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Challenge to SEC's Disgorgement Authority Reaches Supreme Court

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On Nov. 1, 2019, the U.S. Supreme Court granted *certiorari* in *Liu v. Securities and Exchange Commission* to address a question that, until fairly recently, seemed clear beyond cavil: whether the SEC has authority to obtain disgorgement in civil actions to enforce the federal securities laws. Since the 1970s, disgorgement of ill-gotten gains has been a powerful and frequently utilized weapon in the SEC's arsenal. In its June 2017 decision in *Kokesh v. SEC*, 137 S. Ct. 1635 (2017), the Supreme Court characterized SEC disgorgement as a "penalty" rather than an equitable remedy but expressly declined to decide whether courts possess authority to order disgorgement in SEC enforcement proceedings. In *Liu*, the Court will address head-on the question left open in *Kokesh*. The outcome of *Liu* has the potential to upset long-standing precedent and practices. If the Court further restricts the SEC's ability to obtain disgorgement, the decision will have significant ramifications for the SEC's enforcement program.

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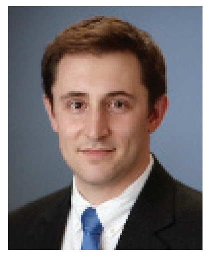

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Evolution of the SEC's Authority

No statute expressly authorizes courts to award disgorgement to the SEC in civil enforcement actions. Rather, by statute, the SEC in district court proceedings may obtain only injunctions, civil monetary penalties, bars and suspensions from certain types of employment in the securities industry, and equitable relief. *See*, 15 U.S.C. §§77t; 78u(d). Nevertheless, for decades the SEC routinely has sought — and courts have granted — disgorgement as a component of equitable relief.

The SEC's disgorgement authority began as a judicially-implied remedy to fill a statutory gap. As originally enacted in the 1930s, federal securities laws authorized the SEC to obtain injunctive relief but did not authorize the SEC to obtain any monetary relief. Beginning with the *Texas Gulf Sulfur* case in 1970, the SEC successfully persuaded courts to order so-called "equitable" monetary relief as an exercise of their "inherent equity power to grant relief ancillary to an injunction" in order to "effectuate the purpose" of the Exchange Act. *SEC v. Texas Gulf Sulphur Co.*, 312 F. Supp. 77, 91 (S.D.N.Y. 1970), *aff'd in part and rev'd in part*, 446 F. 2d 1301 (2d Cir. 1971).

Over time, Congress conferred on the SEC an expanding range of enforcement tools, including the power to seek monetary relief, but no legislation expressly confirmed the SEC's authority to obtain disgorgement in civil actions. In 1984 and 1988, Congress enacted and then expanded the first legislative grant of monetary penalty authority to the SEC, authorizing fines of up to $1 million or three times the profit gained or loss avoided in insider trading actions. *See*, 15 U.S.C. §78u-1(a). In 1990, as part of the Securities Enforcement Remedies and Penny Stock Reform Act (Remedies Act), Congress broadened the SEC's penalty authority in enforcement proceedings more generally, authorizing civil monetary penalties either based on a per-violation calculation, or up to the "gross amount of pecuniary gain." 104 Stat. 932, codified at 15 U.S.C. §77t(d). The Remedies Act also authorized administrative law judges to administratively order disgorgement, 15 U.S.C. §§77h-1; 78u-2; 78u-3; 80a-9(e); 80b-3(j). Notably, however, the Remedies Act contained no express grant of comparable disgorgement authority to the SEC in federal court proceedings. Similarly, in

2002, Congress enacted Section 305 of the Sarbanes-Oxley Act of 2002, which provided that in civil enforcement actions, "the Commission may seek, and any federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors," 15 U.S.C. §78u(d)(5), but contained no express mention of disgorgement. Most recently, the 2010 Dodd-Frank Act explicitly authorized the CFTC to obtain court-ordered disgorgement, 7 U.S.C. §13a-1, but again, no similar authorization was given to the SEC.

Even after Congress provided the SEC with "a full panoply of enforcement tools," *Kokesh*, 137 S. Ct. at 1640, disgorgement has remained a mainstay of the SEC enforcement program. Total disgorgement in recent years has amounted to billions of dollars, dwarfing civil fines. Disgorgement has become a uniquely powerful tool in part because, as a judicial construct, it has been uncabined by any clear statutory limitations. Under the rubric of SEC disgorgement, courts frequently have ordered monetary penalties well in excess of ill-gotten funds retained by defendants. Thus, for example, SEC disgorgement orders have required a defendant to "disgorge" not only the ill-gotten profits that he or she personally retained, but also funds that the defendant had transferred to others or spent in perpetuating the scheme, or even profits earned by others that the defendant never possessed at all. *See*, *SEC v. Contorinis*, 743 F.3d 296, 302 (2d Cir. 2014) ("[A]n insider trader may be ordered to disgorge not only the unlawful gains that accrue to the wrongdoer directly, but also the benefit that accrues to third parties whose gains can be attributed to the wrongdoer's conduct.") Further, the SEC routinely threatens — and often seeks — disgorgement *in addition* to civil fines, even where such fines are calculated based on the gross amount of pecuniary gain.

The Supreme Court's Decision In *Kokesh* and Footnote 3

In June 2017, the Supreme Court unanimously decided *Kokesh v. SEC*, holding that disgorgement was a "penalty" and therefore subject to the general five-year statute of limitations in 28 U.S.C. §2462, which governs any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture." At oral argument, five justices pointedly questioned the SEC's authority to seek disgorgement *at all* in civil actions, and several amici urged the court to resolve that question in the negative. In reaching its decision, the Court declined to address whether courts have authority to award disgorgement in SEC enforcement proceedings, but in the opinion's frequently cited "Footnote 3" the Court highlighted that question as unresolved:

> Nothing 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. The sole question presented in this case is whether disgorgement, as applied in SEC enforcement actions, is subject to §2462's limitations period.

In the more than two years since *Kokesh* was handed down, securities law practitioners and scholars widely predicted that the Supreme Court would soon take up the issue of disgorgement again. *See*, *e.g.*, Robert Anello, "Chronicle of Disgorgement's Death Foretold: Kokesh v. SEC," *Forbes* (Jul. 11, 2017) (http://bit.ly/2skQ4Jr) (describing the *Kokesh* footnote as a "ticking time bomb"). Meanwhile, since *Kokesh*, numerous defendants have challenged, without success, the authority of courts to order disgorgement in SEC actions. Among those unsuccessful defendants were Charles Liu and Xian Wang.

The *Liu* Case

Charles Liu and Xian Wang had raised approximately $27 million from Chinese investors under the EB-5 Immigrant Investor Program, which allows foreign citizens to obtain visas in exchange for investments in the United States. In May 2016, the SEC sued Liu and Wang for violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and SEC Rule 10b-5. The SEC alleged, and the district court ultimately found, that the defendants diverted roughly $8.2 million dollars to themselves, and spent nearly $13 million on marketing expenses, in violation of the offering documents. The district court ordered the defendants to disgorge $26.7 million, representing nearly the entire amount raised from investors, without deducting amounts characterized by the defendants as legitimate business expenses. The court also issued an injunction and imposed civil monetary penalties of $6.7 million on Liu and $1.5 million on Wang, representing the amounts that they each personally gained.

The Supreme Court's *Kokesh* decision was handed down after the district court had ruled but shortly before the defendants' appeal to the Ninth Circuit. On appeal, the Ninth Circuit affirmed, rejecting defendants' argument that the disgorgement award was unsustainable in light of *Kokesh*.

In their *certiorari*-stage brief, petitioners argued that because disgorgement is a "penalty" under *Kokesh*, it does not constitute an injunctive or equitable remedy and therefore cannot be justified on the basis of a court's inherent equity power or the SEC's existing statutory authority. Petitioners emphasized that, like the defendants in *Kokesh*, the disgorgement order was unlike traditional "equitable" relief because it left the defendants in a significantly worse position than prior to the fraud; did not require that the funds be returned to victims; and was intended as punishment and deterrence to vindicate the public interest, rather than merely restoring the status quo to remedy private harm.

In its brief opposing *certiorari*, the solicitor general argued that although disgorgement now constitutes a penalty for statute of limitations purposes, it still qualifies as an equitable remedy. In support, the solicitor general pointed to Supreme Court precedent describing the terms "penal" and "penalty" as "elastic in meaning." The solicitor general also reasoned that the omission of express statutory authorization for SEC disgorgement in civil actions does not imply that lawmakers intended the SEC to have such authority only in administrative proceedings. Rather, because *Texas Gulf Sulphur* and its progeny had seemingly confirmed that SEC disgorgement was equitable, Congress assumed that the SEC did not need express statutory authority to seek such relief in enforcement actions. Moreover, the solicitor general argued that Sarbanes-Oxley's authorization for courts to award the SEC "any equitable relief that may be appropriate or necessary" was enacted against the backdrop of a settled understanding that disgorgement was one such equitable remedy, and was intended to reaffirm the SEC's disgorgement authority.

Potential Implications of *Liu*

Although predicting how the Supreme Court will rule in *Liu* is difficult, that the Court agreed to hear this case at all despite unanimity among the circuits suggests that the SEC's long-recognized disgorgement authority in federal court actions is vulnerable to at least some further limitation and could be eliminated entirely. Moreover, although the votes of only four justices are required to add a case to the Court's docket, the comments by multiple justices at the *Kokesh* oral argument, coupled with a recent trend of Supreme Court jurisprudence toward reining in expansive enforcement power, suggest that skepticism toward SEC disgorgement in its current form crosses ideological lines. Notably, on the same day that Justice Sotomayor handed down the *Kokesh* opinion, she also authored a unanimous opinion in *Honeycutt v. United States*, 137 S. Ct. 1626 (2017), finding that a federal criminal forfeiture statute does not permit a defendant to be held jointly and severally liable for property that co-conspirators derived from a crime, but which the defendant did not personally acquire. Even if the Court sustains the SEC's right to obtain disgorgement in federal court actions, it may restrict such relief to the actual ill-gotten profits personally acquired by a defendant.

Two related trends in modern Supreme Court jurisprudence also may influence the outcome in *Liu*. First, *Texas Gulf Sulfur*'s endorsement of SEC disgorgement as necessary to "effectuate the purpose" of the Exchange Act was typical of an era in which courts assumed that the judiciary should seek to divine a statutes purpose, and liberally craft implied remedies to enforce Congresses unspoken aims. Modern jurisprudence since the 1980s, has been far less willing to imply remedies absent explicit statutory authorization. Second, the Court's conservative wing has been increasingly averse to consideration of legislative history as a guide to statutory interpretation. That may be key to the resolution of the case, since among the SEC's strongest arguments (which has considerable persuasive force) is that Congress intended to authorize SEC disgorgement in federal court proceedings, even if a literal interpretation of the statutory language would suggests otherwise.

In the event the Court rules for petitioner, we expect the SEC will urge lawmakers to pass legislation to effectively overturn *Liu* by restoring the SEC's disgorgement authority in federal court actions. Indeed, legislation currently is pending in both the House and the Senate to do just that. The SEC also could shift toward filing more cases as administrative proceedings, where it has express statutory authority to obtain disgorgement. Doing so, however, would present its own challenges. A significant increase in the number of administrative law judges would be required to handle the larger caseload, and the constitutionality of SEC administrative proceedings remains under attack. Moreover, that option may be foreclosed if Congress enacts provisions of the Financial CHOICE Act of 2017, H.R. 10, 115th Cong. §§714, 823 (2017), which would allow respondents in administrative proceedings to remove their cases to federal district court. Further, civil penalties in SEC administrative proceedings must be set based on a per-violation calculation, unlike court proceedings where the SEC historically had the option of seeking both disgorgement *and* civil penalties based on the gross amount of a defendant's pecuniary gain.

Oral argument has been scheduled for March 3, 2020, with a decision expected in the summer.

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