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SEC Enforcement Actions After *Kokesh*

The Securities and Exchange Commission (SEC) has routinely sought a range of remedies in its enforcement actions, including civil monetary penalties and various forms of equitable relief. Yet the question of whether claims in an SEC enforcement action are subject to the five-year statute of limitations contained in 28 U.S.C. § 2462 has been litigated with varying results depending on the specific relief sought. Practical Law asked *Adam Ford* and *Matt Ford* of *Ford O'Brien LLP* to discuss how the US Supreme Court's landmark decision in *Kokesh v. SEC* clarifies the applicability of the Section 2462 limitations period and potentially impacts the SEC's enforcement strategy and pursuit of remedies.

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What is the statute of limitations for an SEC enforcement action?

Where the SEC seeks a "civil fine, penalty, or forfeiture, pecuniary or otherwise" in an enforcement action, it must bring the action "within five years from the date when the claim first accrued." Congress may extend or shorten this period through legislation. (28 U.S.C. § 2462.)

The limitations period for a civil enforcement action seeking monetary civil penalties begins to run when the alleged misconduct occurred, rather than when the SEC discovered or should have discovered it (*Gabelli v. SEC*, 568 U.S. 442, 448, 454 (2013)).

As discussed below, enforcement actions seeking a civil fine, forfeiture, or disgorgement are clearly subject to the five-year statute of limitations. However, federal courts have differed on whether to apply this limitations period where the SEC seeks injunctive relief. Where the SEC pursues an injunction, courts have tried to determine whether the relief sought constitutes a "penalty" within the meaning of the statute.

How do courts determine whether a particular remedy qualifies as a penalty for Section 2462 purposes?

In *Kokesh v. SEC*, the Supreme Court considered whether disgorgement is a penalty under Section 2462, which would render Section 2462's five-year statute of limitations applicable to any SEC enforcement action seeking disgorgement. The *Kokesh* Court set forth a two-part test for courts to apply when considering whether a form of relief constitutes a penalty under Section 2462.

Kokesh involved an enforcement action against Charles Kokesh over his misappropriation of client funds and filing of false and misleading SEC reports and proxy statements on behalf of the company he owned between 1995 and 2009. Following a five-day trial, a jury found that Kokesh violated various securities laws. The district court found that Section 2462 precluded the SEC from imposing civil monetary penalties for violations that occurred before 2004 (five years before the SEC filed its enforcement action). However, the district court agreed with the SEC that disgorgement was not a civil penalty and, therefore, Section 2462 was not triggered. The court entered a disgorgement judgment, a large portion of which was based on Kokesh's pre-2004 violations.

In keeping with the SEC's usual practice in enforcement actions, the disgorgement order was for the full amount of the funds connected to Kokesh's misconduct, including the amount of funds that third parties received. Kokesh appealed the order, asserting that Section 2462 precluded the SEC from seeking or imposing disgorgement of the amounts associated with his pre-2004 conduct. The Tenth Circuit affirmed the district court's ruling and the Supreme Court granted *certiorari*.

The Supreme Court began its analysis by observing that a penalty is a "punishment, whether corporal or pecuniary, imposed and enforced by the State, for a crime or offen[s]e against its laws." The Court explained that this analysis turns on two factors:

- **Whether the remedy redresses a public or private wrong.** A court should first consider "whether the wrong sought to be redressed is a wrong to the public, or a wrong to the individual." That is, a court must ask whether the relief is sought as a consequence for violating a public law.
- **The purpose of the sanction.** A court should next consider whether the sanction sought is "for the purpose of punishment, and to deter others from offending in like manner." Where the sanction is intended at least in part to punish, it is a penalty.

(*Kokesh v. SEC*, 137 S. Ct. 1635, 1641-42 (2017) (citing *Huntington v. Attrill*, 146 U.S. 657, 668 (1892)).)

Applying this framework, the *Kokesh* Court noted that "in many cases, SEC disgorgement is not compensatory," because some of the disgorged funds are "dispersed to the United States Treasury" rather than "victims." Therefore, the Court concluded that because SEC-sought disgorgement orders "go beyond compensation, are intended to punish, and label defendants wrongdoers as a consequence of violating public laws, they represent a penalty and thus fall within the 5-year statute of limitations of § 2462." (*Kokesh*, 137 S. Ct. at 1644-45 (internal quotations and citation omitted).)

Although *Kokesh* provides a clear two-part framework for evaluating when a form of relief qualifies as a penalty (rendering it subject to Section 2462), courts prior and subsequent to *Kokesh* have grappled with whether injunctions, which the SEC routinely seeks in enforcement actions, may constitute penalties under Section 2462.

Had the circuit courts considered injunctions to be penalties under Section 2462 before *Kokesh*?

Before *Kokesh* was decided, the circuit courts disagreed on whether an injunction qualifies as a civil penalty under Section 2462.

The Fifth, Ninth, and DC Circuits have held that Section 2462, and its five-year statute of limitations, applies to certain injunctions (see *SEC v. Bartek*, 484 F. App'x 949, 956-57 (5th Cir. 2012) (holding that a permanent injunction enjoining the defendants from violating any securities law and barring them from serving as officers or directors of any public company were penalties under Section 2462); *Johnson v. SEC*, 87 F.3d 484, 488, 492 (D.C. Cir. 1998) (holding that censure and a six-month suspension from working with any broker-dealer constituted a penalty under Section 2462); *Fed. Election Comm'n v. Williams*, 104 F.3d 237, 240 (9th Cir. 1996) (in a case brought under the Federal Election Campaign Act,

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holding that because the claim for injunctive relief was connected to the claim for legal relief, Section 2462's statute of limitations applied to both) (citing *Cope v. Anderson*, 331 U.S. 461, 464 (1947))).

The Tenth Circuit anticipated the *Kokesh* test in a case concerning whether an injunction ordering restoration of polluted wetlands operated as a penalty, stating in *dicta* that the court construes Section 2462 as applying to non-monetary penalties. The Tenth Circuit held that the injunction in the case at bar, which sought solely to restore the wetlands damaged by the defendant to their prior condition, was not a penalty because its "purpose" was not to "punish an offense against the public." Rather, the injunction did not go "beyond remedying the damage caused" and sought solely to "restore" the "status quo." (*United States v. Telluride Co.*, 146 F.3d 1241, 1245-46 (10th Cir. 1998).)

Post-*Kokesh* decisions suggest that the question of whether an injunction is a penalty under Section 2462 is ripe for consideration by the Supreme Court.

The Sixth Circuit has been more circumscribed, declining to say whether injunctions can ever be Section 2462 penalties and holding only that the particular injunctions before the court were not punitive (*SEC v. Quinlan*, 373 F. App'x 581, 587-88 (6th Cir. 2010)).

Before the *Kokesh* decision, only the Eleventh Circuit held that injunctions cannot be penalties under Section 2462 (*SEC v. Graham*, 823 F.3d 1357, 1362 (11th Cir. 2016)). As discussed below, following the *Kokesh* decision, the Third Circuit in *SEC v. Gentile* joined the Eleventh Circuit in holding that injunctions are not penalties.

How have courts applied the *Kokesh* analytical framework when determining whether an injunction is a penalty under Section 2462?

Courts have grappled with the interpretation of *Kokesh*, and post-*Kokesh* decisions suggest that the question of whether an injunction is a penalty under Section 2462 is ripe for consideration by the Supreme Court.

In a recent decision, the Third Circuit in *SEC v. Gentile* considered whether an injunction against future securities law violations (known as an "obey the law" injunction) and an injunction barring participation in the penny stock industry constituted penalties under Section 2462. The district court held that both were "punitive in nature" and therefore penalties, finding that neither would "compensate or benefit" a "single 'victim'" or "restore any '*status quo ante*'" (*SEC v. Gentile*, 2017 WL 6371301, at *4 (D.N.J. Dec. 13, 2017)). The Third Circuit reversed, noting that nothing in the text of either provision that authorizes courts to issue injunctions, 15 U.S.C. § 78u(d)(1) and (6), departs from the rule that injunctions are meant to prevent harm rather than punish wrongdoing. The Third Circuit held that injunctions that are properly issued and valid in scope are not penalties and therefore are not governed by Section 2462. The Third Circuit also warned that "[i]f an injunction cannot be supported by a meaningful showing of actual risk of harm, it must be denied as a matter of equitable discretion — not held time barred by § 2462." (939 F.3d 549, 557, 562 (3d Cir. 2019).)

In *SEC v. Collyard*, the Eighth Circuit held that an obey the law injunction was not punitive under Section 2462. The Eighth Circuit found that the deterrent effect of an obey the law injunction was an incidental effect of the particular injunction at issue and that the injunction's primary purpose was to prospectively protect the public from the defendant's potential fraud. Like in *Gentile*, the *Collyard* court highlighted that "[t]he courts of appeals [are] split over whether an injunction can be a § 2462 'penalty.'" In contrast to *Gentile*, however, *Collyard* expressly found that *Kokesh* undermined its prior "determination that a claim is not a 'penalty' simply because it is 'equitable.'" The court reasoned that "[j]ust as disgorgement's 'equitable' label does not exempt it from being a § 2462 'penalty,' injunction's 'equitable' label does not exempt it from being a § 2462 'penalty.'" (861 F.3d 760, 763-65 (8th Cir. 2017).)

A New York federal district court in *SEC v. Cohen* dismissed an SEC enforcement action in its entirety as untimely under Section 2462. Citing *Kokesh*, the court held that an obey the law injunction the SEC sought

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would function at least partially to punish the defendants by stigmatizing them in the eyes of the public and therefore was a penalty that is subject to Section 2462's five-year statute of limitations. The court also used the *Kokesh* analytical framework to dismiss the SEC's disgorgement and civil penalty claims as time-barred under Section 2462. Notably, the court dismissed the action despite multiple tolling agreements between the SEC and one of the defendants, construing those agreements as applying only to the specific investigation referenced in the agreements and not to subsequent investigations that arose out of the initial inquiry. (332 F. Supp. 3d 575, 587-95 (E.D.N.Y. 2018).)

SEC Enforcement Toolkit

The SEC Enforcement Toolkit available on Practical Law offers a collection of resources to help counsel represent clients in all stages of the SEC's investigation and enforcement process. It features a range of continuously maintained resources, including:

- Roadmap of the SEC's Investigation and Enforcement Process
- Navigating the SEC's Wells Process
- Navigating SEC Administrative Proceedings
- Responding to a Securities Regulator's Request for Information and Documents Checklist
- Confidentiality Request to a FOIA Officer Accompanying a Production of Documents to the SEC
- Letter Accompanying the Production of Documents to a Securities Regulator
- SEC Enforcement Actions: Comparison of Key Rules
- Settling Securities Cases with Regulators

How has the SEC interpreted *Kokesh* outside of the disgorgement context?

Respondents and appellants to the SEC have challenged industry suspensions and bars as impermissibly punitive in light of *Kokesh*, but the SEC has remained firm in its interpretation that the *Kokesh* analysis does not extend to remedies other than disgorgement.

For example, in *In the Matter of the Application of John M.E. Saad for Review of Disciplinary Action Taken by FINRA (In re Saad)*, the SEC sustained the Financial Industry Regulatory Authority's (FINRA's) decision to permanently bar John Saad from FINRA membership and from working with any of FINRA's members. The DC Circuit denied Saad's appeal and remanded the case to the SEC to determine whether *Kokesh* had any bearing on the SEC's decision, even though Saad had argued that a lifetime bar was impermissibly punitive, not that it was time-barred under Section 2462 (*Saad v. SEC*, 873 F.3d 297, 304 (D.C. Cir. 2017)).

On remand, the SEC upheld the bar, finding that there was no basis for extending the *Kokesh* analysis to FINRA bars because these types of debarments are remedial to protect investors and not punitive. The SEC also noted that *Kokesh* applies only to pecuniary remedies, which do not include permanent injunctions such as the one FINRA imposed on Saad. (*In re Saad*, 2019 WL 3995968, at *2 (Aug. 23, 2019); see also, for example, *In the Matters of Karen Bruton & Hope Advisors, LLC*, 2019 WL 4693573, at *6 (Sept. 16, 2019) (rejecting the respondents' arguments that a securities industry bar and censure are penalties under *Kokesh* and finding that *Kokesh* did not apply).)

The SEC's attempts to limit the reach of *Kokesh* could be further tested if Saad files another appeal with the DC Circuit. Notably, the SEC's ruling differed from then-DC Circuit Judge Kavanaugh's concurring opinion, in which he reasoned that suspension and expulsion of a securities broker is punitive under *Kokesh* (*Saad*, 873 F.3d at 304-05 (Kavanaugh, J., concurring)).

How does the *Kokesh* decision affect the SEC's ability to seek disgorgement in an enforcement action?

According to the SEC, it has forgone approximately $1.1 billion dollars in time-barred disgorgement due to *Kokesh* (see SEC Division of Enforcement, 2019 Annual Report at 21, available at *sec.gov*). However, the five-year statute of limitations is not the SEC's only potential challenge in seeking disgorgement.

A footnote in the *Kokesh* decision raises a broader question about the SEC's authority to pursue disgorgement, given that there is no statute authorizing the courts to order SEC-sought disgorgement (rather, courts use their equitable power to do so) (137 S. Ct. at 1642 n.3). Indeed, on November 1, 2019, the Supreme Court granted a petition for writ of *certiorari* to determine whether the SEC has the authority to seek and obtain disgorgement in federal court as a penalty for securities law violations (*Liu v. SEC*, 2019 WL 5659111, at *1 (U.S. Nov. 1, 2019)).

Additionally, following the *Kokesh* decision, legislation was introduced in both the House of Representatives and the Senate that would codify the SEC's ability to seek disgorgement. Most recently and of particular importance, the House passed a bipartisan bill on November 18, 2019 that would explicitly authorize SEC-sought disgorgement and give securities regulators an expanded limitations period of 14 years to pursue actions for disgorgement and injunctions. The bill was received in the Senate and referred to the Committee on Banking, Housing, and Urban Affairs. (H.R. 4344, 116th Congress (2019); see also S. 799, S. 2563, 116th Congress (2019-2020), available at *congress.gov*.)

Therefore, the legality of SEC disgorgement is being addressed both by the Supreme Court and Congress.

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What do the post-*Kokesh* decisions suggest about the viability of future SEC enforcement actions seeking injunctions?

As discussed above, the question of whether the SEC may properly seek injunctions as a result of conduct that took place more than five years before an enforcement action is ripe for resolution by the Supreme Court. However, the applicability of Section 2462's statute of limitations is not the only element of the SEC's power to seek injunctions that the Supreme Court should consider. In *Gentile*, the Third Circuit emphasized that under the statute authorizing SEC-sought injunctions, district courts may properly issue injunctions only where the SEC:

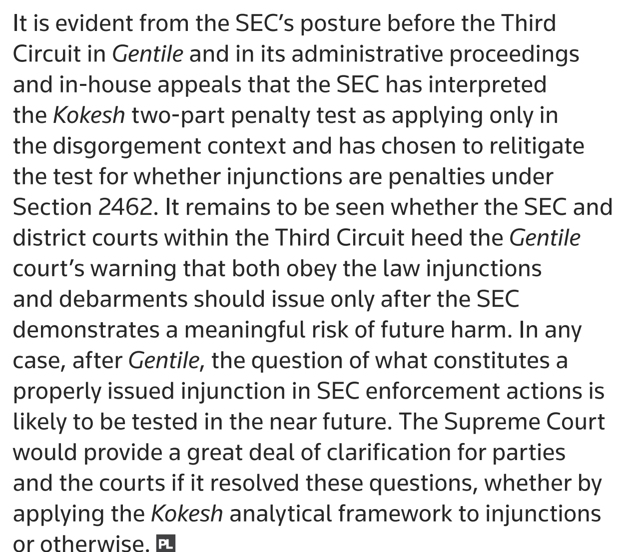
- Supports the request with a substantial showing of threatened harm.
- Tailors the injunction to enjoin only that conduct necessary to prevent a future harm, rather than to punish.

(939 F.3d at 560, 565.)

The Third Circuit therefore left open the possibility for a particular injunction to be denied as unsupported by an adequate showing or overbroad in scope. Should the Supreme Court endeavor to resolve the circuit split on whether injunctions are penalties under Section 2462, by granting *certiorari* in *Gentile* or another case, the Court should apply the two-part test set forth in *Kokesh* because it provides a clear framework for determining whether a sanction is a penalty under Section 2462. The Court should also consider whether certain types of injunctive relief, such as obey the law injunctions and industry bars, are categorically penalties.

In light of these developments and open issues, is the SEC likely to change its approach to seeking remedies in enforcement actions?

Assuming that the combination of congressional action and the Supreme Court's decision in *Liu v. SEC* does not disturb the district courts' authority to order SEC-sought disgorgement, the SEC will continue to have significant freedom to fashion the disgorgement that it seeks to each particular matter before it. There is no reason to believe the SEC will change anything in its approach of seeking disgorgement in enforcement actions where Section 2462's five-year statute of limitations is not a concern unless limited by the Supreme Court or Congress.



It is evident from the SEC's posture before the Third Circuit in *Gentile* and in its administrative proceedings and in-house appeals that the SEC has interpreted the *Kokesh* two-part penalty test as applying only in the disgorgement context and has chosen to relitigate the test for whether injunctions are penalties under Section 2462. It remains to be seen whether the SEC and district courts within the Third Circuit heed the *Gentile* court's warning that both obey the law injunctions and debarments should issue only after the SEC demonstrates a meaningful risk of future harm. In any case, after *Gentile*, the question of what constitutes a properly issued injunction in SEC enforcement actions is likely to be tested in the near future. The Supreme Court would provide a great deal of clarification for parties and the courts if it resolved these questions, whether by applying the *Kokesh* analytical framework to injunctions or otherwise. PL

The authors represented the defendant in the Gentile *case discussed in this article.*

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