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Congress Amends Exchange Act in Response to *Kokesh* and *Liu*, Expanding SEC Enforcement Power

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On December 29, 2020, Congress amended Section 21(d) of the Securities Exchange Act of 1934 (Exchange Act) to codify and expand the power of the Securities and Exchange Commission (SEC) to obtain disgorgement in civil actions.¹ The amendments are tucked within the 1,400 page National Defense Authorization Act (NDAA) and are a direct response to the Supreme Court's recent decisions in *Kokesh v. SEC*² and *Liu v. SEC*³ curtailing the SEC's ability to obtain disgorgement in federal actions. The recent amendments double the time period for which the SEC may obtain disgorgement in cases involving fraud and could expand the SEC's authority to obtain disgorgement in other important ways.

What the Amendments Address

The amendments reverse in part, two recent Supreme Court decisions that had scaled back the SEC's ability to obtain disgorgement in actions brought in federal court.

The first was a 2017 ruling in *Kokesh*. In *Kokesh*, a unanimous Court rejected SEC arguments that disgorgement was a remedial remedy that was not subject to any statute of limitations. The Court held instead that disgorgement, as applied in the SEC

enforcement context, was a penalty: "It is imposed as a consequence of violating a public law and it is intended to deter, not to compensate."⁴ The Court observed that, while district courts may distribute disgorgement funds to victims, there was no statutory command that they do so, and in practice, disgorged funds often were dispersed to the United States Treasury.⁵ As a penalty, SEC disgorgement was subject to the five-year limitations period in 28 U.S.C. § 2462.

The second was the Supreme Court's 2020 ruling in *Liu*. In *Liu*, the Court addressed whether, and to what extent, the SEC may seek disgorgement in civil actions under Section 21(d)(5), which provides that the SEC may seek "any equitable relief that may be appropriate or necessary for the benefit of investors."⁶ The majority agreed with the SEC that it had the authority to seek disgorgement, but only insofar as that disgorgement conformed to traditional principles of equity and was for the benefit of investors. To comply with equitable principles and Section 21(d)(5), the Court instructed that disgorgement awards must not exceed the defendant's gains net of legitimate expenses, and generally must be returned to wronged investors for their benefit (the Court expressed skepticism that payment of disgorged

funds to the Treasury satisfied the requirement that the relief be “appropriate and necessary for the benefit of investors”).⁷ The Court further explained that, although the common law permitted collective liability in some circumstances (for example, when partners engage in concerted wrongdoing), joint-and-several liability generally was inconsistent with equitable principles.⁸

The Division of Enforcement’s Annual Reports following *Kokesh* and *Liu* commented on their significant impact for the Division’s enforcement program. With respect to *Kokesh*, the then Co-Directors warned that it would limit the SEC’s ability to obtain disgorgement in certain long-running frauds.⁹ The Division later reported that *Kokesh* caused the SEC to forgo approximately \$1.1 billion dollars in disgorgement in filed cases, and that the actual impact was “likely far greater ... because—since the *Kokesh* decision—the Division has shifted its resources to those investigations which hold the most promise for returning funds to investors.”¹⁰ Following *Liu*, the then Director cautioned that there may be “changes in the balance between the penalties and disgorgement that the Division seeks and recommends to the Commission” as a result of *Liu*, and that the Division “may [instead] recommend higher penalties in some cases where the statutory scheme permits us to do so.”¹¹

What the Amendments Change

The amendments to Section 21(d) of the Exchange Act included in the NDAA reinvigorate and bolster the SEC’s disgorgement power in two important ways.

First, as amended, Section 21(d) of the Exchange Act now expressly grants the SEC authority to obtain disgorgement in civil actions of “any unjust enrichment by the person who received such unjust enrichment as a result of such violation.” This statutory grant is separate from the authority relied upon by the *Liu* Court in Section 21(d)(5). Although the amendments do not address directly the extent to which this new statutory framework supplants the

requirements for disgorgement outlined in *Liu*, they would appear at least to open the door to further argument by the SEC, including regarding its authority to disburse disgorged funds to the Treasury. However, the statutory language’s focus on “unjust enrichment *by the person* who received such unjust enrichment” provides compelling arguments in favor of a requirement to net legitimate expenses and against expansive joint and several liability, consistent with *Liu*.

Second, as amended, Section 21(d) of the Exchange Act now provides a limitations period for the SEC to obtain disgorgement in civil actions that in certain circumstances is much longer than the five years permitted by Section 2462 and *Kokesh*. The amendments provide that an action for disgorgement for most violations must be brought “not later than five years after the latest date of the violation that gives rise to the action or proceeding in which the Commission seeks the claim occurs.” However, for scienter-based violations, including violations of the antifraud provisions of Section 10(b) of the Exchange Act, Section 17(a)(1) of the Securities Act, and Section 206(1) of the Investment Advisers Act, the SEC may seek disgorgement up to 10 years after the latest date of the violation.¹² Further, when calculating either limitations period, the amendments provide that time outside of the United States “shall not count towards the accrual of that period”—meaning disgorgement could conceivably be sought for conduct substantially older than 10 years in certain circumstances.

The amendments took effect immediately upon enactment and, by their terms, apply to any matter currently pending on the date of enactment.

What the Amendments Mean for Future SEC Enforcement

The amendments are notable for the SEC’s enforcement program and may impact future investigations and charging decisions. Most prominently, the extended statute of limitations for scienter-based frauds may incentivize Division of Enforcement Staff

to investigate conduct that is much more dated than the previous five-year limitations period and to expend additional efforts to determine if there is evidence supporting a scienter-based charge. These dynamics risk complicating responses to SEC requests and increasing defense costs for respondents. Moreover, in order to seek disgorgement from a broader period that is only available for scienter-based fraud, the Division of Enforcement may be less inclined to accept settled resolutions that charge non-scienter-based alternatives. This has the potential to complicate settlement negotiations, including because scienter-based resolutions can trigger more significant collateral consequences for some respondents.

These amendments represent a change of fortune for the SEC and its enforcement program. Although there are open questions regarding the extent to which they reverse the most restrictive elements of *Liu*, amended Section 21(d) provides, for the first time, express authority for the SEC to obtain disgorgement in civil actions and significantly expands the time period for which disgorgement may be sought. With the change in presidential administrations, we expect the new SEC will aggressively use this expanded authority in 2021 and beyond.

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NOTES

¹ National Defense Authorization Act for Fiscal Year 2021, H.R. 6395, § 6501. The Commission has long

had the authority to obtain disgorgement in administrative proceedings. See 15 U.S.C. § 78u-2(e).

² *Kokesh v. SEC*, 137 S. Ct. 1635 (2017). For a more detailed summary of *Kokesh*, see Implications of the Supreme Court’s *Kokesh* Decision (June 19, 2017), available at <https://www.wilmerhale.com/en/insights/client-alerts/2017-06-19-implications-of-the-supreme-courts-kokesh-decision>.

³ *Liu v. SEC*, 140 S. Ct. 1936 (2020). For a more detailed summary of *Liu*, see *Liu v. SEC: The U.S. Supreme Court Upholds the SEC’s Power to Obtain Disgorgement in Civil Actions, But With Important Limitations* (June 24, 2020), available at <https://www.wilmerhale.com/en/insights/client-alerts/20200624-liu-v-sec-the-us-supreme-court-upholds-the-secs-power-to-obtain-disgorgement-in-civil-actions-but-with-important-limitations>.

⁴ *Kokesh*, 137 S. Ct. at 1644.

⁵ *Id.* at 1638.

⁶ 15 U.S.C. § 78u(d)(5).

⁷ *Liu*, 140 S. Ct. at 1946, 1947–1948.

⁸ *Id.* at 1945.

⁹ Div. of Enf., U.S. Secs. & Exch. Comm’n, 2018 Annual Report, at 5, available at <https://www.sec.gov/divisions/enforce/enforcement-annual-report-2018.pdf>.

¹⁰ Div. of Enf., U.S. Secs. & Exch. Comm’n, 2019 Annual Report, at 21, available at <https://www.sec.gov/files/enforcement-annual-report-2019.pdf>.

¹¹ Div. of Enf., U.S. Secs. & Exch. Comm’n, 2020 Annual Report, at 7, available at <https://www.sec.gov/files/enforcement-annual-report-2020.pdf>.

¹² Amended Section 21(d) further provides that the SEC “may seek a claim for any equitable remedy, including for an injunction or for a bar, suspension, or cease and desist order, not later than 10 years after the latest date on which a violation that gives rise to the claim occurs.”

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