The Supreme Court Limits the SEC's Disgorgement Power

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White Collar

On Monday, in *Kokesh v. SEC*,[1] the Supreme Court handed a major loss to the Securities and Exchange Commission, unanimously holding that SEC claims for disgorgement of ill-gotten gains are subject to a five-year statute of limitations. For decades, the SEC had taken the position that its disgorgement claims could reach back *indefinitely*, and recently obtained a judgment in another case ordering disgorgement based on conduct going back 18 years before the agency filed suit.[2] The *Kokesh* decision also calls into question the proper measure of disgorgement (e.g., gross versus net profits) and even whether the SEC and potentially other federal government agencies have authority to seek disgorgement at all.

Justice Sonia Sotomayor, writing for the full Court, quickly dispatched the SEC's position on the statute of limitations. The statute in question, 28 U.S.C. § 2462, establishes a five-year limitations period for "an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise." The Court, resolving a circuit split,[3] held that "[d]isgorgement in the securities-enforcement context is a 'penalty' within the meaning of § 2462," because the sanction redresses a wrong to the public, as opposed to an individual, and because its purpose is to punish and deter, rather than to compensate a victim for a loss.[4] Justice Sotomayor noted that in many cases, SEC disgorgements are not compensatory because they are not paid to the victims. She also squarely rejected the SEC's argument that disgorgement is merely remedial, since SEC disgorgements sometimes exceed the defendant's ill-gotten gains and do not take into account the defendant's expenses. In such cases, the Court ruled, disgorgement is punitive instead of remedial because it "does not simply restore the status quo," but rather "leaves the defendant worse off."[5]

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[1] *Kokesh v. SEC*, No. 16–529, 2017 WL 2407471 (U.S. June 5, 2017).

[2] *See SEC v. Wyly*, 56 F. Supp. 3d 394 (S.D.N.Y. 2014).

[3] *Compare SEC v. Graham*, 823 F.3d 1357, 1364 (11th Cir. 2016) (holding that § 2462 applies to SEC disgorgement claims), *with Riordan v. SEC*, 627 F.3d 1230, 1234 (D.C. Cir. 2010) (holding the contrary); *SEC v. Tambone*, 550 F.3d 106, 148 (1st Cir. 2008) (same); *SEC v. Kokesh*, 834 F.3d 1158, 1167 (10th Cir. 2016) (same).

[4] *See Kokesh*, 2017 WL 2407471, at *1, 7–8.

[5] *Id.* at *10.

In pending SEC actions with facts more than five years old, *Kokesh* will not affect the outcome if the SEC staff has obtained tolling agreements from the defendants before the conduct at issue hit the five-year mark. SEC tolling agreements apply to claims for disgorgement as well as statutory civil penalties, officer-and-director bars, and securities industry bars and suspensions. Without a tolling agreement, however, the SEC can no longer seek any financial remedy for conduct that occurred more than five years before the enforcement action is commenced. As a result of *Kokesh*, companies and individuals under investigation may be less likely to agree to toll the limitations period where disgorgement is a significant component of the relief sought. This issue will most commonly arise when conduct is difficult to detect, such as in complex fraud or foreign payments cases, and the SEC staff does not begin investigating until well after the conduct occurs or the staff takes a long time to unravel it.

Under *Kokesh*'s rationale, the five-year statute of limitations in 28 U.S.C. § 2462 will also likely apply to enforcement actions for disgorgement brought by other government agencies, such as the Commodity Futures Trading Commission and the Federal Trade Commission. The decision may also lead to litigation over whether this limitations period applies to actions seeking other remedies, such as bars, suspensions, and injunctions, that the SEC has historically characterized as remedial but are arguably punitive.

Beyond the statute of limitations, *Kokesh* will arm some defendants with a strong argument to reduce the amount of disgorgement awarded against them. Typically, in seeking disgorgement, the SEC and other federal agencies, such as the FTC, have refused to offset the amount of ill-gotten gains by the expenses incurred in obtaining them, which can be substantial.[6] Under *Kokesh*, however, such a measurement of disgorgement would not be equitable in nature, but rather punitive, and thus should not be available to agencies basing their disgorgement claims on a court's equitable powers.

Most significant of all, *Kokesh* casts doubt on whether the SEC even has authority to seek disgorgement in federal court actions.[7] In reviewing the statutory history, Justice Sotomayor noted that, under the Securities Exchange Act of 1934, the SEC initially lacked any "statutory authorization for monetary remedies" and urged courts to order disgorgement as an exercise of

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[6] *See, e.g., Kokesh*, 2017 WL 2407471, at *10 (noting that "SEC disgorgement sometimes is ordered without consideration of a defendant's expenses that reduced the amount of illegal profit"); *FTC v. Verity Int'l, Ltd.*, 443 F.3d 48, 68 (2d Cir. 2006) (instructing district court to determine amount of total billings that defendants received "without deducting monies paid by the defendants-appellants to other parties"); *FTC v. Kuykendall*, 371 F.3d 745, 765–67 (10th Cir. 2004) (holding that unjust gains equal "gross receipts").

[7] *Id.* at *5 n.3 (declining to opine on "whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context"). In 2002, as part of the Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, Congress explicitly granted the SEC power to impose orders of disgorgement in administrative proceedings, *see* Section 21B(e) of the Securities Exchange Act of 1934, but not in enforcement actions brought in federal district court.

their inherent equitable power.[8] In 1990, Congress authorized the SEC to seek civil penalties[9]—endowing it with what Justice Sotomayor called "a full panoply of enforcement tools"—yet the SEC "has continued its practice of seeking disgorgement in enforcement proceedings."[10] This pointed observation could be viewed as an invitation to challenge the SEC's power to request disgorgement in federal court actions generally. It may also invite challenges to the disgorgement power of other government enforcement agencies that lack express statutory authority to seek disgorgement.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our White Collar Defense and Investigations practice:

Tammy Albarrán	+1 415 591 7066	talbarran@cov.com
Bruce Baird	+1 202 662 5122	bbaird@cov.com
Lanny Breuer	+1 202 662 5674	lbreuer@cov.com
Arlo Devlin-Brown	+1 212 841 1046	adevlin-brown@cov.com
Steven Fagell	+1 202 662 5293	sfagell@cov.com
Nancy Kestenbaum	+1 212 841 1125	nkestenbaum@cov.com
David Kornblau	+1 212 841 1084	dkornblau@cov.com
Daniel Shallman	+1 424 332 4752	dshallman@cov.com
Andrew Smith	+1 202 662 5049	andrewsmith@cov.com
Doug Sprague	+1 415 591 7097	dsprague@cov.com
Anne Termine	+1 202 662 5827	atermine@cov.com
Alan Vinegrad	+1 212 841 1022	avinegrad@cov.com

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[8] *Kokesh*, 2017 WL 2407471, at *2.

[9] Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931.

[10] *Id.* at *3.