Securities Regulation Daily Wrap Up, TOP STORY—U.S.: SCOTUS hears arguments in case challenging SEC disgorgement remedy, (Mar. 3, 2020)

Securities Regulation Daily Wrap Up

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By Anne Sherry, J.D.

The justices' questioning hints at the possibility of limiting the SEC's entitlement to disgorgement in federal court, but there was little indication that they will scrap the remedy entirely.

Having determined in *Kokesh v. SEC* that disgorgement is subject to a five-year statute of limitations, the Supreme Court is now poised to answer a question it left open in that case: whether disgorgement as a judicial remedy is available to the SEC at all. At oral argument, the justices seemed reticent to dispense with the disgorgement remedy entirely, but asked a number of questions about how disgorgement should be calculated and whether it should be conditioned on the return of recovered funds to investors (*Liu v. SEC*, March 3, 2020).

The justices devoted much of their questioning to exploring two potential limitations on the disgorgement remedy. First, should disgorgement be limited in amount to the defendant's net profit? This was the argument urged by a group of law professor amici supporting neither party, and the petitioners themselves—who argue their $26 million disgorgement order would leave them worse off than before the alleged fraud by nearly $16 million—advanced it as a secondary argument in case the Supreme Court was unwilling to do away with disgorgement altogether. The second potential limitation is that disgorgement could be conditioned upon the return of recovered funds to investors.

Disgorgement as penalty. Arguing on behalf of the petitioners, Gregory G. Rapawy (Kellogg Hansen) began by framing the disgorgement question around *Kokesh*. That case made clear that an order that compels payment to the Treasury for violating a public law is a penalty, and a penalty must be authorized by statute. Rapawy argued that Congress has expressly authorized the SEC to require disgorgement in administrative proceedings, but not court actions. Meanwhile, the legislature has expressly authorized agencies other than the SEC to seek disgorgement in federal court. The statute's authorization of equitable relief does not extend to penalties, he said.

Justice Ginsburg immediately clarified the references to *Kokesh* by observing that *Kokesh* was limited to the statute of limitations context. It does not follow that because disgorgement is a penalty in one context, it is a penalty for all purposes. In fact, she added, *Kokesh* specifically made that point in a footnote. Rapawy clarified that he is not arguing that *Kokesh*'s holding resolves this case, but rather that its reasoning cannot be distinguished from this case. It is an equitable principle that a court of equity will not inflict a penalty, and SEC disgorgement is a penalty within the meaning of that rule because it frequently leaves the defendant worse off than if the wrong had not been committed, Rapawy said.

Arguing for the SEC, Malcolm L. Stewart, Deputy Solicitor General, said that the three reasons that the Court in *Kokesh* gave for concluding that disgorgement was a penalty for purposes of the statute of limitations—that disgorgement is imposed as a consequence of violating a public law, serves a deterrent purpose, and is not compensatory—do not map onto the criteria for determining whether something is equitable relief. These three circumstances were present in *Kansas v. Nebraska*, an interstate compact case in which the Court ordered disgorgement.

Stewart also responded to a suggestion by Rapawy that the government had conceded that SEC disgorgement departs from historical norms. What really happened is that federal regulatory agencies were not filing civil enforcement actions until the mid-20th century. When those actions became prevalent, courts had to consider how to transfer an existing body of law from the realm of private suits onto governmental enforcement actions.

The case law evolved to the point that Congress's passing of the statute in 2002 should be seen as a legislative authorization of existing practice, Stewart argued.

Net profits and investor reimbursement rules. Justice Alito used Rapawy's opening about excessive disgorgement to ask about two potential limitations that came to dominate the rest of the argument. If disgorgement were limited to net profits and if every effort were made to return the recovered funds to victims, would it then fall within the traditional bounds of equitable relief? Rapawy said it would not because the analogous form of equitable relief, an accounting, was traditionally available only in cases involving a breach of fiduciary duty or in which the accounting was available as part of the court of equity's ancillary jurisdiction. And to conclude that an equity court could award any kind of relief using its ancillary jurisdiction would be such a broad reading as to provide no limitation at all.

On further questioning from Justice Kavanaugh about Justice Alito's two conditions on disgorgement, assuming the Court did not agree with the argument that disgorgement is entirely unavailable, Rapawy said that those two conditions were the primary inconsistencies with regard to the historical remedy. If the Court disagrees with his primary argument, the SEC should be allowed to extract disgorgement only if it will give the money to harmed investors. However, he added that it would be difficult for courts to police the SEC's efforts. Several justices pushed back on this assertion, noting that there is language available to require the SEC to make good-faith efforts or similar and that the courts regularly do police compliance with such requirements.

Justices Kagan and Breyer asked about the contours of the net profits rule and what expenses the SEC would be required to deduct when calculating disgorgement. Rapawy responded that the agency must start from the gains to the defendant rather than, as here, starting from the losses to investors. Justice Breyer asked whether it would be appropriate to deduct the expenses of printing flyers advertising the fraudulent investment. Rapawy allowed that in some circumstances, such as a Ponzi scheme, the entire enterprise is tainted, but he appeared to decline Chief Justice Roberts's invitation to complete his thought after running out of time.

Stewart argued that expenses such as Justice Breyer's hypothetical fliers would not be deductible under traditional equitable principles. As another example, a defendant in a Foreign Corrupt Practices Act case would not be allowed to count a bribe as a cost of doing business. Stewart stressed that the government is not asking for an SEC-specific rule but rather one that is in line with traditional equitable principles.

On later questioning from Justice Ginsburg, Stewart described the two categories of expenses that the Ninth Circuit below declined to deduct to arrive at net profit. First were the type of marketing expenses that fit Justice Breyer's hypothetical. Second were investments in equipment, facilities, and other items that might be legitimate business expenses in other contexts. Stewart interpreted the appellate court's short analysis on this point to mean that these were not legitimate expenses because the petitioners made those purchases to convince investors that the project was going along as planned and not as a good-faith effort to actually achieve the project. On rebuttal, Rapawy said that there were explicit findings in the record that the petitioners had a total gross pecuniary gain of $8.2 million. The fact that the courts began from the total losses to investors rather than the gain to the defendants shows how far the analysis is from the historical approach, he said.

Justice Sotomayor asked Stewart about the SEC's efforts to return funds to investors. Stewart said that the SEC does try to return the money to investors when it can and is largely successful, but that it is impracticable in some cases, such as FCPA cases or frauds in which the loss to any individual investor is minimal. He cited the whistleblower regime under Dodd-Frank as Congress's acknowledgement that some disgorged funds will not be returned to investors. Although he granted that it would be appropriate for a court to order that disgorgement be paid to investors unless the SEC can explain why that is not feasible, Stewart said it would undermine the statutory scheme to create a rule that distribution to investors is a prerequisite to disgorgement in all circumstances.

Justices Sotomayor and Gorsuch pressed Stewart on this last point, observing that the statute refers to equitable relief for the benefit of investors. Justice Kavanaugh asked why it would be appropriate for a district court to condition disgorgement on the return of funds but not for the Supreme Court to make that the rule. Stewart

replied that while it would be unusual for the Court to make such an instruction, that rule would be consistent with SEC practice and with what district courts already have the equitable discretion to achieve.

The case is No. 18-1501.

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