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Client Alert News Flash

Latham & Watkins Securities Litigation & Professional Liability and White Collar Defense & Investigations Practices

January 4, 2021 | Number 2843

US Congress Affirms and Expands SEC's Disgorgement Authority in Annual Defense Spending Bill

The legislation — passed via the first congressional override of the Trump presidency — extends the SEC's ability to obtain disgorgement for violations of federal securities laws.

Key Points:

- As amended, the Securities Exchange Act of 1934 now expressly authorizes the SEC to seek disgorgement in both pending and future cases filed in federal district court.
- After being limited to a five-year disgorgement period by a 2017 Supreme Court ruling (*Kokesh v. SEC*), the SEC now may pursue disgorgement awards using an expanded 10-year limitations period for certain scienter-based violations, and was granted a 10-year lookback period for other forms of equitable relief in all cases.

On January 1, 2021, the US Congress overrode a presidential veto and passed the National Defense Authorization Act (NDAA), an annual military spending bill that for year 2021 exceeds $740.5 billion and 1,400 pages. Buried near the end of this massive piece of funding legislation, Congress also expressly granted the US Securities and Exchange Commission (SEC or Commission) the authority to seek disgorgement for violations of federal securities laws, and doubled the statute of limitations for disgorgement awards and other equitable remedies in certain fraud-based cases from five years to 10 years.

Background: *Kokesh* and *Liu*

Before these latest amendments, the Securities Exchange Act of 1934 (Exchange Act) did not expressly authorize the SEC to seek, or federal courts to award, "disgorgement" of ill-gotten gains for securities laws violations. Nonetheless, for nearly half a century, federal courts have allowed the SEC to pursue this remedy as a form of "equitable relief" authorized by Section 21(d) of the Exchange Act.[1]

A pair of recent Supreme Court decisions placed limits on the SEC's authority to seek disgorgement as a form of equitable relief. In 2017, the Court unanimously held in *Kokesh v. SEC* that a disgorgement order in an SEC enforcement action constituted a "penalty" subject to the five-year limitations period applicable to other civil penalties.[2] But as noted in Latham's *Client Alert* discussing *Kokesh*, the Court expressly declined to decide the antecedent question of whether the securities laws even authorized the SEC to seek disgorgement in federal court actions in the first place. The Court considered that question last year,

holding in *Liu v. SEC* that the SEC may seek disgorgement as a form of "equitable relief" so long as the remedy remains within "the bounds of traditional equity practice."[3] As noted in Latham's *Client Alert* discussing *Liu*, the Court held that traditional equity practice circumscribed the SEC's disgorgement authority in three ways: (1) the SEC cannot pursue disgorgement from multiple wrongdoers under a joint-and-several liability theory; (2) the amount of a disgorgement award must be limited to net profits, with all legitimate expenses deducted; and (3) the disgorged funds generally must be returned to investors rather than deposited into the US Treasury.

The SEC has been critical of these Supreme Court rulings, with the Director of the Division of Enforcement counting them among the primary "challenges" faced by the agency in its enforcement efforts, particularly with respect to the limitations period established in *Kokesh*.[4] Since the *Kokesh* decision, SEC officials, including former SEC Chairman Jay Clayton, repeatedly urged Congress to establish "reasonable" — but lengthier — "limitations periods" applicable to SEC disgorgement awards.[5] Previous attempts to amend the Exchange Act in light of *Kokesh* enjoyed bipartisan support but never received a floor vote in the Senate.[6]

NDAA Amendments to the Exchange Act

On January 1, 2021, Congress overrode a presidential veto for the first time during the Trump Administration to pass the NDAA.[7] In Section 6501 of the NDAA, which was added to the bill in conference committee after the NDAA had passed in both chambers, Congress appears to have finally acceded to the SEC's wishes. Indeed, Section 6501 — which at first may seem out of place in a defense spending bill — is one of several measures added to the NDAA focused on criminal enforcement against bad actors exploiting US financial systems.[8] Among the key changes to the SEC's disgorgement authority:

- Section 6501 of the NDAA amends Section 21(d) of the Exchange Act so that it now expressly authorizes the SEC, in actions filed in federal district court, 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.[9] And unlike the Exchange Act's provision for "equitable relief" analyzed in *Liu*, the newly added disgorgement provision does not expressly require that the relief be "for the benefit of investors."[10]

- Section 6501 also prescribes extended limitations periods for disgorgement and other equitable relief. The default limitations period for disgorgement is still five years, in accord with the limitations period established in *Kokesh*.[11] But for any violation that requires the SEC to "establish[]" "scienter" — including but not limited to violations of Section 10(b) of the Exchange Act,[12] Section 17(a)(1) of the Securities Act of 1933,[13] and Section 206(1) of the Investment Advisers Act of 1940[14] — Congress increased the limitations period for disgorgement to 10 years from the latest date of misconduct.[15] The extended 10-year limitations period also applies in both scienter and non-scienter actions with respect to other "equitable remedies," including injunctions and other sanctions such as industry bars and suspensions.[16]

- Particularly relevant for multinational actors, the revised Exchange Act now tolls the disgorgement and equitable relief statutes of limitations for periods of time spent by an offender outside of the United States.[17]

- The amendments to the Exchange Act apply to "any [enforcement] action or proceeding that is pending on, or commenced on or after, the date of [the NDAA's] enactment."[18]

Implications of the NDAA Amendments

The NDAA amendments may affect the Commission's enforcement policies, as the expansions of the Exchange Act provide a strong incentive for the SEC to prioritize scienter-based charges in federal court so that it may take advantage of the lengthier limitations period for disgorgement. And the potential financial impact of a 10-year lookback period will provide the Commission Staff with additional leverage in negotiated resolutions.

The extended limitations period could also result in an increase in the amounts paid in negotiated resolutions and litigated cases, as the doubled limitations period not only means more time during which the SEC can seek disgorgement, but also more total disgorgement amounts — the SEC now has the statutory authority to reach back and obtain a decade's worth of ill-gotten gains.

Moreover, the extended limitations period may have the practical impact of extending the length of the SEC's investigations (which are already lengthy) without the time pressure of the five-year clock. As a result, the SEC may seek tolling agreements less frequently. And non-US parties will likely be subject to an even longer period for potential enforcement, as time outside of the United States does not accrue toward the SEC's statute of limitations period (whether it be the standard five-year or the extended 10-year period).

This new legislation does not amend provisions of the securities laws enumerating the relief the SEC can obtain in administrative actions and cease-and-desist proceedings; it affects only the remedies available in actions brought in federal district court. But by expressly acknowledging the SEC's authority to seek industry suspensions and bars in federal court, the amendments could herald a change in SEC practice, as the agency historically has obtained such relief through administrative proceedings.

The NDAA amendments also raise several questions that may provide fertile ground for future litigation:

- As noted above, the new 10-year limitations period for disgorgement applies in actions where the alleged conduct violates any "provision of the securities laws *for which scienter must be established*."[19] This is the first US Code provision to use the term "scienter" as part of the statutory text, and it presumably carries the judicially devised definition most often applied in the Section 10(b) context: "a mental state embracing intent to deceive, manipulate, or defraud."[20] But the full scope of this provision — and whether it will include securities laws requiring the SEC to show *other* mental states, such as Section 30A of the Exchange Act, the anti-bribery provision of the Foreign Corrupt Practices Act, which requires a showing of "corrupt[]" intent[21] — is unclear.

- Whether and how the NDAA amendments will affect the three equitable limitations on disgorgement authority set forth in *Liu* remains to be seen. The SEC may argue that *Liu*'s analysis no longer applies now that the statute expressly authorizes disgorgement. But the statute does not define that term beyond its reference to recovering "unjust enrichment,"[22] and as the Court noted in *Liu*, the term "disgorgement" has generally been understood as an "equitable remedy" that reflects a "profits-based measure of unjust enrichment," "tethered to a wrongdoer's net unlawful profits."[23] Thus, while the statute's longstanding reference to "equitable relief" triggered the Court's analysis of equitable principles in *Liu*, the newly added statutory reference to "disgorgement" — also a term of art "grounded in equity" — should trigger a similar analysis, with the "contours of that term" limited "by longstanding principles of equity."[24] Any effort by the SEC to evade *Liu*'s limitations on disgorgement will therefore likely face strong arguments by defendants that the NDAA's statutory amendments do not materially change the legal standards applicable to SEC requests for disgorgement.

- Interested observers will be watching carefully to see how the SEC and courts will apply the new 10-year limitations period to disgorge past profits in pending cases. As noted, the new limitations period applies not only to future cases, but also to cases that are currently pending. The prospect of retroactively applying this limitations period to disgorge profits earned a decade before the NDAA's passage could provide further reason for courts to preserve *Liu*'s equitable limitations. Those limitations were animated in part by the Court's effort to avoid "transform[ing]" disgorgement from an equitable remedy "into a penalty" — indeed, the Court noted that the disgorgement order in *Kokesh* constituted a "penalty" precisely because it "seemed to exceed the bounds of traditional equitable principles."[25] Because the "retroactive" imposition of a penalty "can raise serious constitutional questions,"[26] courts may avoid those questions by retaining *Liu*'s limitations, thereby reducing the risk that the disgorgement award might be viewed as a penalty.

Ultimately, by affirming the SEC's disgorgement authority and extending its reach with a 10-year limitations period, Congress has paved the way for lengthier investigations and larger disgorgement awards. But the full impact of the NDAA amendments remains to be seen. The amendments not only purport to expand the SEC's options in enforcement cases but also raise several questions to be resolved through litigation.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

William R. Baker III
william.baker@lw.com
+1.202.637.1007
Washington, D.C.

Erin Brown Jones
erin.brown.jones@lw.com
+1.202.637.3325
Washington, D.C.

Leslie R. Caldwell
leslie.caldwell@lw.com
+1.415.395.8134
+1.650.328.4600
San Francisco / Silicon Valley

Kevin Andrew Chambers
kevin.chambers@lw.com
+1.202.637.2248
Washington, D.C.

Andrew Clubok
andrew.clubok@lw.com
+1.202.637.3323
+1.212.906.1272
Washington, D.C. / New York

Blair Connelly
blair.connelly@lw.com
+1.212.906.1200
New York

Alice S. Fisher
alice.fisher@lw.com
+1.202.637.2232
Washington, D.C.

Douglas N. Greenburg
douglas.greenburg@lw.com
+1.202.637.1093
Washington, D.C.

Joshua G. Hamilton
joshua.hamilton@lw.com
+1.424.653.5509
+1.213.891.8742
Century City / Los Angeles

Brian E. Kowalski
brian.kowalski@lw.com
+1.202.637.1064
Washington, D.C.

Roman Martinez
roman.martinez@lw.com
+1.202.637.3377
Washington, D.C.

Matthew Rawlinson
matt.rawlinson@lw.com
+1.650.463.3076
Silicon Valley

Sandeep Savla
sandeep.savla@lw.com
+1.212.906.1395
+44.20.7710.1000
New York / London

John J. Sikora Jr.
john.sikora@lw.com
+1.312.876.6580
Chicago

Clayton D. LaForge
clayton.laforge@lw.com
+1.202.637.2186
Washington, D.C.

Blake E. Stafford
blake.stafford@lw.com
+1.202.637.2200
Washington, D.C.

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Endnotes

1 15 U.S.C. § 78u(d)(5).

2 137 S. Ct. 1635, 1642-43 (2017); *see* 28 U.S.C. § 2462 ("Except as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued . . . .").

3 140 S. Ct. 1936, 1947 (2020).

4 Stephanie Avakian, Director, Division of Enforcement, SEC, Remarks at the Institute for Law and Economics, University of Pennsylvania Carey Law School Virtual Program (Sept. 17, 2020), https://www.sec.gov/news/speech/avakian-protecting-everyday-investors-091720.

5 Letter from Jay Clayton, Chairman, SEC, *reprinted in* 165 Cong. Rec. H8931-32 (daily ed. Nov. 18, 2019), https://www.congress.gov/116/crec/2019/11/18/CREC-2019-11-18-pt1-PgH8929.pdf; *see also Testimony on "Oversight of the Securities and Exchange Commission" Before the S. Comm. on Banking, Housing, & Urban Affairs*, 116th Cong. (Nov. 17, 2020) (statement of Jay Clayton, Chairman, SEC), https://www.banking.senate.gov/imo/media/doc/Clayton%20Testimony%2011-17-202.pdf.

6 *See* Investor Protection and Capital Markets Fairness Act, H.R. 4344, 116th Cong. (2019); Securities Fraud Enforcement and Investor Compensation Act, S. 799, 116th Cong. (2019).

7 William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, H.R. 6395, 116th Cong. (2020) (NDAA), https://www.congress.gov/bill/116th-congress/house-bill/6395.

8 Congresswoman Maxine Waters (D-CA), Chairwoman of the House Committee on Financial Service, cited this bill as one of several "measures that will help law enforcement prevent these criminals from using shell companies to hide their activities and will close loopholes and increase penalties on those bad actors who are using our system for activities that threaten the U.S. and our allies." Press Release, Waters Statement on Inclusion of Key Democratic Financial Services Bills in FY 2021 NDAA (Dec. 3, 2020), https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=407049.

9 NDAA § 6501(a)(1)(B), (a)(3) (to be codified at 15 U.S.C. § 78u(d)(3)(A)(ii), (d)(7)).

10 *Compare* 15 U.S.C. § 78u(d)(5), *with* NDAA § 6501(a)(3) (to be codified at 15 U.S.C. § 78u(d)(7)).

11 NDAA § 6501(a)(3) (to be codified at 15 U.S.C. § 78u(d)(8)(A)(i)).

12 15 U.S.C. § 78j(b).

13 15 U.S.C. § 77q(a)(1).

14 15 U.S.C. § 80b-6(1).

[15] NDAA § 6501(a)(3) (to be codified at 15 U.S.C. § 78u(d)(8)(A)(ii)).

[16] NDAA § 6501(a)(3) (to be codified at 15 U.S.C. § 78u(d)(8)(B)).

[17] NDAA § 6501(a)(3) (to be codified at 15 U.S.C. § 78u(d)(8)(C)).

[18] NDAA § 6501(b).

[19] NDAA § 6501(a)(3) (to be codified at 15 U.S.C. § 78u(d)(8)(A)(ii)(IV)) (emphasis added).

[20] *Aaron v. SEC*, 446 U.S. 680, 686 n.5 (1980) (citation omitted).

[21] 15 U.S.C. § 78dd-1(a); *see, e.g.*, *SEC v. Straub*, 921 F. Supp. 2d 244, 262-63 (S.D.N.Y. 2013).

[22] NDAA § 6501(a)(1)(B) (to be codified at 15 U.S.C. § 78u(d)(3)(A)(ii)).

[23] *Liu*, 140 S. Ct. at 1943 (citation omitted).

[24] *Id.* at 1947.

[25] *Id.* at 1946, 1949.

[26] *Opati v. Republic of Sudan*, 140 S. Ct. 1601, 1609 (2020) (citing *Landgraf v. USI Film Prod.*, 511 U.S. 244, 281 (1994)).