July 5, 2017

The Importance of *Kokesh v. SEC*

In a unanimous ruling issued on June 5, 2017, the U.S. Supreme Court, in the matter of *Kokesh v. SEC*, drastically limited a remedy commonly sought by the U.S. Securities and Exchange Commission (SEC) in securities law enforcement actions. Since the 1970s, as part of the sanctions levied against defendants convicted of securities law violations, the SEC regularly requested the disgorgement of ill-gotten proceeds related to the crime. Disgorgement is typically sought for the period over which the illegal activity occurred, often going back years and resulting in large financial awards from the defendant. In *Kokesh*, the Supreme Court ruled that disgorgement, as it is applied in SEC enforcement proceedings, is, in fact, a “penalty” under federal law, and, accordingly, subject to the 5-year federal statute of limitations under 28 U.S.C § 2462. Section 2462 applies to any action for “enforcement of any civil fine, penalty, or forfeiture,” and limits the time period in which the SEC must bring a claim against a defendant and limits the amount of proceeds that can be sought to five years. Until this case, the SEC had argued, and several Circuit and lower courts agreed, that disgorgement was not a “fine, penalty, or forfeiture” under federal law, but an equitable remedy of the courts not subject to Section 2462 or any other federal statute of limitations. The Supreme Court disagreed and, in effect, redefined the disgorgement remedy to be a penalty, regardless of what it is called by the SEC.

It is difficult to overstate the importance of this decision, since it goes directly to the ability of the SEC to both effectively penalize defendants found guilty of securities law violations and to deter market participants from engaging in future illicit activity. By limiting disgorgement to the five years prior to an action brought by the SEC, the Supreme Court has significantly reduced the monetary amounts that violators would pay in fraud cases involving millions or even billions, of dollars. The *Kokesh* case itself provides an excellent example of the difference – of the $39.4 million in disgorgement sought by the SEC and awarded by the lower courts, $29.4 million was obtained by Kokesh prior to the 5-year statute of limitations.

Background

In 2009, the SEC brought an enforcement action against Charles Kokesh for misappropriation of funds from several registered business development companies (BDCs). Kokesh provided investment advisory services to these BDCs through several wholly-owned and controlled registered investment advisers acting as the general partners to each BDC. Kokesh had reallocated funds for payment of various expenses of the investment advisers (i.e., rent,

salaries, bonuses and tax distributions) in violation of the investment management agreements with the BDCs. Upon finding Kokesh guilty of violating the Investment Company Act of 1940 ('40 Act), the Investment Advisers Act of 1940 (Advisers Act) and the Securities and Exchange Act of 1934 ('34 Act), each as amended, the U.S. District Court for the District of New Mexico imposed a civil monetary penalty of roughly $2.4 million and enjoined Kokesh (a) from further violation of the securities laws and (b) to disgorge over $39.4 million in proceeds from the illegal activity, going back to 1995. Kokesh appealed the disgorgement order, arguing that this sanction was actually a "forfeiture" or "penalty" subject to Section 2462. The Tenth Circuit Court of Appeals, however, disagreed and held for the SEC. The court's decision aligned the Tenth Circuit with similar rulings in the First, Seventh and DC Circuits, but conflicted with a recent ruling by the Eleventh Circuit. The SEC and Kokesh sought review by the Supreme Court, and the Supreme Court agreed to hear the matter and resolve the conflict between the Circuit Courts.

Disgorgement vs. Penalties

The Supreme Court's opinion, written by Justice Sotomayor, focused on the definitions of "disgorgement" and "penalties" under both federal and common law. Disgorgement has long been understood to be an "equitable" remedy available to state and federal courts ancillary to their equitable power to issue an injunction in certain circumstances. The remedy allows a court to force a defendant to turn over ill-gotten gains obtained through illegal activity and compensate those harmed by the activity. Closely related to the concept of "unjust enrichment," disgorgement is intended to make a claimant whole, and to return both the claimant and defendant to their financial status prior to the defendant's harmful actions. The Restatement (Third) of Restitution and Unjust Enrichment states that disgorgement requires repaying "those gains . . . properly attributable to the defendant's interference with the claimant's legally protected right," and should be considered "[r]estitution measured by the defendant's wrongful gain."

The SEC first sought the remedy of disgorgement in securities fraud cases in the 1970s, when it brought the first insider trading cases before the federal courts. At the time, the SEC lacked the authority to seek monetary penalties or forfeiture against securities violators and having only had the authority to seek injunctions against future violations. To force defendants to turn over ill-gotten gains, the SEC sought and was granted the "equitable" relief of disgorgement. In the mid-1990s, Congress passed laws granting the SEC the authority to seek monetary penalties. Yet, the SEC continued to seek disgorgement in most securities fraud cases.
In *Kokesh*, the Supreme Court focused on the SEC's historical use of the remedy and (a) whether it was consistent with the traditional concept of disgorgement, or (b) reflected the characteristics of a "penalty" or "forfeiture" that should be subject to Section 2462. In her opinion on behalf of the court, Justice Sotomayor wrote that disgorgement, as applied by the SEC, "bears all the hallmarks of a penalty," given the following:

- The remedy is typically sought on behalf of the state for violation of criminal laws and to remedy harm to the markets or public at large rather than to compensate specific victims;
- The primary purpose of the remedy (as acknowledged by the SEC) is to deter securities fraud rather than to compensate injured parties;
- The proceeds of disgorgement are often paid to the U.S. Treasury rather than to any harmed investor, and at times cannot be paid to an investor since it is awarded in cases where the public markets are harmed rather than an individual (e.g., insider trading);
- Defendants are often required to "disgorge" monies in excess of the amounts necessary to restore them to the status quo prior to their illicit actions, and the awards typically fail to take into account expenses that would normally reduce the amount of disgorged illegal profit;
- Contrary to the arguments put forth by the SEC, the use of disgorgement reflects pecuniary (i.e., punishment) more than remedial (i.e., restoring the victims) purposes.

Based on these factors, the Supreme Court ruled 9-0 that the SEC's use of disgorgement clearly fell within the definition of a penalty rather than the equitable remedy of disgorgement. It found that even when the SEC's use of disgorgement may in part have a remedial purpose, because the disgorgement orders go beyond compensation, their purpose is still primarily to "punish, and label defendants as wrongdoers," because of violating public laws. Thus, according to the court, the SEC's disgorgement remedy is, in fact, a penalty (or forfeiture) and should be subject to the 5-year statute of limitations in Section 2462. Justice Sotomayor pointed out that such limitations on punitive sanctions are necessary so that prosecutions, and the remedies sought, are based on reasonably fresh evidence and erroneous convictions are minimized. "Even wrongdoers are entitled to assume that their sins may be forgotten."

The Effects of *Kokesh*

The long-term effects of the Supreme Court's opinion in *Kokesh* are unknown – in part because the response of the SEC and Congress will be key to whether the remedy of disgorgement is restored in some fashion. Two immediate effects, however, should be noted. First, and most obvious, the ability of the SEC to seek disgorgement of amounts related to any period prior to the beginning of the 5-year statute of limitations is gone. Had the Supreme Court allowed the SEC to seek disgorgement where it could return proceeds to identifiable investors harmed by the illegal activity, the remedy might have remained intact in certain matters. However, based on Justice Sotomayor's opinion, it seems unlikely the Court would view disgorgement as a remedy brought for any other purpose than punitive. Second, now that disgorgement has been designated a penalty, the amount of penalties and disgorged proceeds sought by the SEC in any criminal securities fraud case could be further limited, since disgorged amounts may now be counted against the aggregate limitations on penalties

that can be sought under federal law. Ostensibly, disgorgements resulting from settlements between the defendant and the SEC will be unaffected. However, it remains to be seen whether defendants will be less inclined to enter into such settlement terms given the new limitations on the remedy that the SEC can seek in court.

Of additional concern is a footnote included in Justice Sotomayor's opinion, which stated: "Nothing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context. The sole question presented in this case is whether disgorgement, as applied in SEC enforcement actions, is subject to §2462's limitations period."

What may have been intended as a more clarification is likely to be interpreted as an invitation to challenge the SEC's authority to seek disgorgement remedies at all. Recall that there is no statutory authority for such a remedy, and this was a point of interest among several Justices when the SEC presented its oral argument before the court. Without statutory authority, the basis of such a remedy must rely on the federal courts' equitable authority. That analysis would require the Supreme Court to look back on arcane principals of law, stretching back to Congress' adoption of the Judiciary Act in 1789, and on state common law. If the Supreme Court found this power lacking, then it could find that the federal courts never had authority to grant disgorgement.

To avoid all of this, the SEC will need help from Congress, which should quickly resolve the scope of the SEC's authority to seek disgorgement. This is especially important where investors have no private right of action – as in certain fraud cases brought under Section 206 of the Advisers Act. In the meantime, investors and their counsel should monitor SEC actions closely to determine whether a private right of action can be brought following a criminal conviction, and whether disgorgement can be sought by the investors themselves.

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