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Supreme Court Rejects SEC's Request for Exception to Statute of Limitations in *Gabelli*

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On February 27, 2013, the Supreme Court issued its much-anticipated decision in *Gabelli v. SEC*, unanimously rejecting the SEC's view that government agencies can bring enforcement actions seeking civil penalties for fraudulent conduct outside the applicable statute of limitations period. The unanimous decision in *Gabelli* is a significant public defeat for the SEC, and while the opinion's immediate impact should be relatively modest, over the longer term, the opinion may have a significant practical effect.

Introduction

The SEC had argued that, in enforcement actions where government agencies seek civil penalties for fraud, a "discovery rule" should apply. While acknowledging that a five-year statute of limitations generally applies to such actions, the SEC claimed that that five-year period should not begin until the government agencies discovered the fraud, rather than when the fraud allegedly took place. The Supreme Court disagreed, reasoning there was no textual, historical or equitable support for such a rule. Although a "discovery rule," subject to statutes of repose, makes sense in the context of private victims suing for fraud, the Court observed that it makes little sense in the context of government agencies specifically charged with rooting out fraud.

While the unanimous decision in *Gabelli* is a significant public defeat for the SEC, the opinion's immediate impact should be relatively modest, given that most pending SEC enforcement cases were brought within five years of the conduct at issue. Over the longer term, however, the opinion may have a significant practical effect. By providing a clear statement on statute of limitations, the opinion may prompt government enforcement agencies to rethink their approach to investigating years-old conduct (other than where statutes of limitations are much longer, such as the 10-year limitations for FIRREA claims). In the meantime, the opinion provides a welcome degree of predictability to targets of those agencies. While *Gabelli* leaves certain questions unanswered, it is unquestionably helpful to those who have been frustrated by efforts of government agencies to pursue fraud investigations for years-old conduct.

SEC v. Gabelli

Gabelli Funds, LLC, is a registered investment adviser that advises the *Gabelli* family of mutual funds. In 2008, the SEC brought a civil enforcement action against *Gabelli*'s Chief Operating Officer and a former portfolio manager. The SEC alleged that, from 1999 to 2002, the defendants had allowed an investor to engage in "market timing" in a *Gabelli* fund. The SEC asserted violations under the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-6(1) and (2), and sought civil penalties under § 80b-9.

The defendants sought to dismiss the SEC's claims as barred by the "catch-all" five-year statute of limitations period set forth in 28 U.S.C. § 2462, which applies to civil enforcement actions brought under the Investment Advisers Act and countless other federal statutes. Because it was undisputed that the allegedly improper conduct ceased in 2002, and the Complaint was not filed until 2008, the district court dismissed the SEC's civil penalty claim as time barred. But the Second Circuit reversed (in an opinion by District Judge Jed S. Rakoff, who was sitting by designation), holding that because the underlying violations sounded in fraud, a "discovery rule" applied, meaning that the statute of limitations period did not start running until the claim was "discovered" by the SEC.

The US Supreme Court granted *Gabelli*'s petition for a writ of certiorari and unanimously reversed, in an opinion authored by Chief Justice Roberts.

The Court focused first on the plain language of § 2462, which states that "an action . . . for the enforcement of any civil fine, penalty, or forfeiture . . . shall not be entertained unless commenced within five years from the date when the claim first accrued." The Court concluded that "the most natural reading of the statute," is that the claim first "accrues" not when the claim is discovered, but when the defendant's allegedly fraudulently conduct occurred, because that is when the claim first "comes into existence." (Slip Op. at 4). As the Court pointed out, "[t]his reading sets a fixed date when exposure to the specified Government enforcement efforts ends, advancing the basic policies of all limitations provisions: repose, elimination of stale claims, and certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities." (Slip Op. at 5).

Finding no textual support for a discovery rule, the Court also rejected the SEC's argument that such a rule should be implied into the statute. The Court pointed out that while a discovery rule had been applied to delay accrual of claims held by victims of fraud, such a rule "has never applied . . . in this context, where the plaintiff is not a defrauded victim seeking recompense, but is instead the Government bringing an enforcement action for civil penalties." (Slip Op. at 6). A discovery rule makes sense in the context of victims of fraud because they have no reason to learn of their victimization until years later. But, as the Court observed, one of the SEC's central missions is to investigate potential violations of the federal securities laws. "Unlike the private party who has no reason to suspect fraud, the SEC's very purpose is to root it out, and it has many legal tools at hand to aid in that pursuit," including the power to subpoena documents and witnesses and to pay monetary awards to whistleblowers. (Slip Op. at 8.).

Finally, the Court pointed out the practical difficulties that would result if a discovery rule were applied to government enforcement actions. As the Court observed, it would be nearly impossible to determine "when the Government, as opposed to an individual, knew or reasonably should have known of a fraud," given the overlapping responsibilities of agencies, their resource constraints, and their differing priorities. (Slip Op. at 9).

In sum, the Court concluded there were no "textual, historical, or equitable reasons to graft a discovery rule onto the statute of limitations of §2462," and it declined to do so. (Slip Op. at 11).

The Likely Impact of *Gabelli*

The *Gabelli* opinion is not only a very visible defeat for the SEC; it is also a significant statement by the Supreme Court regarding the importance of having a clear statute of limitations in government enforcement cases more broadly.

The immediate impact of *Gabelli* should be relatively modest. Even though the SEC pursued this exception to the generally-applicable statute of limitations, the vast majority of the SEC's enforcement actions are already brought within five years of the conduct at issue. The need to improve the pace of SEC investigations is something that was emphasized under Enforcement Director Robert Khuzami, and is likely to remain a focus if Mary Jo White is confirmed as SEC Chairman. Other government agencies generally take a similar approach. Indeed, as observed by Justice Roberts in the Court's opinion, the SEC could not point to a single instance before 2008 where a lower court had employed a fraud-based discovery rule in a government enforcement action for civil penalties.

Moreover, in those rare instances where the SEC or other government agency elects to bring an enforcement action for fraudulent conduct after the statutory period has elapsed, *Gabelli* does not preclude such cases in their entirety. Government agencies can still bring cases beyond the statute of limitations if they seek only equitable relief (such as disgorgement). *Gabelli* leaves unanswered, however, precisely what forms of relief will be considered equitable, as opposed to punitive. For example, *Gabelli* does not address whether an officer-and-director bar pursuant to Section 20(e) of the Securities Act or Section 21(d)(2) of the Exchange Act, which is one of the SEC's favorite remedies to seek, constitutes punitive or equitable relief. Lower courts have divided on that issue, but by analogizing the SEC's enforcement efforts more to criminal prosecutions than to actions by private plaintiffs, the Supreme Court provided significant language for defendants to argue that such remedies are penalties that are now subject to a five-year statute of limitations.

Similarly, there remains a question over whether the SEC or other government agencies can still benefit from "equitable tolling" of the five-year statute of limitations when a defendant engages in specific conduct to conceal the underlying fraud. In the Ninth Circuit, which had rejected a discovery rule even before *Gabelli*, the courts nevertheless permitted SEC enforcement actions for civil penalties outside the statute of limitations if it could show that the statute of limitations should be equitably tolled. While the holdings in those cases are not directly implicated by *Gabelli*, courts may now be significantly less inclined to grant equitable tolling to such cases in the future, particularly because application of an equitable tolling rule to government enforcement agencies presents many of the same practical difficulties identified by the Court in *Gabelli*.

Regardless of the precise outcome of these unanswered questions, the longer-term practical impact of *Gabelli* on government enforcement actions could be significant. *Gabelli* serves as an important check on the powers of the SEC and other government enforcement agencies. It provides a clear limitation on the government's ability to bring claims for civil penalties, and may force government agencies to rethink their allocation of resources when investigations proceed slowly and risk statute of limitations problems. Indeed, because it was a unanimous and resounding decision, government agencies are likely to proceed much more cautiously in the face of other statute of limitations questions going forward. While there is some risk that the existence of a clearer statute of limitations could pressure government agencies to pursue investigations more aggressively to avoid any potential statute of limitations issues, we expect that any such risk could be obviated somewhat by entering into tolling agreements. At the very least, the decision provides targets of government enforcement actions a strong basis to push back when the Government seeks to punish them for stale conduct.

Gabelli may also have a meaningful impact on private actions. Part of the Court's reasoning was rooted in a firm recognition of the critical importance that statutes of limitations and repose play in a fair judicial system. Given the number of important timeliness issues winding their way through the federal courts in private securities cases (including questions related to whether statutes of repose are subject to class action tolling and the application of federal agency extender statutes to the securities laws), defendants in private actions may be heartened by the views expressed by the Court.

Conclusion

The *Gabelli* decision provides a degree of welcome certainty to those facing government enforcement investigations and actions. While it leaves certain questions unanswered, the practical impact of the decision may be to pressure the SEC and other government agencies to rethink the value in bringing enforcement actions for conduct more than five years old, and it may also provide defendants additional arguments in response to stale claims brought by private securities plaintiffs.

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