Liu v. SEC: To Disgorge or Not to Disgorge

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On March 3, 2020, the U.S. Supreme Court will consider whether the Securities and Exchange Commission (SEC) has authority to obtain, through the federal courts, disgorgement of ill-gotten gains against defendants who have violated the federal securities laws. Three developments have made this an important issue: (1) the SEC's long-standing reliance on the federal courts' equitable power to grant (non-monetary) injunctions against SEC defendants; (2) the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("Remedies Act"), by which Congress gave the SEC statutory authority to obtain money penalties in enforcement actions; and (3) the SEC's increased use of federal courts' equitable power to extract ever-larger money disgorgements from defendants. Since 2011, total SEC disgorgements have increased sixty percent. Although the SEC gained the authority to seek monetary penalties through statutory changes in the securities laws enacted in 1990, it has continued to seek equitable relief in the form of injunctions and, more recently, to extract disgorgements for amounts not refunded to the victims of securities violations. Cumulative disgorgement amounts are now dwarfing penalty amounts: in 2015, the SEC extracted $3 billion in disgorgement payments, compared to $1.2 billion in monetary penalties.

Orders requiring that defendants "disgorge" *to the federal government* monetary amounts they have extracted from victims of their illegal securities conduct are not so different from orders requiring that the same defendants pay a significant money penalty to the federal government. In both orders, payments are made to the SEC for the ultimate benefit of the U.S. Treasury. The SEC returns to the victims the disgorged amounts only if it creates a "Fair Fund."

The issues before the Supreme Court are whether disgorgement is effectively a second penalty, and if so, should the SEC be denied the authority to obtain *disgorgements at all* or simply precluded from seeking *both* disgorgements *and* penalties?

Kokesh

In *SEC v. Liu*, 262 F.Supp.3d 957 (C.D. Cal. 2017), aff'd, 754 F. App'x 505 (9th Cir. 2018), the Ninth Circuit case under review, the SEC had alleged that Charles Liu and Xin "Lisa" Wang engaged in a securities scheme that defrauded Chinese immigrants who sought visas as part of the EB-5 program administered by the U.S. Citizenship and Immigration Services (which allows foreign citizens to obtain visas in return for investing in job-creating activities in the United States). The District Court granted summary judgment to the SEC and ordered Liu and Wang (1) to pay *to the SEC* about $26 million *in disgorgement*, an amount representing the money defrauded investors had paid them and (2) to pay *to the SEC* another $8.2 million, the amount Liu and Wang had compensated themselves during the fraud, *in civil money penalties,* and (3) to be permanently enjoined from soliciting EB-5 Program investors in the future. *SEC v. Liu,* 262 F.Supp.3d 957, 972-976. The characterization of the Defendants' "ill-gotten" gains as more than $8.2 million is problematic.

Shortly before Liu and Wang appealed the district court's decision, the Supreme Court decided *Kokesh* v. SEC, 137 S. Ct. 1635 (2017), in which the Court decided that disgorgement constituted a penalty for the purpose of the statute of limitations, but declined to decide whether the SEC had statutory authority to seek disgorgement. The unanimous Court noted that an SEC disgorgement action "bears all the hallmarks of a penalty: it is imposed as a consequence of violating a public law and it is intended to deter, not to compensate." *Kokesh*, at 1644. In considering *SEC v. Liu*, the Ninth Circuit agreed with the SEC that it was still bound by pre-*Kokesh* circuit law. *SEC v. Liu*, 754 F. App'x 505 (9th Cir. 2018).

After losing before the Ninth Circuit, Liu and Wang petitioned the Supreme Court to review the requirement to pay disgorgement. Their petition for certiorari noted that *Kokesh* had reserved the question of whether courts could order disgorgement in SEC cases and sought to have the disgorgement order undone. Petition at 2-3.

If disgorgement is a penalty, then most other enforcement remedies are also penalties and thus time-limited to five years. Moreover, if disgorgement is a penalty, then the SEC cannot seek disgorgement in court actions at all, and several SEC defendants have already set out to litigate this point. Not only did the Supreme Court determine that disgorgement was a penalty subject to the 5-year statute of limitations, set out in section 28 U.S.C. § 2462, but also that the statute of limitations starts to run upon completion of the violation.[1] In other words, the date that the SEC discovers the violation is irrelevant to the statute of limitations. Thus, it has been argued that although *Kokesh* rightly applied the proper statute of limitations to all SEC enforcement actions, it nevertheless exceeded its mandate by using the extra-statutory disgorgement to pursue civil penalties in the first place, because Disgorgement does not fit neatly into any of the categories of remedies that Congress has been specifically made available to the SEC in civil actions, and so cannot be pursued under federal securities laws. Nor can it be sought in equity, as the Supreme Court's reasoning in *Kokesh* determined that disgorgement is punitive, and courts sitting in equity cannot enforce punitive civil penalties.

In essence, the *Kokesh* decision has been the proverbial third rail of federal enforcement. Because *Kokesh* is a court decision, rather than a statute or a regulation, it also raised more questions than it answered. More than two years after the *Kokesh* decision, the SEC's use of disgorgement remains uncertain, especially in a case like *Liu v. SEC*, where the disgorgement ordered dwarves the ill-gotten gains and leaves the Target/Defendant in debt. Even where SEC does not seek punitive levels of disgorgement, the SEC has simply kept the disgorgement rather than return the ill-gotten gains to the defrauded investors, as it did in *Kokesh*.

While the *Kokesh* decision generated tremendous uncertainty and confusion, it has highlighted two important gaps within the SEC's authority that a statutory amendment can easily address: (1) the efficacy of the SEC's disgorgement power outside of the context of an administrative proceeding; and (2) determining the appropriate statute of limitations period. On September 20, 2019, the U.S. House Financial Services Committee approved a proposed solution to the problems *Kokesh* posed and the SEC's limited disgorgement authority called the Investor Protection and Capital Markets Fairness Act (H.R. 4344), also known as the "Kokesh-fix." The Bill authorizes the SEC to bring disgorgement claims in lawsuits and lengthens the statute of limitations for disgorgement, injunctions, and officer & director bars from five (5) years today to fourteen (14) years. A statutory amendment like the one proposed will likely alter the settlement calculus for public firms that violate the FCPA, and public-firm executives who accept or solicit bribes and kickbacks. The proposed statutory solution to extend the statute of limitations period takes into consideration the length of time that it can take to identify, investigate, and resolve the types of cases that often take longer to identify and resolve, like foreign bribery. The Bill also provides a definitive legal source for disgorgement outside of the administrative context.

The Kokesh-fix has several benefits. First, the SEC frequently prosecutes violations older than 5 years. Based on charges included in the filed complaints and OIPs, 37 percent of cases filed in FY 2010 to 2018 included at least some violations that were completed more than five years before the SEC filed suit. That share has gradually increased from fewer than 30 percent in FY 2010 to almost half in 2018. By extending the statute of limitations from five (5) years to fourteen (14) years, the SEC will have greater clarity as to the temporal extent of its authority. On the other hand, the Kokesh-fix does not address that manner in which the SEC extracts perpetrators of their ill-gotten gains. SEC actions frequently net awards in excess of the dollar value of such gains, leaving the defendant worse off than before. *See, e.g., SEC v. Contorinis*, 743 F.3d 296, 306 (2d Cir. 2014); and *SEC v. Clark*, 915 F.2d 439, 454 (9th Cir. 1990).

1 According to an earlier Supreme Court decision in *Gabelli v. SEC*, the 5-year clock begins to run the moment the violation is completed, not when the agency discovers it. Any violations outside that window cannot be prosecuted, even if part of a long-running fraudulent scheme.

Second, while some types of violations are easier to discover, and therefore, investigated and prosecuted during the five-year statute of limitations, others types of violations are exceedingly difficult to even identify, let alone resolve within five years. Schemes involving insider trading or stock manipulation, for example, are, on average, concluded within a 5-year limitations period. Regulators can detect possible suspicious trading activity nearly instantaneously.

Conversely, FCPA violations and foreign bribery/extortion cases can rarely prosecuted within a 5-year limitations period, because the underlying conduct is often done secretly or covertly, and the parties involved typically have no incentive to report the violations. Potential whistleblowers may be discouraged from reporting or even partially implicated further disincentivizing from reporting the illegal activity.

Third, as evidenced by the fact that the SEC settles approximately half of the cases it brings (52% in FY 2018), the ability to leverage the panoply of remedies at its disposal during negotiations can better allow the SEC to tailor “optimal” settlements in lieu of litigation. With regard to the five (5) year limitations period, the SEC typically secures a tolling agreement to pause the statute of limitations during an investigation to preserve its claims for civil fines and disgorgement. While it remains to be seen whether defendants prove more reluctant to agree to tolling agreements as a result of *Kokesh*, that possibility has caused some to suggest that the SEC should seek a statutory fix to this problem, and an adverse outcome in *Liu* would lend more impetus to such suggestions.

Ultimately, the need for clarity is apparent given the confusion that *Kokesh* has caused. Even with disgorgement classified as a penalty, the important regulatory objectives of partial deterrence and compensation can still be achieved. The SEC has been settling most of its cases since the 1940s and can still negotiate disgorgement in exchange for a more limited injunction. In the same vein, the SEC’s ability to compensate fraud victims should remain largely unaffected, because perpetrators still have incentive to settle. While the proposed statutory “fix” will provide the definitive temporal cut-off to liability that many defendants desire, it is unlikely to completely satisfy potential victims of illegal activity, because many violators will likely be undeterred by an extension of the limitations period for two reasons. First, limiting disgorgement to the administrative context can incentivize the commission of fraud, because the probability of being caught decreases. Second, investors who invest $5,000 or less may not have enough incentive to sue, and many perpetrators target the unsophisticated, the elderly, and relatively poorer investors specifically because they lack the means to detect the fraud, much less sue.

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