

Second Circuit Limits the SEC's Disgorgement Power

By Thomas McKay

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In *Liu v. SEC*, 140 S. Ct. 1936 (2020), the Supreme Court limited the U.S. Securities and Exchange Commission's (SEC) disgorgement power to cases where disgorgement is "awarded for victims." In its recent decision in *SEC v. Govil*, 2023 WL 7137291 (2d Cir. Oct. 31, 2023), the U.S. Court of Appeals for the Second Circuit further limited the SEC's power by construing "victims" to be limited to those who suffer pecuniary harm. This holding will likely prevent the SEC from obtaining disgorgement in numerous types of cases, such as those involving books and records or registration violations, and even insider trading.

'Liu' and Subsequent Statutory Amendments

In 2020, the Supreme Court held that the SEC may seek disgorgement in a civil enforcement action, even though it is not explicitly authorized by the Securities Exchange Act of 1934 (Exchange Act), so long as the disgorgement award does not exceed a wrongdoer's net profits and the award is paid to the wrongdoer's victims. See generally *Liu*, 140 S. Ct. 1936.

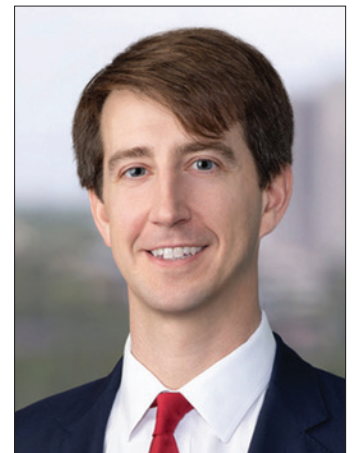
The court reasoned that since 15 U.S.C. §78u(d)(5) authorizes the SEC to seek "equitable relief" in civil proceedings, equity jurisprudence instructs that disgorgement can qualify as

an equitable remedy if courts restrict the SEC from seeking disgorgement in excess of a wrongdoer's net profits.

Further, to adhere to the language of §78u(d)(5), which authorizes equitable relief "for the benefit of investors," the court held that disgorgement must be awarded for victims.

After *Liu*, Congress amended the Exchange Act as part of the National Defense Authorization Act for Fiscal Year 2021 (NDAA) to add §78u(d)(7), which explicitly authorizes the SEC to "seek" and courts to "order" disgorgement. Following the amendment, questions arose whether Congress intended §78u(d)(7) to simply codify *Liu* or to expand the SEC's authority.

The U.S. Court of Appeals for the Fifth Circuit took the latter view in *SEC v. Hallam*, 42 F. 4th 316 (5th Cir. 2022), holding that the amendment authorizes a distinct type of "legal disgorgement" not subject to equitable limitations recognized in



Thomas A. McKay of Morvillo Abramowitz Grand Iason & Anello.

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Liu. The U.S. Court of Appeals for the Second Circuit disagreed with *Hallam's* statutory analysis in *SEC v. Ahmed*, 72 F.4th 379 (2023), holding that the amendment did not supplant *Liu* and that “disgorgement under § 78u(d)(7) must comport with traditional equitable limitations as recognized in *Liu*.”

Therefore, at least in the Second Circuit, *Liu* and its limitations apply to both §§78u(d)(5) and (d)(7).

‘Govil’

In *Govil*, the Second Circuit addressed who qualifies as a “victim” for whom SEC disgorgement proceeds may be sought and awarded. See generally *Govil*, 2023 WL 7137291. In *Govil*, the SEC brought a civil enforcement action against Aron Govil for causing Cemtrex Inc., a purported diversified industrial and technology company he controlled, to engage in fraudulent securities offerings in violation of the Securities Act and Exchange Act.

From 2016 through 2017, Govil represented to investors that Cemtrex would use transaction proceeds to satisfy outstanding debts and for general corporate purposes, such as new product development and acquisitions, when in fact Govil had diverted over \$7.3 million of offering proceeds to his private accounts.

Govil entered into two agreements to resolve his misconduct. First, Govil entered into an agreement with Cemtrex in which Govil agreed to surrender all company stock, valued at \$5,556,720, and agreed in a promissory note to pay the remaining amount owed to the company, in exchange for the company’s release of all claims against Govil. Second, Govil entered into an agreement with the SEC in which Govil agreed not to challenge the SEC’s civil enforcement action and the entry of several permanent

injunctions and civil fines. However, that agreement left it up to the court to decide the issue of monetary relief, including a disgorgement award.

The SEC sought disgorgement of approximately \$7.3 million pursuant to §§78u(d)(5) and 78u(d)(7). U.S. District Judge J. Paul Oetken of the Southern District of New York decided that while disgorgement was available, Govil must receive credit for the amount he owed in the promissory note (approximately \$1.5 million) because it would “right” at least some of the “wrong” that the victims of Govil’s fraud suffered – the money would go towards corporate expenses. See *SEC v. Govil*, 2022 WL 1639467 (S.D.N.Y. May 24, 2022).

In contrast, the district court held that Govil’s surrender of company stock should not be credited toward disgorgement, since the “real victims” were Cemtrex’s investors, who “received nothing” from the stock transfer. Govil appealed, arguing that the court did not have the authority to order disgorgement pursuant to §§78u(d)(5) or 78u(d)(7), and even if it did, the disgorgement award should be offset by the value of his surrendered securities.

The Second Circuit agreed with both arguments and vacated and remanded the decision with instructions.

The court reiterated that, consistent with *Liu* and *Ahmed*, disgorgement must be “awarded for victims.” Critically, the court then held that “an investor who suffered no pecuniary harm as a result of the fraud is not a victim.” *Govil*, 2023 WL 7137291, at *5. It reasoned that equitable disgorgement is focused on “returning value to a wronged party,” which presupposes pecuniary harm.

It had reasoned that the investors were victims because they were lied to about the intended

uses of their investments, but the Second Circuit rejected that analysis. It found that while the investors might be victims in some colloquial sense, the term “victim” in this context requires a finding of pecuniary harm. The “pecuniary harm” requirement also serves to prevent the SEC from circumventing similar limitations on private securities fraud claims. Even defrauded investors might earn a profit on their investment notwithstanding the defendant’s wrongdoing, and in such cases, disgorgement would confer a windfall.

Because the district court made no finding of pecuniary harm, the circuit remanded for further proceedings. The court instructed that on remand, the district court undertake a valuation of the securities surrendered by Govil and offset any disgorgement award by that amount.

Consequences of ‘Govil’

Going forward, the SEC may only seek disgorgement—at least in the Second Circuit—where it can establish the presence of a victim or victims who suffered pecuniary harm. This holding will likely prevent the SEC from obtaining disgorgement in a variety of contexts in which it has routinely done so in the past.

For example, the SEC has frequently sought disgorgement in the context of books and records or internal control violations. Similarly, the SEC has sought disgorgement for a variety of registration violations, such as unregistered securities offerings, failures to register as a securities exchange, or failures to register as an investment advisor. In all these types of cases, the SEC may have serious difficulties

identifying a victim who has suffered pecuniary harm, and therefore may be unable to obtain disgorgement.

Govil also casts serious doubt on the SEC’s ability to seek disgorgement in insider trading cases. Courts and scholars have recognized that the principal harm of insider trading is that a trader who misuses inside information undermines the integrity of and public confidence in a fair market. That sort of diffuse informational harm does not satisfy *Govil*’s pecuniary harm requirement.

While the SEC and private litigants have at times attempted to quantify losses to investors, it is difficult if not impossible to identify particular counterparties that have been harmed by alleged insider trades. That is so for a number of reasons, including that most contemporaneous traders would have traded at the same price anyway.

Govil thus imposes a substantial barrier to the SEC’s ability to obtain disgorgement in insider trading cases, which it may rarely, if ever, be able to surmount.

Conclusion

The Second Circuit’s holding in *Govil* is a substantial blow to the SEC’s enforcement powers and provides defendants the ability to oppose disgorgement in a wide variety of cases in which there is no pecuniary harm to identifiable victims.

Thomas McKay is a partner at *Morvillo Abramowitz Grand Iason & Anello*. **Emily Smit**, an associate at the firm, assisted in the preparation of this column.