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Expert Analysis

Understanding the Full Impact of 'Kokesh' On SEC Enforcement Proceedings

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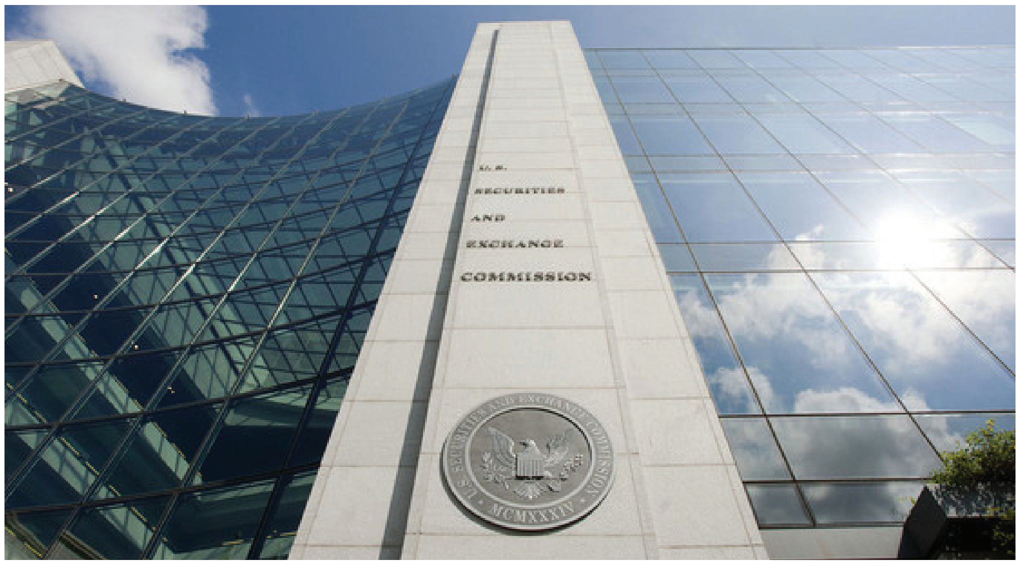

Headquarters of the U.S. Securities and Exchange Commission

The U.S. Supreme Court's recent decision in *Kokesh v. SEC* has been viewed as a significant setback for the U.S. Securities and Exchange Commission in its ability to obtain monetary remedies for violations of the federal securities laws. While most commentary on the case has focused on the court's holding that a five-year statute of limitations applies both to awards of disgorgement and civil monetary penalties (extending the court's holding in *Gabelli v. SEC*), the more meaningful impact is the court finding that disgorgement itself is not an equitable remedy but a penalty. By defining disgorgement as a penalty, the court has set the stage for defendants in SEC enforcement proceedings to attack the Commission's very ability to seek disgorgement or to limit strictly its amount. Most notably, if disgorgement is a penalty, then it is limited by statute to the maximum prescribed penalty amounts. This is a far more important outcome of the case than the relatively minor issue of the limitations period, and it is one that could significantly reduce the size of the monetary remedies the SEC can obtain in many of its most high profile cases.

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Background

Disgorgement has long been the lion's share of monetary remedies the SEC seeks for proven violations of the securities laws. In recent years, more than 60 percent of the monetary remedies the Commission has obtained through its enforcement program has been deemed disgorgement. *See* U.S. Securities and Exchange Commission, Year-By-Year Monetary Sanctions in SEC Enforcement Actions. Yet, the legal basis for the Commission to request, and for courts to grant,

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disgorgement against defendants in enforcement actions in federal courts has never been clear. In creating the SEC and granting the Commission its broad enforcement powers, Congress did not provide an express statutory provision for the Commission to obtain disgorgement. (The Securities Act of 1933 empowers the Commission to bring affirmative actions enforcing the federal securities laws and to seek remedies including injunctions, cease-and-desist orders, and bars from the securities industry. 15 U.S.C. §§77t(b), (e); 77h-1(a), (f). The Securities Exchange Act of 1934 provides the Commission the right to seek similar relief. 15 U.S.C. §§78u(d)(1), (2); 78u-3(a), (f); 78o(b)(4), (6). The Investment Advisers Act of 1940, 15 U.S.C. §§80b-3(e), (f), also provides authority for the Commission to seek industry bars. None of these statutes provide express authority for a federal district court to order disgorgement.) Indeed, it was not until the passage of the Remedies Act in 1990, more than half a century after the formation of the Commission itself, that Congress first granted statutory authority for courts to assess penalties in SEC enforcement cases. Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Remedies Act), 15 U.S.C. §77t(d). The silence of Congress on the question of disgorgement in federal court actions should not be ignored, particularly since Congress *did* grant the SEC an express right to order disgorgement in its own administrative proceedings. 15 U.S.C. §§77h-1(e), 78u-2(e).

In the absence of a direct right to obtain disgorgement by legislative authority, the SEC has historically argued that disgorgement is an equitable remedy within the inherent powers of the courts. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1307 (2d Cir. 1971) (affirming award of restitution as exercise of "courts' general equity powers to award complete relief."). The federal judiciary had accepted this rationale for decades, routinely granting disgorgement where violations of the federal securities laws had been proven. See, e.g., *SEC v. DiBella*, 409 F. Supp. 2d 122, 130-31 (D. Conn. 2006) (referring to SEC's "typical and traditional claim for equitable relief in the form of disgorgement"). This link between disgorgement being viewed as an equitable remedy, rather than a remedy at law, has formed a cornerstone of the SEC's enforcement program and has accounted for the majority of the monetary remedies the Commission has obtained. This may all change very soon.

'Kokesh v. SEC'

In *Kokesh v. SEC*, the court considered whether a federal five-year statute of limitations for actions "for the enforcement of any civil fine, penalty, or forfeiture" applied to claims for disgorgement in SEC enforcement proceedings. *Kokesh v. SEC*, No. 16-529, slip op. at 1 (June 5, 2017) (quoting 28 U.S.C. §2462). Holding that it does, the court concluded that "SEC disgorgement constitutes a penalty." Id. at 5.

The court explained that the primary purpose of disgorgement is to deter and punish violations of the securities laws. SEC enforcement actions do not redress a private injury but instead further the public policy of protecting investors and safeguarding the integrity of the markets. The court found disgorgement is inherently punitive because deterrence is its primary purpose and "not simply an incidental effect." Id. at 8.

The court noted that disgorgement is not compensatory because funds are often paid to the district courts which are not required to distribute them to victims. Most disgorged funds ultimately are paid to the U.S. Treasury. The court rejected the SEC's contention that disgorgement is remedial because "it is not clear that disgorgement … simply returns the defendant to the place he would have occupied had he not broken the law." Disgorgement sometimes exceeds the profits gained as a result of the violation, and "sometimes is ordered without consideration of a defendant's expenses that reduced the amount of illegal profit." Id. at 10.

Disgorgement as Penalty

The impacts of *Kokesh* are several fold and important. First, the most immediate effect of the court finding that disgorgement, as applied by the SEC, is a penalty is that now *all* penalties (by whatever name) in SEC enforcement proceedings are subject to the statutorily prescribed limits. Under the Remedies Act, the SEC may seek, and federal district courts may impose, civil penalties against persons who committed violations of the securities laws. See Remedies Act, 15 U.S.C. §77t(d). But those penalties cannot exceed the amounts set by Congress (as adjusted annually by the Commission for inflation (see Federal Civil Penalties Inflation Adjustment Act Improvements Act of 2015, Pub. L. No. 114-74, §701, 129 Stat. 584 (Nov. 2, 2015))) or up to "the gross amount of pecuniary gain to such defendant as a result of the violation." 15 U.S.C. §78u(d)(3)(B). Thus, both penalties and "disgorgement" in the aggregate must fall under these amounts.

While the language allowing a penalty up to "the gross amount of pecuniary gain" could be used, in effect, to "disgorge" the ill-gotten gains of a violator—a result much closer to the status quo ante the court referenced in *Kokesh*—the Commission would be left with far less relief than was available under its traditional model. Other than for insider trading violations which carry their own penalty structure (providing for a penalty up to three-times the gains or losses avoided (15 U.S.C. §78u-1(a)(2)-(3))), the Commission would be unable to obtain any monetary relief beyond separating the violator from his illicit profits. Put another way, a violator would be no worse off—at least in a strict monetary sense—than if the wrongful conduct had not occurred. The "penalty" aspect would be lost. (The focus of this article on monetary remedies should not overlook the significant weight of various injunctive remedies available to the SEC in enforcement proceedings. Often times a ban from the securities industry, even for a relatively short period of time, can impose the greatest financial hardship of all.)

Second, if disgorgement is a penalty, then there is no basis for the Commission to claim it can be assessed jointly and severally. In *Honeycutt v. United States*—decided the same day as *Kokesh* in an opinion also authored by Justice Sotomayor (and also unanimous)—the court considered the extension of joint and several liability to obtain forfeiture from a defendant who never actually "obtained" the proceeds of a crime. Because the statute at issue limited forfeiture to tainted property and "define[d] forfeitable property solely in terms of personal possession or use," the court held that defendants cannot be required to forfeit proceeds that they never actually "obtained." *Honeycutt v. United States*, No. 16-142, slip op. at 5-6 (June 5, 2017). This holding cuts against the long held position of the SEC that orders of disgorgement can be assessed against defendants jointly and severally *and* that disgorgement need not be limited to funds a defendant actually received. *See SEC v. Whittemore*, 659 F.3d 1 (D.C. Cir. 2011) (imposing joint and several liability for full amount to be disgorged and holding seller liable for funds that he acquired and then transferred to others).

Third, if disgorgement is a penalty, then federal district courts may lack the authority to award this remedy at all. Though outside the scope of this article, where Congress has specified a list of remedies for violations of the law (e.g., injunctions, penalties, bars) the courts cannot graft others onto a statute. See *Mobil Oil v. Higginbotham*, 436 U.S. 618, 625 (1978) ("There is a basic difference between filling a gap left by Congress' silence and rewriting rules that Congress has affirmatively and specifically enacted. In the area covered by the statute, it would be no more appropriate to prescribe a different measure of damages than to prescribe a different statute of limitations, or a different class of beneficiaries."). If disgorgement is a remedy at law, there is no statutory basis for granting it (other than only as a penalty up to the level of "pecuniary gain" and subject to the limitations discussed above).

Lastly, if disgorgement is not an equitable remedy within the inherent powers of the courts to order, then defendants in enforcement proceedings should have a right to a jury determination on that issue. *See SEC v. Commonwealth Chem. Sec.*, 574 F.2d 90, 96 (2d Cir. 1978) (denying request for jury trial in action seeking disgorgement because disgorgement "is entrusted to the discretion of the court").

Conclusion

The impacts of *Kokesh* in SEC enforcement proceedings are significant and will unfold quickly in the coming years. Defendants in SEC actions have a series of cogent arguments—backed by the authority of the High Court—to bring against the Commission as it seeks monetary remedies. These issues will be litigated vigorously in federal courts across the country. The Commission seems to be holding the losing hand.