies only to the SEC's claims for penalties'' and not to ''traditional equitable remed[ies]'' such as disgorgement.); *SEC v. Wey* (holding that the SEC could seek disgorgement because the defendant was ''unjustly enriched by his participation in [a] fraudulent scheme.'').

In a twist, however, the U.S. Court of Appeals for the Eleventh Circuit gave new hope to market participants last year when it held in *SEC v. Graham* that disgorgement is synonymous with forfeiture and therefore covered by Section 2462. *See generally SEC Enforcement Landscape Post-*Gabelli.

Although dismissed as an ''outlier'' decision by numerous other courts, *Graham* substantially impacted the debate regarding the scope of Section 2462—not least because it contributed to the circuit split that ultimately led to the Supreme Court's decision to grant certiorari in *Kokesh* to review the issue. *See, e.g.*, *Ahmed* (describing *Graham* as an ''outlier''); *Saltsman* (same).

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.

Kokesh 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. The SEC alleged that Kokesh used the misappropriated funds to pay $23.8 million in salaries and bonuses to corporate officers (including himself), $5 million to pay office rental fees for two related investment advisers, and ''$6.1 million in payments described as 'tax distributions' in SEC reports that [Kokesh] signed.'' *SEC v. Kokesh* (10th Cir.).

Following a jury trial, Kokesh was found guilty of all charges alleged in the complaint. 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 argued that the $34.9 million disgorgement order was time-barred under Section 2462 because, in part, it was effectively a punishment that would have ''crushing financial consequences' to [him].'' *SEC v. Kokesh* (D.N.M.) (internal quotations and citations omitted). The district court disagreed, concluding that the disgorgement order was ''remedial, equitable, and thus, not subject to § 2462.''

Kokesh appealed to the U.S. Court of Appeals for the Tenth Circuit, which upheld the district court's determination that disgorgement was not subject to the five year statute of limitations set forth in Section 2462.

First, the appeals court reasoned that ''disgorgement is not a penalty under § 2462 because it is remedial'' and, ''[p]roperly applied . . . does not inflict punishment.'' Second, it disagreed with *Graham* and held that disgorgement is not forfeiture under Section 2462 because, absent specific congressional action, the meaning of ''forfeiture'' should not be expanded to ''encompass traditional disgorgement remedies. . . .'' (noting that certain ''federal forfeiture statutes have been expanded to include disgorgement-type remedies'' but that this does not ''expand the meaning of the word *forfeiture* in § 2462 to encompass traditional disgorgement remedies outside those forfeiture statutes.'') (emphasis in original).

Kokesh then appealed to the Supreme Court. In their arguments before the Court, each side advocated for a categorical ''all or nothing'' decision that definitively answered the question of whether Section 2462 *does* or *does not* apply to disgorgement. As such, both Kokesh and the government appeared to caution against a conditional, fact-specific holding—in this way acknowledging the importance of the question to ongoing and future litigation, regardless of the result.

In a unanimous decision on June 5, 2017, the Court agreed with Kokesh 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 the two fundamental characteristics that constitute the definition of a ''penalty.''

First, like penalties, the Court said disgorgement represents a sanction imposed for a violation of a ''public law'' as opposed to a private wrong. (Noting that disgorgement is a consequence for a wrong committed against the United States as opposed to ''an aggrieved individual''). The SEC, accordingly, imposes disgorgement orders in the public interest as a penalty to address harms to the general public, it said.

Second, the Court found that ''disgorgement is imposed for punitive purposes''—i.e., as a means to deter and punish wrongdoers by depriving them of ill-gotten grains, rather than as a means of ''compensating a victim for his loss.''

The Court stressed that ''[s]anctions imposed for the purpose of deterring infractions of public laws are inherently punitive'' in that deterrence is a legitimate objective of government enforcement. To this end, the Court noted that disgorgement is not purely compensatory because disgorged profits sometimes exceed the loss suffered by the victims and are paid to district courts that allocate the profits to victims and/or the government according to their discretion. (''Even though district courts may distribute the funds to the victims, they have not identified any statutory command that they do so. When an individual is made to pay a noncompensatory sanction to the Government as a consequence of a legal violation, the payment operates as 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 further explained that these aspects of disgorgement belie the Government's argument that the sanction is remedial because it sometimes ''exceeds the profits gained as a result of the violation.''

In Kokesh's case, as in others, the SEC ordered disgorgement ''without consideration of a defendant's expenses that reduced the amount of illegal profit.'' The Court found that this type of disgorgement ''does not simply restore the status quo; it leaves the defendant worse off,'' making disgorgement a ''punitive, rather than remedial, sanction . . . .''

Reasoning that a sanction serving remedial as well as deterrent or retributive purposes is still a punishment for the purposes of Section 2462, the Court concluded that disgorgement falls squarely within the purview of Section 2462.

IV. Implications of the Court's Decision in Kokesh

The impact of the Court's ruling in *Kokesh* is likely to be immediate and profound.

The SEC has frequently targeted profits in its enforcement efforts: in fiscal year 2016, the SEC collected more than $4 billion in penalties and disgorgement alone. *See* U.S. Sec. and Exch. Comm'n, *SEC Announces Enforcement Results for FY 2016*. Approximately $2.809 of the $4.082 billion collected was for disgorged profits, or roughly 68.8%. *See* Brief for Petitioner at 5, *Kokesh*, *citing* U.S. Sec. and Exch. Comm'n, *Select SEC and Market Data: Fiscal 2016*.

The SEC's increased use of disgorgement has had a material financial impact on enforcement targets. Notably, as in Kokesh's case, the Commission has often collected a substantially larger amount in disgorgement than in penalties based on its virtually unfettered ability to reach back in time with respect to profits arising from securities law violations. *See, e.g.*, *Kokesh*, 834 F.3d at 1160 (affirming penalties of $2.4 million for conduct in five-year period and disgorgement of $34.9 million in fourteen-year period); *SEC v. Wyly* (imposing no penalties and disgorgement of more than $100 million for defendants' conduct in eighteen-year period); *SEC v. Geswein* (seeking disgorgement for conduct occurring eight years before filing of complaint and settling for $1.08 million in disgorgement and $270,000 in penalties).

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.

Against this backdrop, defense counsel have frequently criticized the SEC for doing indirectly that which it could not do directly in the aftermath of *Gabelli*—impose severe financial consequences on targets for conduct beyond the five year statutory period. *See, e.g.*, *Wyly* Brief, *Kokesh* (arguing that ''the SEC has increasingly relied upon disgorgement to perform an end-run around the time limit on pecuniary penalties.'').

The Court's ruling in *Kokesh* has closed any such loopholes, unequivocally precluding the SEC from seeking disgorgement for conduct that occurred more than five years from the date of the alleged violation. 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.

It is also worth noting that, in a footnote, the Court made clear that it was 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.

Notwithstanding that *Kokesh* represents an important victory for market participants, however, the SEC still retains powerful enforcement mechanisms that can wreak havoc on their finances, careers, and reputations.

The Supreme Court's ruling unequivocally precludes the SEC from seeking disgorgement for conduct that occurred more than five years from the date of the alleged violation.

Indeed, the Court's discussion of SEC disgorgement practices suggests that it may support the Commission if it seeks disgorgement from an individual based on profits obtained from another participant in the scheme versus just the individual's own gain. One lingering concern is that the SEC may revisit the use of equitable-based restitution claims as a means to retain the possibility of monetary awards for conduct beyond the statute of limitations.

We note, however, that—as with disgorgement—the Commission lacks any statutory basis to include restitution as a remedy in its enforcement cases. Perhaps for this reason, the Commission to date has rarely if ever actually sought an order for the equitable restitution remedy, and in fact does not have the infrastructure to support the collection and distribution of such funds.

Additionally, given the Court's ostensible inclination to revisit the SEC's authority to seek disgorgement in the first place—coupled with its observation in *Kokesh* that successful restitution claims have been based on express statutory authority—such an approach is unlikely to be successful.

Nonetheless, one way or another, *Kokesh* may simply force the SEC into more creative enforcement areas as the industry awaits its next move.

Thus, while celebrations are in order and there is certainly reason to hope that the scope of SEC enforcement matters and related exams will be more limited going forward, there is still much work to be done by the defense bar to ensure a fair shake for their clients.

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