

The SEC's Expanded Disgorgement Authority Complicates Investigations and Settlements

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On January 1, 2021, Congress overrode a legislative veto by President Trump for the first time to pass H.R. 6395 National Defense Authorization Act for Fiscal Year 2021 (“NDAA”).¹ The NDAA was a must-pass piece of legislation to authorize appropriations for military- and defense-related activities, to prescribe military personnel strengths, and “for other purposes.” Deep within Division H (“Other Matters”), Section 6501 of the NDAA amends the Securities Exchange Act of 1934 (“Exchange Act”) to codify, refine, and expand the SEC’s ability to seek disgorgement and other equitable relief for violations of the federal securities laws.

Creation of a Statutory Remedy of Disgorgement. Section 6501 of the NDAA expressly authorizes the U.S. Securities and Exchange Commission (the “SEC” or “Commission”) to seek disgorgement in any action or proceeding brought by the Commission “under any provision of the securities laws” where “any person received unjust enrichment as a result of the violation.” Although courts have routinely awarded to the SEC disgorgement of “ill-gotten gains” under the catch-all authority to seek equitable relief under Section 21(d)(5) of the Exchange Act, the federal securities laws did not previously expressly authorize the SEC to seek disgorgement in federal court actions.

In *Liu v. SEC*,² the Supreme Court recently upheld the SEC’s ability to obtain disgorgement as equitable relief under Section 21(d)(5), although in doing so imposed arguably new restrictions on the remedy. The Court concluded that the remedy was available, if disgorgement did not “exceed a wrongdoer’s net profits” and “was awarded for victims.” Accordingly, *Liu* questioned the SEC’s disgorgement authority where 1) disgorgement was not returned to victims; 2) joint-and-several liability was imposed; or 3) disgorgement exceeded the defendant’s net profits after deducting legitimate business expenses.

¹ National Defense Authorization Act for Fiscal Year 2021, H.R. 6395, 116th Congress (2020).

² 140 S. Ct. 1936 (2020).

Section 6501's statutory grant of authority to the SEC to seek disgorgement arguably frees the SEC from the restrictions on the remedy imposed by *Liu*. We expect the SEC staff will likely take the view that the new authority obviates any requirement in *Liu* that disgorgement be awarded to victims. At the same time, however, Section 6501 expressly limits the SEC's ability to seek disgorgement only from the person(s) who received unjust enrichment, thereby eliminating the confusion arising from *Liu* over whether disgorgement can be available in cases where joint-and-several liability has been imposed.

Bifurcated Statute of Limitations. Section 6501 bifurcates the statute of limitations applicable when seeking disgorgement for scienter and non-scienter based violations of the federal securities laws. It extends the limitations period to seek disgorgement for scienter-based violations³ to 10 years, and sets the limitations period to seek disgorgement for other, non-scienter based violations at five years.

In *Kokesh v. SEC*,⁴ the Supreme Court held that disgorgement actions were a penalty and therefore subject to the five-year, catch-all statute of limitations for government actions in 28 U.S.C § 2462. Section 6501 essentially codifies the application of the five-year limitations period for non-scienter based violations, while superseding it with respect to scienter-based violations. Congress considered including an even longer limitations period, and draft legislation included a 14-year statute of limitations for disgorgement, but ultimately settled on this bifurcated solution.

Creation of a 10-Year Statute of Limitations for SEC Actions. Section 6501 also imposes a 10-year statute of limitations on the SEC to bring an action for an equitable remedy, including for an injunction or for a bar, suspension, or cease and desist order. This is the first time Congress has enacted a general statute of limitations period for the filing of SEC actions. Prior to the enactment of Section 6501, the SEC could file a civil injunctive proceeding for any historic conduct, even conduct that had occurred decades ago.

Automatic Tolling for Defendants Outside the United States. Section 6501 adds a provision to automatically toll "any limitations period" for defendants who remain outside the United States. As a result, enforcement actions against such individuals will be tolled indefinitely or at least until they enter the United States.

³ Section 10(b) of the Exchange Act, Section 17(a)(1) of the Securities Act of 1933, Section 206(1) of the Investment Advisers Act of 1940, or "any other provision of the securities laws for which scienter must be established."

⁴ 137 S. Ct. 1635 (2017).

Investigation and Settlement Dynamics. The NDAA amendments will likely alter SEC incentives in conducting investigations and settling matters where both scienter and non-scienter based charges are possible.

- **The SEC’s document demands may become more burdensome.** Because of the new, decade-long statute of limitations for scienter-based antifraud violations, the SEC will likely seek information from a longer historical time period (up to the full 10-year period) as the staff weighs charging decisions.
- **The SEC may be incentivized to “overcharge” conduct in an investigation.** With the passage of the NDAA, charging more serious scienter-based fraud claims will permit the SEC to claw back disgorgement for a full 10-year time period, as opposed to the five-year period applicable to less serious, negligence-based conduct. Although courts generally agree that a showing of recklessness is sufficient to establish scienter, there is a fine line between recklessness and negligence, which the SEC may well now be incentivized to test.
- **The SEC may bring more charges against individuals.** We expect that the Biden Commission will hesitate to authorize firm- or company-only cases. For scienter-based cases, while the SEC has historically been reluctant to charge entities with scienter-based violations unless the individual whose scienter is imputed to the entity is also charged, such cases were nevertheless brought from time-to-time; we expect that the Biden Commission will be less willing to permit scienter to be imputed to an entity without charging the culpable individual. Most problematically, for negligence-based cases, we expect that the Biden Commission will look skeptically at enforcement recommendations where any potential disgorgement is not being recouped, thus pressuring the staff to pursue scienter-based charges against individuals where the relevant conduct is older than five years.
- **Settlements may become more difficult.** The SEC enforcement staff may be unwilling—or unable, in light of Commission scrutiny—to settle investigations for entity-only, non-scienter charges. As a result, settlement discussions may now break down because the staff may insist on charging individuals with scienter-based violations. Given that most individuals refuse to settle with the SEC for scienter-based charges—particularly when such charges result in significant penalties, industry and officer and director bars, and other sanctions and collateral consequences—cases that previously might have settled for negligence-based charges may now litigate. This is also true for certain firm or company defendants, such as asset managers, where intentional fraud findings may trigger (i) “bad boy” provisions of the federal securities laws that would require the defendants to seek increasingly unobtainable waivers from the SEC,

and (ii) termination provisions in limited partnership agreements. Both of these outcomes limit the appeal of settling, as opposed to fighting, scienter-based charges.

- **An open question exists on the deduction of business expenses.** The NDAA’s “unjust enrichment” language provides room to advocate that legitimate business expenses must continue to be deducted from any disgorgement award.
- **The new amendments to the Exchange Act impact all new and pending investigations before the Commission.** As a result, these concerns are immediately relevant in ongoing investigations, where the SEC enforcement staff may now consider whether to expand the temporal scope of any investigations to ensure older conduct is evaluated and may focus more intensely on individuals in an attempt to determine whether any individual(s) acted recklessly. The cases that may be impacted by this change include not only those involving particularly egregious frauds, but also cases involving conduct that may fall closer to line between negligence and scienter and present an opportunity for the staff to focus on older conduct, such as cases involving asset managers, accounting issues, and potential violations of the Foreign Corrupt Practices Act.

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