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By Anne Sherry, J.D.

An investment adviser argued before the SEC that the $3.55 million in sanctions imposed upon him were time-barred. Specifically, the Eleventh Circuit held in SEC v. Graham that disgorgement is equivalent to forfeiture and thus subject to 28 U.S.C. § 2462's five-year statute of limitations. The Division of Enforcement countered that Graham was wrongly decided and that the penalty was permissible even if constrained to the adviser's violations within the limitations period (In the Matter of Grossman, August 17, 2016).

In late 2014, an ALJ found that the adviser recommended unsuitably risky funds to retiree clients of his firm, Sovereign International Asset Management, Inc., in exchange for kickbacks. He did not disclose the conflict resulting from the kickbacks or do proper due diligence on the investments. In fact, the underlying funds were invested in Madoff feeder funds. The ALJ ordered the adviser to pay a $1.55 million civil penalty and about $3 million in disgorgement plus interest. The adviser appealed, asserting the sanctions were time-barred under Section 2462 by way of Graham.

Should the SEC follow Graham? At oral argument, Chair White asked whether Graham is not the minority view. Zachary Messa, arguing for the adviser, acknowledged that numerous district courts have distinguished Graham, but said that it is the only post-Gabelli appeals court decision to have come down on whether disgorgement falls within the Section 2462 statute of limitations. The concerns that prompted the Supreme Court to decline to apply a discovery rule to the U.S.C. provision in Gabelli—faded memories, disappearing witnesses, lost documents—likewise existed in the proceeding before the administrative law judge.

In the view of the Division of Enforcement, however, Graham was wrongly decided. Arguing for the Division, Patrick Costello noted that the Eleventh Circuit panel limited its analysis to the modern dictionary definitions of the terms "forfeiture" and "disgorgement," ignoring 200 years of history distinguishing the two concepts. Costello said that disgorgement serves the remedial purpose of returning parties to the status quo ante, while forfeiture is meant to punish. As an example, disgorgement is available even from a relief defendant who is not accused of a violation, but the government cannot seek forfeiture from a third party without charging the party with a crime.

The SEC has argued as recently as Timbervest that disgorgement is not a forfeiture subject to Section 2462's limitations period, and has taken the position in three circuit court appeals that Graham was wrongly decided, Costello argued. He added that the Commission is not bound by the decision of a single circuit court.

Penalties still apply. Furthermore, Costello identified 15 separate Advisers Act violations that were not time-barred; these alone could support the $1.5 million penalty. Each violation can be sanctioned with a second- or third-tier penalty, justifying a total penalty in the range of $975,000 to $1.95 million. Furthermore, even conduct that predates the limitations period, while not directly actionable, can still be considered in terms of motive, intent, opportunity, and course of conduct. The prior misconduct informs how the adviser behaved during the limitations period.

Messa rebutted this characterization. The underlying misconduct was the adviser's failure to conduct proper due diligence on the feeder funds in which he placed his clients' assets. That occurred during his ownership of Sovereign. The adviser sold Sovereign in 2008 and, although he stayed on as a consultant, there was no evidence tying his post-2008 compensation to the rendering of financial advice. When Commissioner Stein asked Costello about the post-2008 payments, Costello responded that they were in the nature of salary payments from Sovereign. The Division is not contending that the adviser received kickbacks within the limitations period, other than in two situations where he recommended clients swap out funds, he said.

There was ample testimony during the administrative proceeding that the advice to swap out shares was sent out in error, Messa countered. These were not the actual swap documents, and the ALJ agreed with that by declining to consider those alleged violations in her determination of the penalty amount.
SEC had time to act within the five-year period. Messa also argued that the SEC had ample opportunity to bring its claims well before the statute of limitations expired. In fact, the Commission deposed the adviser in 2012, as well as issued a subpoena request, to which he responded. The order instituting proceedings was not filed until November 2013.

The administrative proceeding is File No. 3-15878.


Companies: Sovereign International Asset Management, Inc.

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