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Kokesh May Lead to Lower Monetary Sanctions in SEC Enforcement Proceedings

The U.S. Supreme Court's recent decision in *Kokesh v. SEC*[1] provides the defense bar with significant ammunition to argue for lower monetary sanctions in securities enforcement matters pending in federal district courts. In fact, the Supreme Court's decision may signal that the Securities and Exchange Commission's disgorgement remedy is ripe for more aggressive defense challenges in the coming years. Since 1971, the SEC has used its disgorgement remedy to collect ill-gotten gains with interest from defendants for securities law violations.

In *Kokesh*, the Supreme Court analyzed whether the SEC's disgorgement remedy is subject to the five-year statute of limitations period of 28 U.S.C. § 2462, which applies to "an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture." This was an important issue for the SEC, since it routinely sought and collected disgorgement from defendants for ill-gotten gains received more than five years before a case is filed. Prior to the *Kokesh* decision, several circuit courts of appeals were split on the issue; with the Eleventh Circuit holding that Section 2462 applies to disgorgement, and the Tenth, First, and D.C. Circuits holding that it does not.[2]

In the *Kokesh* matter, the SEC sought disgorgement of $34.9 million from Charles Kokesh, where $29.9 million was received by him outside of the five-year limitations period. After the SEC successfully prosecuted Kokesh in a jury trial, the trial court ruled in favor of the SEC on the issue of disgorgement, ordering disgorgement of the full $34.9 million plus interest. The Tenth Circuit affirmed the trial court's decision.[3]

In overruling the Tenth Circuit in a unanimous decision, the Supreme Court in *Kokesh* found disgorgement to be punitive in nature. In so doing, the court noted that disgorgement is ordered to redress violations of public laws rather than harms to private individuals, and that a primary purpose of disgorgement is deterrence. Additionally, the court found it significant that in many instances disgorgement does not have a compensatory purpose since district courts have discretion to determine whether disgorgement is used to compensate victims or simply be paid to the government. For these reasons, the court found that the SEC's disgorgement remedy "bears all the hallmarks of a penalty" and held that Section 2462 applies. As a result, the SEC is now barred from seeking disgorgement of funds received by defendants more than five years before the date a case is filed in court.

Looking ahead, the *Kokesh* decision also raises a question of whether the SEC's practice of collecting disgorgement and a civil penalty in the same case is overly punitive. In one of its few footnotes to the *Kokesh* decision, the Supreme Court made clear that it was not taking a position on the legality of the disgorgement remedy by stating, "[n]othing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context . . .." This footnote could foretell problems for the SEC. It likely signals that the court has reservations regarding whether federal district courts have the authority to order disgorgement in SEC cases, or if they do, whether that authority has been exercised correctly.

Currently, a federal district court's authority to order disgorgement is not authorized by statute. Rather, federal district courts adopted the remedy at the SEC's urging. In its early decades, the SEC was mostly limited to seeking injunctive relief in federal district courts. However, an SEC injunction only orders a party to stop committing misconduct—hardly a sanction with any teeth. Beginning in the 1960s, the SEC began pursuing ancillary relief in its injunctive proceedings in an effort to boost its enforcement powers. As part of these efforts, in 1971, the SEC successfully convinced the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*[4] to uphold a district court's disgorgement order as an equitable remedy in an insider trading case. Since then, the SEC has been successful in obtaining disgorgement orders from federal courts based on the courts' inherent equitable powers, solidifying disgorgement as a significant remedy in the SEC's enforcement arsenal. That is, until now.

After *Kokesh*, the SEC's disgorgement remedy will come under increased scrutiny. A critical question is whether disgorgement is in fact an equitable remedy as federal courts have largely presumed since *Texas Gulf Sulphur Co.* If not, federal district courts will be without power to order the remedy in SEC enforcement proceedings. By holding in *Kokesh* that disgorgement is essentially a penalty, the Supreme Court opened the door for arguments that disgorgement is not an equitable remedy since such remedies generally are not punitive in nature, but rather serve remedial purposes. Defense arguments will be stronger in cases where disgorgement is not being sought for a compensatory purpose, where the SEC is seeking disgorgement of funds not directly traceable to, or in possession of, the defendant at issue, and cases lacking egregious conduct.

Even if federal courts reject these arguments, the defense bar may be successful in arguing for lower monetary sanctions in light of the *Kokesh* decision. Going forward, federal district judges may be wary of imposing significant disgorgement and civil penalty awards in the same case since disgorgement is now considered to be a penalty. In recent years, the SEC frequently sought "one plus one" monetary sanctions where it sought a civil penalty equal to the total disgorgement amount which in turn was based on the gross pecuniary gain to a defendant. After *Kokesh*, this practice could be perceived by federal district judges as being overly punitive.

The fallout from *Kokesh* could be significant for the SEC. Ultimately, the agency may have to call on Congress for a legislative fix to grant the SEC statutory authority to seek disgorgement in district court proceedings. When it granted the SEC authority to seek civil penalties under the Remedies Act of 1990, Congress clearly intended civil penalties to supplement disgorgement as federal courts were consistently ordering the remedy by that time.[5] However, that was 27 years ago and before the *Kokesh* decision. How this plays out will be difficult to predict but expect to see further challenges to the SEC's disgorgement remedy in the coming months and years.

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[1] *Kokesh v. SEC*, No. 16-529, 2017 WL 2407471, at *9 (U.S. June 5, 2017).

[2] *SEC v. Kokesh*, 834 F.3d 1158, 1164-67 (10th Cir. 2016); *SEC v. Graham*, 823 F.3d 1357, 1363 (11th Cir. 2016); *Riordan v. SEC*, 627 F.3d 1230, 1234 (D.C. Cir. 2010); *SEC v. Tambone*, 550 F.3d 106, 148 (1st Cir. 2008).

[3] *SEC v. Kokesh*, 834 F.3d 1158, 1164-67 (10th Cir. 2016).

[4] *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir. 1971).

[5] S. Rep. No. 101-337, at 10 (1990).