ROPES & GRAY

ALERT

Securities & Futures Enforcement

January 23, 2017

Supreme Court to Decide Whether SEC Claims for Disgorgement Are Subject to Any Statute of Limitations

I. Introduction

Attorneys
Daniel V. McCaughey
Anne Hancock
Matthew Tolve
Janine Paré

The Supreme Court recently granted certiorari to review whether civil enforcement claims brought by the SEC for the remedy of disgorgement are subject to any statute of limitations, or whether instead the SEC can effectively pursue such claims based on conduct dating back to the enactment of the federal securities laws as part of the New Deal.[1] This pending case, *Kokesh v. SEC*, will have significant implications for registered entities and any other participants in the financial markets subject to potential SEC enforcement actions.

The SEC regularly pursues two principal types of monetary remedies in its enforcement actions: disgorgement, which is designed to deprive wrongdoers of ill-gotten gains, and civil monetary penalties. It is now settled law that claims by the SEC for civil monetary penalties are subject to the five-year statute of limitations established in 28 U.S.C. § 2462, which expressly applies to any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise."[2]

The federal courts of appeals have reached differing views on whether Section 2462 separately applies to the SEC's claims for disgorgement. The SEC has contended—and recently convinced the 10th Circuit in *SEC v. Kokesh*—that claims for disgorgement fall outside the scope of the statute. 834 F.3d 1158 (10th Cir. 2016). Under the 10th Circuit's decision, the SEC can pursue claims for alleged violations of the federal securities laws based on conduct that dates back indefinitely, so long as it seeks disgorgement as a remedy.[3] The *Kokesh* decision created a circuit split with an 11th Circuit decision from earlier in 2016, which held that Section 2462 does in fact apply to disgorgement claims, reasoning that disgorgement is a synonym of the "forfeiture" remedy expressly covered by the statute. *SEC v. Graham*, 823 F.3d 1357, 1363-64 (11th Cir. 2016).

In the wake of that circuit split—and with encouragement from both the SEC and the respondent in the *Kokesh* case—the Supreme Court granted certiorari last week to review the 10th Circuit's *Kokesh* decision. The question facing the Court will have a concrete impact on a number of SEC enforcement matters, as the agency has demonstrated its willingness to aggressively seek disgorgement for conduct well outside of the five-year limitations period, and will likely be emboldened to expand that practice if the Supreme Court upholds the ruling in *Kokesh*. That approach would not only erase the finality and protection of reliable evidence that statutes of limitations are intended to provide, but would give the SEC added leverage to negotiate for settlements in cases that respondents might otherwise choose to litigate on the merits.

---

[1] *Kokesh v. SEC*, No. 16-259, 2017 WL 125673 (U.S. Jan. 13, 2017).
[2] *See Gabelli v. SEC*, 133 S. Ct. 1216, 1221 (2013) (noting that § 2462 "sets a fixed date when exposure to the specified Government enforcement effort ends.").
[3] Disgorgement claims play a large role in many SEC enforcement matters: In 2015 alone, the SEC collected $3 billion in disgorgement—more than double the $1.2 billion it collected in money penalties—which represents a 60% jump since 2011. *See Select SEC and Market Data, Fiscal 2015*, at 3, available here.

In addition to examining the reasoning behind the *Kokesh* and *Graham* decisions, this article will address the significance of the statute of limitations question in the SEC's recent private equity initiative, which underscores the potential for abuse that the *Kokesh* decision presents for any respondent in an SEC enforcement matter.

II. The Current Circuit Split

The parties and the courts in both *Graham* and *Kokesh* have focused their arguments on two distinct goal posts: first, whether the SEC's disgorgement remedy is punitive, and is accordingly covered by the statute's application to "penalt[ies]" or, alternatively, whether disgorgement is equivalent to "forfeiture," another type of remedy covered by the statute.

In *Graham*, the SEC had sought disgorgement from a group of defendants charged with selling unregistered securities from 2004 to 2008—conduct that almost entirely predated the five-year period before the 2013 commencement of the suit. In affirming the district court's dismissal of the suit as time-barred under Section 2462, the 11th Circuit looked to the ordinary definition of forfeiture, and concluded that forfeiture and disgorgement "are effectively synonyms," or that, at a minimum, disgorgement is a "subset of forfeiture." 823 F.3d at 1363-64. The 11th Circuit had no need to reach the related issue of whether disgorgement constitutes a "penalty" under Section 2462. *Id*. at 1363 n.3.

In *SEC v. Kokesh*, the 10th Circuit upheld an approximately $35 million dollar disgorgement judgment against Charles Kokesh, an investment adviser charged with misappropriating investor funds dating back in time to 1995—a full thirteen years before the action was filed. 834 F.3d at 1161. Initially, the 10th Circuit rejected the respondent's argument that disgorgement was a penalty, because it "just leaves the wrongdoer 'in the position he would have occupied had there been no misconduct.'"[4]

The *Kokesh* court then expressly disagreed with the conclusion in *Graham* that disgorgement was equivalent to forfeiture, despite acknowledging that the terms "capture similar concepts." The Court determined that Congress used the term "forfeiture" in a "historical sense" to refer to "in rem proceedings brought by the government against property that either facilitated a crime or was acquired as a result of criminal activity." *Id*. at 1165-66. Because "forfeiture" is "linked in § 2462 to the undoubtedly punitive actions for a *civil fine or penalty*," the Court reasoned that the statute must only apply to punitive forfeiture, and the "nonpunitive remedy of disgorgement does not fit in that company." *Id*. at 1166.

III. The Supreme Court Should Adopt the Reasoning of *Graham*, not *Kokesh*

Graham is the better reasoned decision for several reasons.

First, as *Graham* correctly held (and *Kokesh* acknowledges), the terms *forfeiture* and *disgorgement* are either synonymous, or disgorgement is a "subset" of forfeiture, and thereby subject to the statute. *Graham*, 823 F.3d at 1364. Both types of remedies involve taking something away from someone as a result of unlawful conduct. *Kokesh* attempts to exclusively limit the statute's reference to "forfeiture" to what the Court described as its traditional and punitive use in *in rem* proceedings, citing as examples the use of the forfeiture remedy in historical actions for "the seizure of ships engaged in piracy" and illegal moonshine distilleries. *Kokesh*, 834 F.3d at 1166. But the opinion cites no historical authority that precluded a court from ordering the forfeiture of money. And it is hard to understand why these arcane examples of civil forfeiture should restrict the plain meaning of the word as it appears in the statute.

Second, by limiting the definition of forfeiture as used in the statute to "*in rem* proceedings," *Kokesh* writes the phrase "pecuniary or otherwise" out of the statute. *In rem* proceedings are by definition actions against tangible property; "pecuniary" actions instead involve money. If Congress intended to limit the statute to *in rem* proceedings as *Kokesh* suggests, it simply would not have used the word "pecuniary" in the statute. In fact, since "fines" and "civil penalties" are always "pecuniary," that word would be redundant and unnecessary unless applied to the remedy of forfeiture (which immediately precedes the term "pecuniary" in the statutory text, after all). When viewed against the plain language of the statute, *Kokesh*'s historical review establishes why pecuniary forfeiture (or "disgorgement") is

[4] *Id*. at 1164 (citing Restatement (Third) of Restitution and Unjust Enrichment § 51 cmt. k (2011)).

covered by a common sense interpretation of the statute: if you do something illegal, the government can take away your pirate ship or your moonshine still, and can force you to disgorge your ill-gotten monetary gains, so long as it initiates its case within five years.[5]

Third, the historical examples relied upon in *Kokesh* establish that forfeiture could be either punitive or not. *Kokesh* notes that in the piracy, distillery, and drug cases, "[t]he owner of the seized property could be completely innocent of any wrongdoing." *Id*. Indeed, the Court cites approvingly to a 1974 Supreme Court case in which an ***innocent owner*** had his yacht seized because a single marijuana cigarette was found on the boat while under the control of a third party. Given the non-punitive version of "forfeiture" that *Kokesh* identifies, there is no basis for the 10th Circuit to distinguish "disgorgement" from forfeiture solely on the ground that disgorgement is arguably a non-punitive remedy.

Finally, *Kokesh*'s holding undermines the purposes of any statute of limitations that the Supreme Court described in *Gabelli*: preservation of evidence and repose.[6] A respondent in a civil enforcement matter can be disadvantaged in defending itself when key employees depart, memories diminish, and helpful documentation becomes harder to find with the passage of time. In addition to that important evidentiary purpose, market participants should know with certainty when disgorgement actions are barred—just like defendants facing any other kind of civil action—so that they can effectively govern their affairs, such as financial and insurance planning, and compliance and records retention.

IV. The SEC's Enforcement Actions Against Private Equity Advisers Illustrate The Need For A Limitations Period

The SEC's ability to pursue enforcement cases based on conduct that dates back indefinitely in time creates potential unfairness for any participant in the financial markets. One area of SEC focus that illustrates that unfairness is the SEC's enforcement initiative with respect to private equity firms and other private fund advisers.

The SEC's private equity enforcement matters come with a palpable dose of retroactivity to begin with, separate and apart from the statute of limitations issue. In contrast to public companies and mutual funds, which have been regulated and subject to extensive SEC rulemaking for over seventy years, private equity advisers were not required to register with the SEC until March 2012, based on rules promulgated under the 2010 Dodd Frank Act. Prior to that time, private fund advisers' legal obligations were primarily determined by detailed limited partnership agreements governed by well-established state common law, and negotiated with sophisticated institutional investors, who frequently succeeded in negotiating improved economic terms and more stringent disclosure obligations over time.

When the SEC waded into this new area of jurisdiction, it began with a "Presence Exam Initiative," in which it conducted examinations of over 50 advisers to "sharpen[] its understanding" and "better assess the issues and risks" presented by the private equity business model.[7] Yet after completing this crash course, the SEC did not use its findings to propose new rules or regulations that would be subject to public comment and would apply to the industry on a going-forward basis. Instead, the agency promptly launched a series of enforcement actions against a number of advisers, relying on the broad and generic "anti-fraud" provisions of the 1940 Investment Advisers Act as its sole legal authority. The best advance notice that the SEC provided of its views was a May 2014 speech by Andrew

---

[5] Tellingly, 28 U.S.C. 2461—a companion to 2462, and its immediate predecessor in the U.S. Code—provides that "[w]henever a civil fine, penalty or ***pecuniary forfeiture*** is prescribed for the violation of an Act of Congress without specifying the mode of recovery or enforcement thereof, it may be recovered in a civil action." That statute's use of the term "pecuniary forfeiture" refutes any suggestion that Congress viewed forfeiture as an exclusively *in rem* remedy. Moreover, the language of Section 2461 indicates that both statutes are catch-all provisions for any civil enforcement action for which federal law does not otherwise provide more exacting specifications. That context suggests that Section 2462's limitations period is generally intended to apply to virtually any civil enforcement action, notwithstanding granular distinctions regarding the history behind the government's sought-after remedies.

[6] *See Gabelli*, 133 S. Ct. at 1217 (describing "the basic policies of all limitations provisions" as "repose, elimination of stale claims, and certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities.").

[7] Andrew J. Bowden, Former Director, OCIE, "Spreading Sunshine in Private Equity" (May 6, 2014) (transcript available here.)

Bowden, then the Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE"), in which Mr. Bowden outlined a number of existing practices employed by numerous advisers with respect to the treatment of fees and expenses paid by their funds' portfolio companies and investors. The SEC questioned whether such practices were adequately disclosed to investors under governing fund documents. Many of the issues that would emerge in the SEC's subsequent enforcement matters the following two years had been outlined in Mr. Bowden's 2014 speech.

Upon pursuing its first wave of enforcement actions against private equity advisers in 2015 and 2016, the SEC did not equitably limit its claims to conduct that post-dated its 2014 pronouncements about private equity market practices, in order to give advisers an opportunity to first comply with its guidance. Nor did it limit its claims to the 2012 expansion of registration requirements under Dodd Frank, contending that even unregistered advisers "have always been . . . subject to certain provisions of the Investment Advisers Act"[8] (without regard to whether the Commission had historically taken any action to address their long-standing fee and expense practices). On top of that, when certain private equity advisers took steps on their own initiative to re-allocate historical fees and expenses based on the SEC's subsequent guidance, the SEC brought public enforcement actions imposing penalties against them anyway![9]

Whether or not that retroactive approach was legally authorized, the agency significantly exacerbated it by failing to limit its disgorgement claims to conduct that fell within the five-year limitations period established by Section 2462. In fact, the settlement orders in several of its recent private equity matters suggest that the SEC has sought disgorgement for conduct dating back nearly ten years, not unlike its approach in Mr. Kokesh's case.[10] The consistent application of the five-year statute of limitations to these matters would significantly limit the unfair retroactivity of forcing advisers to defend conduct that occurred years before the SEC had offered its guidance on the propriety of long-existing market practices, and before the respondents were even required to register with the SEC.

In addition to that policy consideration, the evidentiary unfairness of SEC claims that are not subject to any limitations period is also exaggerated in newly regulated areas like private equity. Private fund advisers defending an investigation of conduct from more than five years ago are not only forced to deal with the natural deterioration of evidence that occurs in any type of civil case, but may also have to rely on a historical compliance record that was focused on their private contractual obligations and areas of investor focus, rather than subsequent and more detailed SEC guidance that frames the agency's enforcement case.

This recent enforcement trend highlights the significance of the *Kokesh* case for any participant in the financial markets, especially private fund advisers and other entities who have recently become subject to increased SEC oversight. A decision that follows the result and reasoning outlined in *Graham* is not only supported by a common sense interpretation of the statute, but by a fair and practical approach to civil enforcement actions.

---

[8] Andrew J. Ceresney, Former Director, Division of Enforcement, "Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement" (May 12, 2016) (transcript available here).

[9] *See, e.g.*, *In the Matter of First Reserve Management, L.P.*, Investment Advisers Act of 1940, Release No. 4529 (Sept. 14, 2016) (asserting claims for misallocation of insurance expenses, advisory service expenses, and a legal fee discount, even though adviser had reallocated amounts in question "prior to any contact by Commission investigative staff."); *In the Matter of JH Partners, LLC*, Investment Advisers Act of 1940, Release No. 4276 (Nov. 23, 2015) (asserting claims based on loans by adviser and its principals to portfolio companies and violations of funds' concentration limits, even though respondents had already subordinated loans, waived repayments on security agreements, and waived $24 million in management fees and carried interest).

[10] *See e.g.*, *In the Matter of Apollo Mgmt. V, L.P.*, Investment Advisers Act of 1940, Release No. 4493 (Aug. 23, 2016) (asserting claims for conduct dating back to 2008); *In the Matter of Blackstreet Capital Mgmt., LLC*, Investment Advisers Act of 1940, Release No. 77959 (June 1, 2016) (asserting claims related to expenses and donations dating to 2005); *In the Matter of Kohlberg Kravis Roberts & Co. L.P.*, Investment Advisers Act of 1940, Release No. 4131 (June 29, 2015) (asserting claims for conduct dating back to 2006).