REGULATORY ACTION

Supreme Court rules SEC disgorgement actions subject to limitations period

By Peter Hamner, Esq.

The U.S. Supreme Court has ruled that the Securities and Exchange Commission waited too long to seek disgorgement of ill-gotten gains from a New Mexico-based investment adviser who misappropriated investor money for more than a decade.


In a 9-0 decision, the top court determined that disgorgement is a penalty and is therefore subject to the five-year limitations period provided in 28 U.S.C.A. § 2462 for SEC actions seeking “any civil fine, penalty or forfeiture.”

The ruling reverses a 2016 decision by the 10th U.S. Circuit Court of Appeals that held Section 2462 does not apply to disgorgement because it is an equitable remedy and not a penalty or forfeiture under the statute. SEC v. Kokesh, 834 F.3d 1158 (10th Cir. 2016).

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Fintech forecast: Lawmakers and regulators poised to revamp the legal landscape in 2017

Sean C. Wagner and Erin J. Illman of Bradley Arant Boult Cummings describe recent government enforcement efforts relating to oversight of the financial technology industry and discuss the potential for regulatory reform in this area.

EXPERT ANALYSIS

When it’s too good to be true: A Ponzi primer

Michael Braverman and Christopher Ekimoff of consulting firm Resolution Economics LLC analyze the characteristics of a Ponzi scheme and discuss how investors can prevent falling prey to the fraud.
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‘THE NEED FOR SPEED’

According to several attorneys who have been following the case, the Supreme Court’s holding is a setback for the SEC and a win for Wall Street.

Dixie L. Johnson, co-leader of King & Spalding’s securities enforcement and regulation practice, said the decision “shatters” the SEC’s “long-standing view that the disgorgement remedy is equitable, and therefore not subject to any statute of limitations.”

“Those who previously paid disgorgement purportedly for ill-gotten gains more than five years after the relevant violation will be reviewing their situations against this case to determine whether the disgorgement award should have been allowed,” she said.

Marc D. Powers, the leader of BakerHostetler’s securities litigation and regulatory enforcement and hedge fund industry practices, noted the ruling will be “advantageous” for “all proposed SEC defendants, including Wall Street.”

“They will be able to sleep at night, not fearing the SEC and forever looking over their shoulders for their questionable conduct in the securities markets,” said Powers, who is also a former SEC staff attorney and branch chief.

Dorsey & Whitney partner Thomas O. Gorman said the opinion rightfully limits SEC claims.

“While the commission is charged with safeguarding the securities markets by halting violations and preventing a reoccurrence of wrongful conduct, it is questionable at best that bringing years-old cases furthers those goals,” he said.

John J. Carney, a co-leader of BakerHostetler’s white collar defense and corporate investigations teams, who formerly served as an SEC securities fraud chief and assistant U.S. attorney, said the SEC can continue seeking disgorgement but it must proceed quickly.

“Importantly, the court did not say the SEC cannot seek and secure disgorgement, but merely that they have to do it within the five-year statute of limitations,” he said. “Going forward ‘the need for speed’ in bringing actions will be paramount.”

SEC ACTION AGAINST KOKESH

The case involves Charles R. Kokesh, who controlled the now-defunct advisory firms Technology Funding Ltd. and Technology Funding Inc., which in turn controlled and advised four business development companies.

Kokesh misappropriated nearly $35 million of investor money from 1995 through July 2007 by causing the BDCs to pay illegal distributions, performance fees and expense reimbursements to the advisory firms, the SEC alleged in a complaint filed in 2009 in the U.S. District Court for the District of New Mexico.

The SEC claimed he concealed the scheme by distributing misleading proxy statements to BDC investors and filing false reports with the commission on the BDCs’ behalf.


Kokesh was ordered to pay a fine and repay the ill-gotten gains with interest.

PENALTY OR FORFEITURE?

U.S. Magistrate Judge Stephan M. Vidmar of the District of New Mexico affirmed the jury’s finding despite Kokesh’s contention that the SEC had waited too long to seek disgorgement. Some of the misappropriation occurred more than five years before the SEC commenced its action, Kokesh said. SEC v. Kokesh, No. 09-cv-1021, 2015 WL 11142470 (D.N.M. Mar. 30, 2015).

Kokesh appealed the decision, and the 10th Circuit upheld Judge Vidmar’s holding. Although Section 2462 sets a five-year limitations period for suits seeking punitive remedies, it does not apply to claims for disgorgement, the panel determined.

Disgorgement is not a penalty or forfeiture under the statute because disgorgement is remedial, not punitive, the panel said.

DISGORGEMENT IS A PENALTY

Reversing the 10th Circuit’s ruling, the Supreme Court held that disgorgement is a penalty under Section 2462.

SEC disgorgement is imposed by courts for violating securities laws, it is punitive and it is not always compensatory, the opinion said.

“SEC disgorgement thus bears all the hallmarks of a penalty: It is imposed as a consequence of violating a public law and it is intended to deter, not to compensate,” Justice Sonia Sotomayor wrote for the unanimous court. W1

Related Filings:
Opinion: 2017 WL 2407471
Complaint: 2009 WL 5054989
The Supreme Court made clear that disgorgement can go far beyond “restoring the status quo.” If the defendant is required to pay back more than his net profits, it hard to make the argument that the impact is not punitive.

Importantly, the court did not say the Securities and Exchange Commission cannot seek and secure disgorgement, but merely that they have to do it within the five-year statute of limitations.

Going forward “the need for speed” in bringing actions will be paramount.

The Supreme Court’s conclusion that the five-year statute of limitations applies to SEC claims for disgorgement is limitation on the enforcement actions brought by the agency.

The ruling also at least suggests the possibility of further limitations on the remedies the agency may be able to obtain in the future. Enforcement actions brought by the SEC are frequently based on years-old conduct as the Kokesh decision illustrates.

While the commission is charged with safeguarding the securities markets by halting violations and preventing a reoccurrence of wrongful conduct, it is questionable at best that bringing years-old cases furthers those goals.

Here, for example, the commission sought to trace back conduct not just five years as permitted by the statute of limitations but years beyond that.

As the Supreme Court pointed out, statutes of limitations serve the salutary purpose of saying essentially “enough” – either bring an action in a timely manner or it is barred.

This is consistent with the court’s 2013 ruling in Gabelli v. SEC, 568 U.S. 442, where the same five-year statute of limitations was applied to SEC requests for penalties in addition to disgorgement, essentially doubling down on monetary sanctions in many instances.

The Kokesh decision may be more significant that its literal holding however. First, the reasoning of the opinion leaves open the possibility that the five-year statute of limitations could be applied to SEC requests for an injunction. That statute of limitations applies where the remedy is for a violation of law against the state and it is sought to deter others, according to the court.

Viewed in this context, a request for a permanent injunction prohibiting future violations of the law is clearly a penalty which should be subject to the five-year statute of limitations — it is a remedy for a violation of law sought by a federal agency not just to prevent future violations by the defendant but to deter others.

Second, the Court’s ruling calls into question the SEC’s use of the disgorgement remedy. During the oral arguments the court questioned the SEC’s authority to seek disgorgement. Other questions asked about the guidelines used by the agency to govern such claims.

As the court’s opinion makes clear, the authority for SEC disgorgement claims is not a statute but an earlier court decision which concluded that federal district courts have inherent authority to grant such a remedy, a kind of implied cause of action. And, as was clear at the oral argument, there are no SEC guidelines cabining the remedy.

These points should be considered in the context of footnote two in the opinion which expressly states that the Supreme Court is not holding that courts have inherent authority to grant SEC disgorgement claims.

This at least presents the question of whether the Supreme Court might in the future consider whether the SEC can seek disgorgement absent express statutory authority — an approach to remedies which is consistent with the increasing conservative approach of the court, particularly in the area of implied remedies.

What is clear today, however, is that SEC monetary remedies are delimitied by the five-year statute of limitations, meaning the agency would be well advised to speed its enforcement processes while carefully examining its demands for disgorgement.

In part, the ruling focuses on the way the SEC had expanded the disgorgement remedy over time to include gains, rather than simply profits or compensation.

Those who previously paid disgorgement purportedly for ill-gotten gains more than five years after the relevant violation will be reviewing their situations against this case to determine whether the disgorgement award should have been allowed.

Now with Kokesh, the SEC in enforcement cases may not seek disgorgement, or ill-gotten gains that a defendant obtains, more than five years old.

Disgorgement, the Kokesh court has held, is another form of “penalty” that is subject to 28 U.S.C.A. § 2462, which limits commencement of governmental actions for a “civil fine, penalty or forfeiture.”

This will be more advantageous to all proposed SEC defendants, including Wall Street. They will be able to sleep at night, not fearing the SEC and forever looking over their shoulders for their questionable conduct in the securities markets.

It will also force the SEC to move more quickly on its cases. That is good for everyone. Because of the cloud of an SEC investigation over a possible defendant, it should come to as fast a conclusion as possible. Litigate or not within five years!

Also, any enforcement action brought will have newer facts and evidence. Not faded memories and missing documents from 10 or more years ago. In Kokesh, the conduct looked at, and subject to the SEC lawsuit, was from 1995-2009!

Criminal statutes have five- or 10-year statute of limitations for criminal charges of securities violations. Now the SEC cannot do an “end run” around a five-year criminal statute and charge a civil defendant for possibly oversized disgorgement amounts in litigation.