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DISGORGEMENT

The SEC's New Disgorgement Powers: Questions and Consequences

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Although predominantly a military spending bill, the National Defense Authorization Act (NDAA) includes consequential changes to the SEC's power to recover disgorgement of ill-gotten gains for securities violations. Passed on January 1, 2021, over President Trump's veto, the NDAA extends the statute of limitations for disgorgement for scienter-based violations from five to 10 years and also establishes a 10-year statute of limitations for other equitable remedies, such as industry bars, for both scienter- and non-scienter-based violations. These changes may motivate the SEC to be more aggressive in pursuing scienter-based violations and in litigating cases in district courts. Regulated entities and individuals should be aware of these changes and the questions that courts will need to answer about them in coming years. In this article, we provide concrete steps companies can take in anticipation of this sea change in SEC enforcement.

See "What to Expect From the Biden Administration's New Anti-Corruption Tools" (Mar. 3, 2021).

Background

Two recent Supreme Court cases restricted the SEC's capacity to recover disgorgement for securities violations. The NDAA amends the Securities and Exchange Act in response to those decisions.

Kokesh

In *Kokesh v. SEC*, the Supreme Court held that a disgorgement order in an SEC action constitutes a "penalty." SEC disgorgement thus became subject to the five-year statute of limitations applicable to other civil penalties codified at 28 U.S.C. § 2462, which states that, "*[e]xcept 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 … ." (emphasis added).

See "SEC Enforcement After *Kokesh*" (Jun. 21, 2017).

Liu

In *Liu v. SEC*, the Supreme Court held that, while the SEC could recover disgorgement, disgorgement cannot exceed "the bounds of traditional equity practice." Per *Liu*, equity imposes three limits on disgorgement: (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 United States Treasury.

Together, *Kokesh* and *Liu* drastically altered how the SEC could seek and recover disgorgement for securities-laws violations.

See "Supreme Court Scales Back SEC's Disgorgement Remedy in *Liu v. SEC*" (Jul. 22, 2020).

The NDAA

In response to the Supreme Court reducing its disgorgement powers in *Kokesh* and *Liu*, the SEC aggressively petitioned Congress for a legislative override. For example, Stephanie Avakian, the former Director of the SEC's Division of Enforcement, counted the five-year limitations period annunciated in *Kokesh* and *Liu* amongst the key "extraordinary challenges" facing the SEC in a speech at the University of Pennsylvania Law School in September 2020.

Further, then-SEC Chairman Jay Clayton sent a letter to Congress in November 2019 urging it to lengthen the limitations period for disgorgement beyond the five years proscribed by *Kokesh*. Chairman Clayton told Congress:

> I agree that statutes of limitations serve important functions in our legal system, and as a general matter, our remedial authority should be subject to reasonable limitations periods. However, as I look across the scope of misconduct we encounter, including most notably Ponzi schemes and affinity frauds, I believe a period longer than five years from the date of the misconduct is appropriate in various circumstances. This is especially the case in our private, retail markets where there are fewer causes of action and safeguards available compared to the public capital markets.

With the NDAA, Congress directly responded to *Kokesh* and *Liu* by broadening the SEC's power to seek disgorgement. Section 6501 of the NDAA amends Section 21(d) of the Exchange Act to grant the SEC express authority, in federal district court actions, 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.

Although the default limitations period for disgorgement remains five years under *Kokesh*, the NDAA creates a 10-year limitations period – from the latest date of misconduct – for any violation that requires the SEC to prove "scienter," or an intent to deceive. Examples of such violations include Sections 10(b) and 17(a) of the Exchange Act, and Section 206(1) of the Investment Advisers Act. In contrast to the Exchange Act's "equitable relief" provision, the newly added disgorgement provision does not expressly require that the relief be "for the benefit of investors." Moreover, the 10-year statute of limitations applies to both scienter and non-scienter actions with respect to other "equitable remedies" such as injunctions, industry bars and suspensions.

Additionally, the NDAA now tolls the disgorgement and equitable relief statutes of limitations for periods of time spent by an offender outside of the United States. The NDAA applies to "any [SEC enforcement] action or proceeding that is pending on, or commenced on or after, the date of [the NDAA's] enactment."

See "Five Takeaways From Congress' Codification and Extension of SEC's Disgorgement Authority" (Feb. 3, 2021).

Open Questions Remain

Although the NDAA is a military spending statute, its changes apply broadly beyond defense procurement matters because it amends the Securities Act. Additionally, while it does not entirely revert to the pre-*Kokesh* state of play – where effectively no statute of limitations existed for SEC disgorgement – it does double the limitations period for scienter-based violations and equitable remedies from five to 10-years.

Certain of the NDAA's implications for individuals and regulated entities will not be apparent for some time. While the NDAA clearly expands the SEC's disgorgement authority, regulated persons and entities nevertheless should expect challenges to that authority on at least four grounds.

1) How Will Conduct More Than Five, but Less Than 10, Years Old Be Treated?

Given that the NDAA applies to "any [SEC enforcement] action or proceeding that is pending on, or commenced on or after, the date of [the NDAA's] enactment," courts should expect constitutional challenges by defendants now facing a 10-year limitations period for conduct they committed when the governing limitations period was only five years. These challenges will likely be based on the Ex Post Facto Clause or the Due Process Clause. The Supreme Court has held that a law which revives a time-barred prosecution after a previously applicable statute of limitations period has expired violates the Ex Post Facto Clause. Moreover, extending a statute of limitations in the civil context can infringe upon the constitutional rights of defendants under the Due Process Clause. *Kokesh*'s determination that disgorgement is a "penalty" may continue to prove relevant for purposes of the Ex Post Facto Clause analysis because the Supreme Court has held that this constitutional provision applies to "penal" statutes of limitations.

See "How the SEC May Circumvent the Five-Year Statute of Limitations on Disgorgement Under *Kokesh v. SEC*" (Aug. 16, 2017).

2) Must the SEC Return Funds to Investors?

In contrast to the Exchange Act's "equitable relief" provision as described in *Liu*, the newly added disgorgement provision does not expressly require that the relief be "for the benefit of investors." This suggests that the SEC might be able to place disgorged funds in the Treasury instead of returning them. However, Congress chose to use the term "disgorgement" and to focus on "unjust enrichment" in the NDAA, suggesting that the "bounds of traditional equity practice" associated with that term as described in *Liu* – including "return[ing] funds to victims" – still apply.

Courts likely will need to assess whether this legislative omission is sufficient to bypass the requirement that the SEC return funds to investors. The same is likely true for the two other "bounds of traditional equity practice" identified in *Liu*: (1) the SEC cannot pursue disgorgement from multiple wrongdoers under a joint and several liability theory; and (2) the amount of a disgorgement award must be limited to net profits, with all legitimate expenses deducted.

3) Which Limitations Period Applies to Violations of the FCPA's Anti-Bribery Provisions?

For the SEC to prove a violation of the FCPA's anti-bribery provisions, it must demonstrate "corrupt[]" intent.[1] Courts likely will need to analyze whether this requirement makes FCPA violations scienter-based offenses which can trigger the NDAA's 10-year limitations period for disgorgement.

No such intent must be demonstrated under the books-and-records provisions of the FCPA, suggesting that actions seeking disgorgement based on violation of the FCPA's accounting provisions remain subject to the five-year statute of limitations.

The legal definitions of "corrupt" intent and "scienter" are slightly different, suggesting the NDAA's 10-year limitations period for disgorgement might not apply. Courts define the term "scienter" in the securities context as "intent to deceive, manipulate, or defraud." By contrast, courts define the term "corruptly" to mean "a bad or wrongful purpose and an intent to influence a foreign official to misuse his official position." Put differently, "scienter" encompasses a defendant seeking to influence a *victim* through a lie, whereas "corruptly" encompasses a defendant trying to influence a foreign official *co-conspirator* through paying a bribe. Consequently, the FCPA's bribery provisions may very well not be subject to the NDAA's 10-year limitations period for disgorgement, and continue to be subject to the five-year limitations period.

Notably, the FCPA was not mentioned as an example of a scienter-based securities law in either the SEC's remarks that pre-dated the NDAA or in the language of the NDAA and its legislative history.

4) When Is an Entity Outside of the United States?

The NDAA tolls the statute of limitations "for periods of time spent by an offender outside of the United States."

This provision's application appears straightforward with respect to natural persons. For example, the statutes governing tax fraud include tolling provisions that exclude from the applicable statute of limitations any time period during which a defendant is outside of the United States. Courts apply this provision to toll the statute of limitations if the defendant is outside the United States "for whatever reason"—including "business or pleasure trips."

However, the analysis may prove more complex with respect to foreign entities. Specifically, courts likely will need to analyze whether foreign companies with United States listings, which are required to file Form F-X with the SEC – thereby appointing an agent for service of process in the United States – are "outside of the United States" at any time for purposes of this provision.

Likely Consequences

The extended limitations period for disgorgement may change the SEC's incentives when bringing enforcement actions.

More Aggressive Prosecution

A 10-year limitations period for disgorgement for a scienter-based offense may motivate the SEC to pursue such offenses more aggressively, rather than to pursue a non-scienter-based

offense that carries a five-year statute of limitations. The longer period affords the SEC more time to investigate potential claims before bringing an action and to seek a larger penalty. While this may translate into more time for entities to respond to investigative requests and to attempt to negotiate a resolution, it also means that an investigation will be open longer, subject to continued disclosure to shareholders and other investors and, in the case of individuals, restrictions on work responsibilities or employment in general.

This extended disgorgement period also may be leveraged tactically by the SEC in negotiations, in the same way entities sought to leverage the *Kokesh* and *Liu* decisions. Entities must be mindful of the strategic impact of a scienter-based offense with a 10-year disgorgement penalty on the SEC's approach to negotiations or the SEC's expectations of a company's scoping of an investigation which in and of itself may impact cooperation credit in a negotiation of a resolution. For example, the threat of a longer statute of limitations for disgorgement and other equitable remedies, such as industry bars, may be used in an attempt to convince companies and individuals to agree to settlement terms than they would not have prior to the NDAA's enactment.

Notably, an investigation of non-scienter-based offenses for which only five years of disgorgement can be recovered may proceed more quickly because the SEC remains under pressure to file an action within the five-year period, prompting the SEC to initiate an inquiry and to issue a subpoena before an entity has much of an opportunity to negotiate. The SEC likely will continue to seek tolling agreements to extend this period and to allow for more time to investigate potential claims. As evidenced by the SEC's tolling requests in the wake of *Kokesh* and *Liu*, such tolling agreements often apply to all conduct potentially violative of securities laws and not just to the conduct subject to the pending inquiry or disclosure.

Fewer Administrative Proceedings

Because the NDAA applies to district court actions, it may motivate the SEC to litigate more actions in federal court where it has an extended statute of limitations, rather than funnel the actions into administrative proceedings where the SEC might be able to recover less than 10 years' worth of disgorgement. Moreover, concerned by the prospect of a 10-year disgorgement penalty, more companies may settle matters with the SEC without the need for administrative proceedings that provide illustrative value to other entities faced with similar regulatory concerns.

Increased Pursuit of Equitable Remedies

The SEC also may be more likely to pursue other equitable remedies such as industry bars, which are now subject to the extended 10-year limitations period under the NDAA. Industry bars and debarment present significant business disruption consequences beyond monetary penalties and fines and now are subject to the extended limitations period. Entities likely will resist and potentially litigate the imposition of such remedies given the harm, but doing so further extends the life and costs of the matter, rendering negotiations all the more consequential.

See "Five FCPA Enforcement Trends That Matter to Regulators: Individual Prosecutions, Administrative Proceedings, Global Coordination, Corporate Monitors and Third Parties" (Dec. 4, 2013).

More Actions Will Be Tolled

One of the most significant aspects of the NDAA is tolling the statute of limitations for scienter-based offenses "for periods of time spent by an offender outside of the United States." Regardless of how this provision is interpreted to apply to entities (*i.e.*, whether the limitations period be tolled if an entity has an agent in the United States capable of service), this provision is likely to apply fairly strictly to individual defendants. Accordingly, firms and individuals overseas should remain cognizant of the NDAA's new tolling provision, which will effectively extend the statute of limitations even beyond 10 years in investigations with international components.

How Companies Should Respond

Although the NDAA does not eliminate completely the limitations on SEC disgorgement imposed by *Kokesh* and *Liu*, it goes a long way to restoring the SEC's disgorgement powers prior to those cases. Given the NDAA's changes, parties subject to SEC regulation should consider the following steps:

Rethink Retention Policies

Corporate entities should review their document retention and litigation hold policies. Such a review may involve working with corporate information technology departments to revise policies relating to automatic storage (and subsequent destruction) of electronically stored information (ESI) for certain periods of time. Entities subject to GDPR or similar data privacy and protection rules must ensure that any expansion of their data collection and retention based on the NDAA's limitations periods also comports with their obligations to safeguard and retain personal and consumer data under applicable privacy laws.

See "GDPR Lives On in the U.K. Post-Brexit" (Feb. 17, 2021).

Consider Expanding the Scope of Current Investigations

Parties currently subject to SEC investigations or engaging in internal investigations relating to scienter-based offenses should consider expanding the timeframe of their ESI searches and custodian interviews to reflect the expanded 10-year statute of limitations under the NDAA. This may be challenging, given that many individuals with relevant information from 10 or more years ago may have left the relevant organization and their ESI may no longer be available. However, given the expanded limitations period, extending the investigation's chronology deeper into the past will likely be necessary to evaluate the full scope of potential damages and necessary remediation.

See "eDiscovery in Multi-Jurisdictional Investigations: Preparing to Play Multi-Level Chess" (Jan. 6, 2021).

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[1] See 15 U.S.C. § 78dd-1(a); S.E.C. v. Straub, 921 F. Supp. 2d 244, 262 (S.D.N.Y. 2013).