

ALERTS

SEC's Disgorgement Authority Under Review

November 22, 2019

On Nov. 19, 2019, the U.S. House of Representatives passed the Securities Fraud Enforcement and Investor Compensation Act with wide bipartisan support in a 314-95 vote.[1] The bipartisan support of the House bill indicates strong interest in expanding the enforcement authority and remedies currently available to the SEC in federal court. It comes on the heels of a 2017 decision by the U.S. Supreme Court, which limited some remedies available to the SEC, and another case, just accepted for review, that may further limit the remedies the SEC can seek in federal court.

The House bill and the cases before the Supreme Court deal with the SEC's authority to seek a remedy known as disgorgement. Disgorgement refers to the SEC's ability to require those who violate the securities laws to forfeit any ill-gotten gains. For a long time, the SEC operated under the assumption that it had the authority to seek disgorgement as a remedy in federal court under its broad mandate to pursue "equitable relief." This assumption has been challenged in federal courts in recent years as it is not expressly granted by statute. The availability of this remedy as an enforcement tool is far from trivial. According to the Division of Enforcement's latest report, the agency had a record year in FY2019, with over \$3.2 billion in disgorgement ordered against individuals and entities sued by the SEC.[2]

While the status of the House bill in the U.S. Senate is unclear, a companion to it has bipartisan sponsors in Senators Mark Warner (D-VA) and John Kennedy (R-LA).[3] The Senate bill would expressly grant the

SEC authority to pursue restitution for up to 10 years, and to pursue disgorgement for up to five years. While disgorgement limits the SEC to recovering unlawful profits, restitution would provide the agency authority to recover the full amount of investor losses. The Senate bill is currently pending action in the Senate Banking Committee.

If Congress passes legislation along these lines, the future effects of the case currently before the Supreme Court would be limited. Either way, it appears likely that either Congress or the courts (or both) will provide clarity in the coming months about the enforcement tools the SEC has at its disposal.

The Case Currently Before the U.S. Supreme Court

The passage of the House bill came after the Supreme Court's decision earlier this month to hear an appeal in *SEC v. Liu*. In *Liu*, the court is reviewing the same question the House addressed in its bill: "[w]hether the Securities and Exchange Commission may seek and obtain disgorgement from a court as 'equitable relief' for a securities law violation even though this Court has determined that such disgorgement is a penalty."

This case follows up on a 2017 Supreme Court decision on a more narrow question in *Kokesh v. SEC*, which held that disgorgement actions in federal court were subject to a five-year statute of limitations.[4] The broader question in *Liu* contemplates, and could significantly limit, the recovery available to the SEC in federal court actions.

Background

Under 28 U.S.C. § 2462, the SEC's ability to seek punitive relief against a defendant is restricted by a statute of limitations.[5] Specifically, "enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise," must take place within a five-year period of when the claim arose — known as a statute of limitations.[6] Accordingly, federal courts have grappled with the question of whether certain SEC actions — the ordering of disgorgement among them — constitute "punitive relief," which is restricted by the statute of limitations, or "equitable relief" which is not subject to that statute of limitations. In *Kokesh v. SEC*, the Supreme Court puts to rest this question in finding that that SEC disgorgement

orders are punitive, and therefore, subject to the five-year statute of limitations, because such orders “go beyond compensation, are intended to punish, and label defendants wrongdoers’ as a consequence of violating public laws.” [7] A prior *SRZ Alert*[8] discusses in detail the implications of *Kokesh*.

In its decision, the *Kokesh* Court did not directly address whether the SEC had the statutory authority to pursue disgorgement in federal court. Instead, it highlighted this looming issue in a footnote, ominously writing that “nothing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement.”[9] In *Liu*, the Court has taken on the mantle of deciding this very question.

In 2018, the SEC obtained a judgment against defendant *Liu* and others in U.S. District Court for fraudulently raising and misappropriating \$27 million from investors in a scheme related to the EB-5 visa program. The court ordered the defendants to disgorge more than \$26 million in profits and pay an additional \$8 million in other penalties.[10]

The defendants appealed the ruling to the U.S. Court of Appeals for the Ninth Circuit, arguing that the SEC did not have the statutory authority to seek disgorgement, citing the footnote in *Kokesh*. In affirming the District Court, the Ninth Circuit pointed out that *Kokesh* “expressly refused to reach this issue,”[11] and therefore, the court needed to rely on its own precedent, which permitted the SEC to pursue disgorgement. The defendants appealed this ruling to the U.S. Supreme Court, which granted certiorari.

Recent history suggests that the Supreme Court is sympathetic to the view of *Liu* and his co-defendant here. Appellants petition to the court notes that during oral arguments in *Kokesh*, four currently sitting justices observed that the SEC does not have any clear statutory authority for disgorgement (Justices Roberts, Alito, Sotomayor and Gorsuch). [12] Absent action from Congress, a decision to strip the SEC of its authority to pursue disgorgement in federal court would significantly limit the remedies available in the agency’s enforcement actions.

The Supreme Court has not yet scheduled oral arguments in the case, which will likely be decided no later than the end of June.

Implications for Parties to SEC Investigations

The SEC collects billions of dollars in disgorgement from defendants annually. Disgorgement has become a primary tool used by the SEC to recover for securities law violations and the availability of disgorgement as a remedy gives the agency significant leverage in settlement negotiations. A decision in favor of the petitioners in the Supreme Court would curtail the SEC's ability to pursue disgorgement in civil actions filed in federal court, which has already been limited to those within the statute of limitations by *Kokesh*. Yet, if Congress grants express authority to the SEC, this would trump any Supreme Court decision here on a going-forward basis, and would provide expanded enforcement authority to the SEC.

There appears to be bipartisan support in Congress for expanding the enforcement powers of the SEC regardless of how the Supreme Court decides *Liu*. Both the House and Senate bills contemplate extending the statute of limitations and, while the details of both bills are subject to change, the clear indication is that Congress envisions more express enforcement authority for the SEC, rather than less. This change would significantly expand the remedies available to the SEC and may increase the number of enforcement actions the SEC brings in federal court.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the attorneys in the firm's Securities Enforcement Group or White Collar Defense & Government Investigations Group.

[1] H.R. 4344, 116th Cong. (2019).

[2] 2019 Annual Report, Sec. & Exch. Comm'n Div. of Enf't (2019), available [here](#).

[3] S. 799, 116th Cong. (2019).

[4] *Kokesh v. SEC*, 137 S. Ct. 1635 (2017). The SEC already has express statutory authority to pursue disgorgement in enforcement actions filed before its own Administrative Law Judges.

[5] 28 U.S.C. § 2462.

[6] *Id.*

[7] *Kokesh*, 137 S. Ct. at 1643.

[8] “Supreme Court: SEC Disgorgement Claims Are Subject to Five-Year Statute of Limitations,” *SRZ Alert*, June 6, 2017, available [here](#).

[9] *Id.* at n.3.

[10] *SEC v. Liu*, 262 F. Supp. 3d 957 (C.D. Cal. 2017).

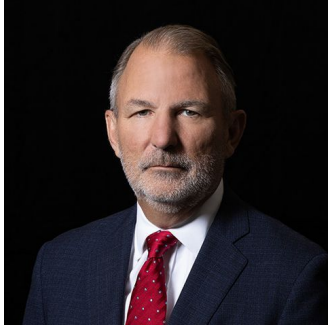
[11] *SEC v. Liu*, 754 F. App’x 505, 509 (9th Cir. 2018), *cert. granted*.

[12] Petition for Writ of Certiorari, *Liu v. SEC*, No. 18-1501 (U.S. May 31, 2019).

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