Supreme Court to Review SEC's Authority to Seek Disgorgement

November 4, 2019

On Friday, November 1, 2019, the Supreme Court granted certiorari in *Liu v. Securities and Exchange Commission*,[1] a case that challenges the SEC's long-held position that it has authority to seek disgorgement for securities laws violations as a form of equitable relief. This view has come under fire since *Kokesh v. Securities and Exchange Commission*, in which the Supreme Court held that disgorgement constituted a "forfeiture" or "penalty," rather than a remedial tool, and was therefore subject to a five-year statute of limitations. As we noted previously, several justices observed during oral argument in *Kokesh* that the SEC did not have express statutory authority to seek disgorgement in district court actions, and the *Kokesh* opinion affirmatively stated that the Court was reserving judgment on the question of whether the SEC had the authority to seek disgorgement at all. These statements signaled an invitation for a challenge to the SEC's disgorgement authority. With the grant of certiorari in *Liu*, the Court appears ready to address the issue directly. Any decision that further restricts the SEC's ability to obtain disgorgement could have major ramifications for the SEC's enforcement efforts.

Kokesh v. SEC

The federal securities laws give the SEC authority to seek several types of relief in enforcement actions, including injunctive relief and civil monetary penalties. The SEC has long taken the position that disgorgement constitutes equitable relief that is within the inherent authority of district courts to grant, arguing that it serves a remedial purpose by requiring violators to give up their ill-gotten gains.

In *Kokesh*, the Supreme Court addressed the narrow question of whether the 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"—applies to SEC enforcement actions for disgorgement. The Court held that disgorgement constituted a "forfeiture" or "penalty" under § 2462, based in part on the fact that the disgorged funds are not always returned to victims, and also signaled that there is an open question regarding whether the SEC is authorized to seek disgorgement at all:

- Chief Justice Roberts noted that "the SEC devised this remedy or relied on this remedy without any support from Congress."
- Justice Sotomayor asked "[c]an we go back to the authority? . . . [H]ow could [the statutory provision authorizing the SEC to seek equitable relief] be the basis of disgorgement [when there is no restitution to investors]?"
- Justice Alito stated that "it would certainly be helpful and maybe essential to know what the authority for [disgorgement] is."

[1] *Liu v. Sec. & Exch. Comm'n*, No. 18-1501, 2019 WL 5659111 (U.S. Nov. 1, 2019).

- Justice Gorsuch questioned whether and when the SEC has to return disgorged funds to victims "because there's no statute governing" disgorgement and "[w]e're just making it up."

The Court did not decide the issue and made clear in a footnote that it was not expressing any "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."[2]

Liu v. SEC

In *Liu*, the SEC sued Charles Liu and Xin 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 that Liu and Wang defrauded investors by leading them to believe that they were funding an enterprise that met the EB-5 immigrant investor program requirements, which offers lawful permanent residence status to aliens who make a substantial investment in a U.S. enterprise, when the enterprise did not actually meet the requirements.

The district court granted summary judgment to the SEC and found that Liu and Wang violated Section 17(a)(2) of the Securities Act. The court issued an injunction, imposed civil monetary penalties of $6.7 million on Liu and $1.5 million on Wang, and ordered disgorgement of "all funds received from [the] illegal conduct, together with prejudgment interest thereon," which amounted to $26.4 million.

The Supreme Court decided *Kokesh* after the district court's decision in *Liu*, but prior to Liu and Wang's appeal to the Ninth Circuit. In their appeal, Liu and Wang argued that the district court lacked authority to award disgorgement under the principles of *Kokesh*. The Ninth Circuit noted that the Supreme Court had not reached the issue and that therefore *Kokesh* was not "clearly irreconcilable" with pre-*Kokesh* law of the circuit upholding similar disgorgement awards.[3] As a result, the Ninth Circuit declined to overturn the district court's order.

Liu and Wang sought certiorari on the basis that this question is important and recurring for the circuit courts because, pre-*Kokesh*, the circuit courts had held that disgorgement was remedial, not punitive, and therefore equitable in nature.[4] They argued that *Kokesh*'s ruling that disgorgement constitutes a "forfeiture" or "penalty" turned that reasoning on its head, undermining the historical justification the SEC has used to seek disgorgement. The Supreme Court granted certiorari on November 1, 2019.

Potential Impact on SEC Enforcement

A Supreme Court decision in *Liu* eliminating the SEC's ability to seek disgorgement in district court could have profound consequences for the agency's enforcement program. Disgorgement is by far the SEC's largest financial remedy. In its 2018 annual report, the Enforcement Division reported that it obtained more than $2.5 billion in disgorgement in fiscal year 2018 and more than $11 billion combined in the last

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[2] *Kokesh v. Sec. & Exch. Comm'n*, 137 S. Ct. 1635, 1642 n.3 (2017).

[3] *Sec. & Exch. Comm'n v. Liu*, 754 F. App'x 505, 509 (9th Cir. 2018), *cert. granted sub nom. Liu v. SEC*, No. 18-1501, 2019 WL 5659111 (U.S. Nov. 1, 2019).

[4] Several district and circuit courts have upheld the SEC's authority to seek disgorgement post-*Kokesh*. *See, e.g.*, *Sec. & Exch. Comm'n v. de Maison*, No. 18-2564, 2019 WL 4127328, at *1 (2d Cir. Aug. 30, 2019) (upholding district court decision ordering disgorgement and noting that the panel was bound by Second Circuit precedent because the Supreme Court explicitly said in *Kokesh* that it was not deciding the question of whether the SEC had the authority to seek disgorgement); *Sec. & Exch. Comm'n v. Ahmed*, 343 F. Supp. 3d 16, 27 (D. Conn. 2018) ("[N]othing in Kokesh disturbed Second Circuit precedent that disgorgement is a proper equitable remedy."); *Sec. & Exch. Comm'n v. Berkey*, 374 F. Supp. 3d 355, 359 (S.D.N.Y. 2019) ("[S]ince *Kokesh*, the Second Circuit has upheld disgorgement awards . . . and numerous district courts in this circuit have imposed disgorgement as a penalty.") (internal citations omitted); *Sec. & Exch. Comm'n v. Weaver*, 773 F. App'x 354, 357 (9th Cir. 2019) ("*Kokesh* specifically declined to consider [whether the SEC is authorized to seek disgorgement], so that case is not 'clearly irreconcilable' with our longstanding precedent on this subject.") (internal citations omitted).

four fiscal years.[5] This far exceeded the total amount of penalties during the same time periods, with $1.4 billion ordered in penalties in fiscal year 2018 and $4.7 billion total over four years.[6]

If the Court were to rule that the Commission does not have authority to seek disgorgement, the SEC might respond in several ways:

- First, it could articulate a need for legislation to authorize the SEC to seek disgorgement.[7]
- Second, the SEC might argue that it may seek disgorgement-style relief, perhaps restyled as "remediation," if it returns the money to investors. As discussed above, in *Kokesh*, the Court concluded that disgorgement is not "compensatory" because disgorgement in SEC actions often is paid to the government, not investors, and that courts have ordered disgorgement regardless of whether the money would be returned to investors.[8] In response to an unfavorable decision in *Liu*, the SEC might argue that an award is compensatory, and within a district court's equitable authority, if the money will be returned to investors. Even if it were successful in making this distinction, the results could be relatively modest—the Enforcement Division reported that it returned $794 million to investors in fiscal year 2018.[9]
- Third, the Enforcement Division might seek larger penalties to make up for any loss of authority to seek disgorgement. In district court cases, the SEC is authorized to seek penalties based on a "tier" analysis of the severity of the conduct,[10] or an amount up to "the gross amount of pecuniary gain to such defendant as a result of the violation."[11] The SEC might try to use the "gross pecuniary gain" provision to seek penalties that include what it would have sought in disgorgement. If this strategy were ineffective, the SEC would have to argue for penalties closer to the maximum tier amount authorized by statute. With either approach, it is uncertain whether district court judges or a majority of SEC commissioners would agree to larger penalties to compensate for reduced disgorgement authority.
- Fourth, the SEC might consider pursuing more cases in administrative proceedings, where it has express statutory authority to "enter an order requiring accounting and disgorgement, including

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[5] *See* **SEC 2018 Annual Report** at 11. The SEC's 2019 Annual Report is expected soon.

[6] *Id.*

[7] For example, in March 2019, a bipartisan bill, known as the **Securities Fraud Enforcement and Investor Compensation Act**, was introduced in the Senate to offset losses from *Kokesh* by giving the SEC ten years to seek restitution for fraud victims and to codify the SEC's ability to seek disgorgement in district court. The Enforcement Division has stated that it may have to forgo approximately $900 million in disgorgement due to *Kokesh* for matters that had already been filed as of FY2018. ***See*** **SEC 2018 Annual Report** at 12.

[8] *Kokesh*, 37 S. Ct. at 1644.

[9] *See* **SEC 2018 Annual Report** at 11.

[10] Tier 1 is the base-level penalty for each "violation" in district court cases. Tier 2 allows for larger penalties if the violation involved "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." Tier 3 further allows for increases to the penalty if, in addition to meeting the requirements of Tier 2, the violation involved substantial losses or created a significant risk of substantial losses to other persons. At each tier, the penalty is lower for natural persons than for all other persons. The tier analysis is essentially the same across the Securities Act, Exchange Act, Investment Company Act, and Investment Advisers Act.

[11] Securities Act of 1933, 15 U.S.C. § 77t(d)(2); Securities Exchange Act of 1934, 15 U.S.C. § 78u(d)(3); Investment Company Act of 1940, 15 U.S.C. § 80a-41(e)(2); Investment Advisers Act of 1940, 15 U.S.C. § 80b-9(e)(2).

reasonable interest."[12] This strategy would involve additional risk because of the challenges to the constitutionality of the SEC's administrative proceedings that we explained in a **prior alert**.[13]

Oral argument on the case is likely to be scheduled for early next year, with a decision expected by the summer. It is difficult to predict the future impact on the SEC—how the Court will rule in this case, whether it will limit the SEC's ability to seek disgorgement, and how the SEC might respond to such a decision. What is clear is that this case could have a dramatic impact on the SEC's enforcement program and will be a priority for the SEC in the year ahead.

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[12] Securities Act of 1933, 15 U.S.C. § 77h-1(e); Securities Exchange Act of 1934, 15 U.S.C. § 78u-3(e); Investment Company Act of 1940, 15 U.S.C. § 80a-9(e); Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(j).

[13] As we previously noted, the Court's decision in ***Lucia v. SEC***, which found that SEC administrative law judges ("ALJs") are subject to the Appointments Clause of the Constitution, raised the question of whether the statutory removal protections afforded to SEC ALJs are also unconstitutional. That issue is currently being considered by the Fifth Circuit in *Cochran v. SEC*, No. 19-10396 (5th Cir.).