

Congress Expands the SEC's Disgorgement Powers...In a Defense Spending Bill

Sometimes, the important things are in the fine print. That is the lesson to the securities defense bar, when a sweeping change to the SEC's disgorgement powers is taking effect after being authorized in section 6501, contained on page 1,238, of the National Defense Authorization Act ("NDAA") that passed in December over a presidential veto.

The provision was not widely reported in the press, nor was it debated in either chamber of Congress, since it was added in conference committee after the NDAA was voted on and approved by both houses. Nonetheless, the provision amended Section 21(d) of the Securities Exchange Act of 1934 and (i) legislatively overruled the Supreme Court's unanimous decision in *Kokesh v. SEC*, (ii) will almost certainly be used by the SEC to test the limits of the Supreme Court's decision in *Liu v. SEC*, (iii) doubled the statute of limitations available to the SEC for injunctive action and to seek disgorgement for scienter-based violations to ten years, and (iv) provided the SEC with a legislative hook for disgorgement where previously there was none.

The amendment followed two prior efforts to overrule *Kokesh*: H.R. 4344, the "Investor Protection and Capital Markets Fairness Act," which passed the House in November 2019 but never came to a vote in the Senate, and S. 799, the "Securities Fraud Enforcement and Investor Compensation Act," which never moved beyond the Senate Committee on Banking, Housing, and Urban Affairs.

A cynic could be forgiven for wondering how many members of Congress knew that in passing the NDAA they were drastically expanding the powers of the SEC.

Recent Limitations on the SEC's Disgorgement Power

The amendment to the Exchange Act followed two recent cases in which the Supreme Court drastically limited the SEC's longstanding practice of seeking disgorgement from violators of the securities laws. In each instance, the Court placed strict limitations on the SEC. The most recent limitation was imposed just last summer, in *Liu v. SEC*, 140 S. Ct. 1936 (2020). In that action, the Supreme Court held that the SEC had the power to seek disgorgement as equitable relief in certain circumstances despite an acknowledged absence of statutory authority allowing the SEC to do so. *Liu*, 140 S. Ct. at 1946–47. The Supreme Court held that the SEC's ability to seek disgorgement was found in equity, but as such the SEC's authority was limited by "longstanding principles of equity." *Id.* at 1947. Principally, the Supreme Court held that the SEC could not seek disgorgement from multiple wrongdoers under a theory of joint and several liability; that disgorgement was limited to the net profits the wrongdoer received; and that disgorgement had to be paid to victims and not to the U.S. Treasury. *Id.* at 1947–50.

Prior to *Liu*, in 2017, Justice Sotomayor, writing for a unanimous court, issued an even more stark limitation on the SEC's disgorgement powers. In *Kokesh v. SEC*, 137 S. Ct. 1635, 1639 (2017), the Supreme Court held that disgorgement is a punitive remedy and therefore subject to the five-year statute of limitations contained in 28 U.S.C. § 2462. The two rulings were widely seen as a victory for the defense bar and the SEC has been openly critical of them, noting that they are among the largest "challenges" that the SEC faces in enforcement actions. Taken together, they limited the scope of relief that the SEC could seek in court, and the time frame in which the SEC could seek it. But the relief for the defense bar has proved to be short lived.

Congress Amends the Exchange Act to Expand the SEC's Disgorgement Power

As it does every year, this December, Congress approved a bill authorizing the funding of the military. This year, that bill was the \$740.5 billion National Defense Authorization Act (the “NDAA”). Both houses approved the NDAA by veto-proof majorities. That was important, because, as widely reported in the press, President Trump threatened to (and eventually did) veto the bill due to its failure to repeal Section 230 of the Communications Decency Act—which shields social media companies such as Twitter and Facebook from liability for content that their users post. The House and Senate overruled the President’s veto.

The NDAA addresses such issues as troop withdrawal from Afghanistan and Germany, pay increases for service members, and procurement of equipment. Importantly for securities litigators, the NDAA also amends the Exchange Act. Specifically, Section 6501 of the NDAA addresses “*Investigations and Prosecution of Offenses for Violations of the Securities Laws*.” Section 6501 amends Section 21(d) of the Exchange Act to provide the SEC with express statutory authority to seek disgorgement as a remedy for unjust enrichment gained through a securities law violation.

Specifically, Section 6501 provides the SEC with authority to seek “disgorgement . . . of any unjust enrichment by the person who received such unjust enrichment as a result of [a] violation” of the securities laws.

With respect to the statute of limitations, Section 6501 extends the SEC’s statute of limitations to ten years from the “latest date” of misconduct in two ways: first, for a claim “for any equitable remedy, including for an injunction or for a bar, suspension, or cease and desist order.” And second, to seek disgorgement for any violation that requires the SEC to “establish[] scienter” including Section 10(b) of the Exchange Act, Section 17(a)(1) of the Securities Act, and Section 206(1) of the Investment Advisers Act. In other words, the SEC’s broad authority to bring an action (whether in district court or before its administrative law judges) for *any claim* is extended to ten years. Claims for disgorgement for most claims remain limited to five years under *Kokesh*, but disgorgement for scienter-based claims is extended to ten years. The limitations period for seeking penalties, limited by § 2462 and the Supreme Court’s decision in *Gabelli v. SEC*, 568 U.S. 442 (2013), remains at five years. Finally, foreign and multinational actors should also be aware that Section 6501 tolls the statute of limitations for disgorgement and other equitable relief for time spent outside the United States under new subsection (9) of Section 21(d). On its face, the amendment applies to “any [enforcement] action or proceeding that is pending on, or commenced on or after, the date of [the NDAA’s] enactment.” Section 6501(b).

Key Takeaways

It is obvious that the expansion of the statute of limitations for disgorgement actions will lead to lengthier investigations. SEC investigations have never been short, but they were limited by the five-year statute of limitations. What may be less obvious is the impact the change will have on the size of settlements with the SEC. With the SEC now able to cover much longer time periods, we expect that the SEC will begin seeking larger disgorgement awards. In the short term, we will need to wait to see how staff interprets and deploys Section 6501. One immediate question is whether staff will continue to seek tolling agreements as insistently as they have been post-*Kokesh*. Certainly from the defense perspective, it will be hard to grant SEC staff any tolling in light of the new limitations period, even though the limitations period may in some cases still limit the SEC’s ability to seek full disgorgement for the period of time it is investigating.

A second issue that will be addressed immediately in practice is whether the SEC will attempt to use its new statutory authority to avoid the limitations placed on it by the Supreme Court in *Liu*. For example, the statutory authorization of disgorgement does not, on its face, require the disgorgement to go to investors rather than the U.S. Treasury. Will courts limit the SEC's statutory disgorgement rights in the same way that the Supreme Court limited the SEC's equitable disgorgement rights? We expect that the limitations that the Supreme Court placed on the SEC in *Liu* will be the subject of litigation over the next few years until the courts settle on the meaning of the new amendments.

If you have any questions about the issues addressed in this Client Alert, or if you would like a copy of any of the materials we reference, please do not hesitate to contact us:

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