New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 265—NO. 49
TUESDAY, MARCH 16, 2021

Outside Counsel

Legislation Misses Mark in Attempt To Expand SEC Disgorgement Powers

By **Sarah E. Aberg**

And **Christopher Bosch**

On Jan. 1, 2021, the U.S. Congress rang in the new year by passing the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021. Buried in the massive spending bill is §6501, a provision authorizing the U.S. Securities and Exchange Commission to seek disgorgement of unjust enrichment within 10 years for certain securities law violations, and five years for others. Congress passed this legislation in apparent response to a pair of U.S. Supreme Court decisions that limited disgorgement in SEC enforcement actions to a five-year statute of limitations and required that the remedy not exceed a wrongdoer's net profits and be awarded for the benefit of victims. See Kokesh v. Sec. & Exch. Comm'n, 137 S. Ct. 1635 (2017); Liu v. Sec. & Exch. Comm'n, 140 S. Ct. 1936, 1940 (2020).

While Congress may have intended for §6501 to free the SEC from the limits imposed by these two High Court decisions, a close reading of the statute's text reveals that the legislation fell short of its mark. As such, the new law leaves defendants in enforcement actions free to argue that Congress has not actually restored any of the agency's lost powers, subjecting the SEC to continued litigation over disgorgement absent an additional legislative fix.

Summary of Recent Precedent

In 2017, the Supreme Court decided whether disgorgement in SEC enforcement actions constituted a "civil fine, penalty, or forfeiture" subject to a five-year statute of limitations under 28 U.S.C. §2462, which governs the authority of federal courts to issue such relief in all actions, including those brought by the SEC. Kokesh, 137 S. Ct. 1635. A unanimous court held that the five-year statute of limitations applied, since the remedy in these cases bore all the hallmarks of a penalty: It is imposed as a consequence for violations of public laws committed against the United States rather than an aggrieved individual, and is intended to deter, not to compensate.

Armed with a ruling that classifies disgorgement as a penalty, defendants could then argue that the SEC lacked the authority to seek disgorgement at all under 15 U.S.C. §78u(d)(5), a provision allowing the agency to seek, and any federal court to grant, only "*equitable relief* that may be appropriate or necessary for the

SARAH E. ABERG *is special counsel and* CHRISTOPHER BOSCH *is an associate in Sheppard, Mullin, Richter & Hampton's government contracts, investigations and international trade practice group, with particular experience in white-collar defense and securities enforcement. They can be reached at saberg@sheppardmullin.com and cbosch@sheppardmullin.com, respectively.*

benefit of investors" (emphasis added).

The Supreme Court heard such an argument in Liu v. Securities & Exchange Commission, 140 S. Ct. 1936, 1940 (2020). In an 8-1 decision, the court preserved but narrowed the SEC's power to seek disgorgement, holding that, despite its unequivocal conclusion that disgorgement operates as a penalty, *Kokesh* did not prohibit the SEC from seeking, and federal courts from granting, disgorgement as "equitable relief" under 15 U.S.C. §78u(d)(5), so long as it "does not exceed a wrongdoer's net profits and is awarded for victims." 140 S. Ct. 1936, 1940 (2020). In other words, to avoid transforming disgorgement into an impermissible penalty, the requested relief had to comport with these traditional equitable requirements, since disgorgement is a profit-based measure of unjust enrichment that falls "squarely within the heartland of equity." Id. at 1942.

The court highlighted three specific historical practices by the SEC in seeking disgorgement that "test the bounds of equity practice" and risk transforming the remedy into a penalty outside of courts' equitable powers: (1) ordering the proceeds of fraud to be deposited with the United States Treasury instead of disbursed to victims, (2) imposing joint-and-several disgorgement liability, and (3) declining to deduct legitimate expenses from the receipts of fraud. See id. at 1942, 1944-46, 1949.

Collectively, *Kokesh* and *Liu* placed two key limitations on the SEC's disgorgement power. First, the SEC must seek disgorgement within five years of the date the claim accrued. Second, it must ensure that the disgorged proceeds did not exceed the defendant's net profits and were awarded for victims.

> The new law leaves defendants in enforcement actions free to argue that Congress has not actually restored any of the agency's lost powers, subjecting the SEC to continued litigation over disgorgement absent an additional legislative fix.

Effect of §6501 on the SEC's Disgorgement Powers

Section 6501 appears to be Congress' response to these Supreme Court decisions, intended to lift the restrictions they placed on the agency's disgorgement powers. Then-Chairman Clayton had previously testified that Kokesh and Liu had essentially tied the SEC's hands when it came to returning ill-gotten gains to Main Street investors. Jay Clayton, Chairman, Testimony on Oversight of the Securities and Exchange Commission Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Dec. 10, 2019). The ILLICIT CASH Act (S. 2563), another bill introduced in 2019 from which §6501 has borrowed much of its language, was aimed at "strengthening the ability of the SEC to pursue violations of the securities laws." See Sen. Mark Warner et al., The ILLICIT CASH Act, S.2563. However, the resulting text of §6501 belies this claim.

A review of §6501 shows that the legislation fails to meet its apparent objective of restoring the lost SEC's disgorgement tools in at least four ways:

First, §6501 purports to authorize the SEC to seek, and any federal court to order, disgorgement. 15 U.S.C. §78u(d)(7). However, this merely reflects the result of *Liu*, in which the Supreme Court confirmed the SEC's authority to seek disgorgement so long as it "does not exceed a wrongdoer's net profits and is awarded for victims." See *Liu*, 140 S. Ct. at 1940, 1942, 1944, 1949. The court based these limitations in the remedy's historical application subject to principles of equity. Section 6501 does nothing to redefine the concept of disgorgement. In such situations, courts may readily conclude that the historical definition of disgorgement, as articulated by the Supreme Court in *Liu*, continues to constrain the remedy under 15

U.S.C. §78u(d)(7). See, e.g., *Morissette v. United States*, 342 U.S. 246, 263 (1952) (when Congress uses a term of art "in which [is] accumulated … legal tradition and meaning," it is presumed to adopt that meaning). Indeed, *Liu* itself admonishes that "Congress does not enlarge the breadth of an equitable, profit-based remedy simply by using the term 'disgorgement' in various statutes." *Liu*, 140 S. Ct. at 1947.

Second, while §6501 authorizes the SEC to seek disgorgement to prevent unjust enrichment pursuant to newly-created 15 U.S.C. §78u(d)(3)(A)(ii), the court has already acknowledged the SEC's authority in this regard, subject to the aforementioned equitable limitations. See *Kokesh*, 137 S. Ct. at 1640, 1645; *Liu*, 140 S. Ct. at 1940, 1942-44, 1949. Without redefining disgorgement, this provision similarly fails to explicitly alter the status quo. Moreover, while 15 U.S.C. §78u(d)(3)(A)(ii) has been inserted into a subsection titled "Civil Money Penalties," Congress' decision to reference disgorgement, a remedy rooted in equity, in a section purportedly related to penalties creates an incongruity that courts will have to resolve before concluding that this new provision frees disgorgement from its equitable underpinnings. If a court determines the statute does allow for a novel form of punitive disgorgement, the statute will be of little assistance in determining the appropriate contours of such relief.

Third, the legislation establishes a five-year limitations period for all disgorgement claims except those relating to violations of §10(b), §17(a)(1) of the Securities Act of 1933, §206(1) of the Investment Advisers Act of 1940, or any other provision of the securities laws for which scienter must be established. 15 U.S.C. §78u(d)(8)(A). This provision appears to override *Kokesh*'s five-year limitation on disgorgement only insofar as it is sought in connection with these specific violations. However, the statute falls short even here because it leaves room for defendants to argue that a remedy fashioned as disgorgement that operates as a penalty is not, in fact, disgorgement, but a penalty subject to 28 U.S.C. §2462's five-year statute of limitations, bringing the matter full circle back to the holding in *Kokesh*.

> A review of §6501 shows that the legislation fails to meet its apparent objective of restoring the lost SEC's disgorgement tools in at least four ways.

Conclusion

At oral argument in *Kokesh*, several justices expressed frustration that the lack of statutory text made it hard to define disgorgement in the context of SEC enforcement actions. See Transcript of Oral Argument at 7-9, 13, 31, 52, *Kokesh v. Sec. & Exch. Comm'n*, 2017 WL 1399509 (No. 16-529). Section 6501 will not ease this frustration because it does nothing to overcome this lack of clarity. It does not redefine the term for purposes of SEC enforcement actions, nor does it authorize the SEC to seek, or courts to order, a punitive form of the otherwise equitable remedy. As a result, the propriety and availability of SEC disgorgement is likely to be the subject of ongoing litigation unless and until Congress passes additional legislation resolving these issues.

Reprinted with permission from the March 16, 2021 edition of the NEW YORK LAW JOURNAL © 2021 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-256-2472 or reprints@alm.com. # NYLJ-03182021-485021