Litigation & Arbitration Group

# Client Alert

Milbank

## Congress Clarifies SEC's Authority to Obtain Disgorgement and Expands the Statute of Limitations on SEC Claims for Equitable Relief

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Overriding President Trump's veto of legislation for the first time, on January 1, 2021 Congress enacted the National Defense Authorization Act for Fiscal Year 2021 (the "Act"). In doing so, Congress adopted a rider to the operative legislative bill—having no connection to the military or national defense—that amends the Securities Exchange Act to grant the Securities and Exchange Commission ("SEC") relief from adverse rulings in two recent Supreme Court cases. The Act represents a victory for the SEC because it significantly broadens the SEC's authority to pursue disgorgement of ill-gotten gains arising from violations of the securities laws.

In *SEC v. Kokesh*, 137 S. Ct. 1635 (2017), the Supreme Court held that SEC claims for disgorgement were subject to a five-year statute of limitations. The Supreme Court rejected the SEC's argument, nearly universally accepted by lower courts, that disgorgement claims were not subject to any statute of limitations. Moreover, the *Kokesh* Court explicitly reserved judgment on whether disgorgement qualified as a form of equitable relief, thereby raising significant questions about whether such relief fell within a district court's statutory authority to grant in an SEC action "any equitable relief that may be appropriate or necessary for the benefit of investors." *Id.* at 1642, n. 3.

In *Liu v. SEC*, 140 S. Ct. 1936 (2020), the Supreme Court addressed the question of whether disgorgement is a permissible form of equitable relief. Although the *Liu* Court concluded that a district court has authority to award disgorgement as a form of equitable relief, it imposed limitations on the exercise of that authority. Most significantly, the Supreme Court held that an award of disgorgement may be justified only when such relief derives from, and conforms with, a traditional equitable remedy, such as an accounting for profits or equitable lien. The Court also suggested that disgorgement may not be permitted except for the limited purpose of restoring funds to harmed investors, noting that disgorgement "must do more than simply benefit the public at large by virtue of depriving a wrongdoer of ill-gotten gains" and that "the Government has pointed to no analogous common-law remedy permitting a wrongdoer's profits to be withheld from a victim indefinitely without being disbursed to known victims." *Id.* at 1948.

Legislatively overturning parts of *Liu*, the Act amends section 21(d) of the Exchange Act to grant district courts explicit authority to "require disgorgement . . . of any unjust enrichment by the person who received such unjust enrichment as a result of" of a violation of the securities laws. This provision effectively creates a cause of action for disgorgement that is distinct from other equitable causes of action and not necessarily subject to the same limitations as traditional equitable remedies. It also makes clear that district courts are not restricted to awarding disgorgement only “when appropriate or necessary for the benefit of investors” and may do so even when such relief is not required in order to compensate victims but simply to avoid unjust enrichment.

Legislatively overturning *Kokesh*, the Act subjects the SEC’s newly created cause of action for disgorgement to a 10-year statute of limitations if the claim arises from a violation of any provision of the securities laws requiring 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—and otherwise subjects the cause of action to a 5-year limitation period. The Act also for the first time creates a 10-year limitation period for any other claim for an equitable remedy, including an injunction, bar, suspension, or cease and desist order. Notably, the Act does *not* alter the 5-year period applicable to SEC claims for a money penalty. Nor does it alter the 5-year period generally applicable to disgorgement and penalty claims brought by the Commodity Futures Exchange Commission and other federal financial markets regulators.

Finally, although the courts and Congress have long disfavored retroactive application of legislation, the Act purports to apply the newly amended provisions of the Exchange Act to “any action or proceeding that is pending on, or commenced after, the date of enactment of this Act.” On its face, therefore, the Act would authorize the imposition of an award of disgorgement in any pending or future action that the SEC may bring and would subject the claim for this relief to the newly created statutes of limitation even if the previously applicable limitations period had already expired. Although there may be grounds to challenge such retroactivity, the Constitution’s Ex Post Facto clause is not generally implicated by retroactive application of civil regulatory statutes. Thus, the Act may revive SEC claims for disgorgement arising from conduct that was thought to be time barred.

The Act does not define “unjust enrichment” and thus leaves open important questions about how to compute the amount of disgorgement in different scenarios. For example, the SEC occasionally takes the position that compensation for work performed at an hourly rate of pay (*e.g.*, an accountant’s performance of an audit), measured as a percentage of assets under management (*e.g.*, an investment adviser’s management of a client account), or fixed by commission (*e.g.*, a broker’s receipt of a transactional fee), may be subject to disgorgement if a violation of the securities laws occurred during the performance of the work. May fees for such work properly be considered “unjust enrichment” under the newly created statutory cause of action?

Similarly, the Supreme Court in *Liu* significantly curtailed the SEC’s authority (1) to impose joint-and-several liability for disgorgement on joint tortfeasors and (2) to disgorge gross gains (without deduction of “legitimate” expenses) on the basis that such awards offended traditional equitable principles. Do these same restrictions still apply even where the new cause of action—now grounded in statute—no longer depends upon application of traditional equitable remedies?

While the courts will need to resolve these questions, the Act may have a more immediate impact on the SEC’s charging decisions. Congress’s creation of a longer 10-year statute of limitations exclusively for disgorgement claims involving *scienter* unfortunately may create an incentive for the SEC to pursue scienter-based charges in circumstances in which it previously would have pursued negligence-based charges, or to resist settlements involving negligence-based claims even when such claims would be appropriate. In certain scenarios, the Act may also put pressure on those under investigation to proactively seek to toll the statute of limitations or otherwise waive statute of limitations defenses to preserve the ability to negotiate a negligence-based settlement or avoid tying the SEC’s hands in making charging decisions.

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