Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION—2d Cir.: Disgorgement award decreased to align with actual postage fees taken in suitability claim appeal, (Jul. 26, 2021)

Securities Regulation Daily Wrap Up

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The defendant only received half of the postage fees charged to his customers, but the district court had required him to disgorge the full amount.

Donald Fowler appealed a judgment against him from the U.S. District Court for the Southern District of New York, in which he was found to have recommended an unsuitable trading strategy and made unauthorized trades in customer accounts. The Second Circuit affirmed the judgment and, because both parties agreed that a modest change in the disgorgement award was appropriate, modified that award (*SEC v. Fowler*, July 22, 2021, Lohier, R.).

Fowler's fees. Fowler was a registered representative (broker) from January 2007 to November 2014. His trading strategy involved an extremely high rate of asset turnover in his customer accounts: while his firm considered an average of four times a year a high turnover rate, his customer accounts experienced a turnover rate of 116 times per year. This came at significant costs to his customers, including fees charged by Fowler for every purchase or sale.

Fowler took still other actions to increase his commission which compounded his customers' losses and overshadowed any potential gains: his customers required an average of 142.5 percent rate of return to cover the charged costs and break even. This was over ten times what his firm considered a high cost-to-equity ratio.

Moreover, Fowler failed to get his customers' approval before making over half of the trades at issue on appeal. At trial, the jury had found that Fowler had lied to his investors, recommended a high frequency trading strategy that was not suitable to any customer, and made a series of unauthorized trades in customer accounts in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, and Sections 17(a)(1), (a)(2), and (a)(3) of the Securities Act of 1933. After trial, the district court ordered Fowler to disgorge $132,076 with prejudgment interest and to pay $1,950,000 in civil penalties.

Statute of limitations. Fowler argued that the five-year statute of limitations was jurisdictional and could not be tolled by agreement between the parties, and so the limitations period elapsed in 2016 and the SEC could not have brought the case. The court, following an earlier Supreme Court decision, determined that there was no clear statement of legislative intent showing that Congress wanted the rule to be jurisdictional; the court looked at both the statute's text and the legislative history. The court also found that this case was not sufficiently exceptional to find contrary to that legislative intent to establish a "standard time bar." As such, the court found that the parties' tolling agreement was enforceable.

Suitability claim. The court also rejected Fowler's argument that the SEC improperly pursued a suitability claim instead of a churning claim arising from his excessive trading in customers' accounts. The court explained that churning claims and suitability claims can arise from overlapping conduct and are not mutually exclusive events. The court found that the SEC had an adequate basis to pursue the suitability claim and that, while its approach was novel, allowing the novel approach was not error.

Control of accounts. The court also rejected the defendant's argument that the SEC failed to show he controlled his customers' accounts. The court noted that control was an element of a churning claim, but not a suitability claim, and so the SEC was not required to demonstrate control.

Unauthorized trading. Fowler argued that the verdict against him for unauthorized trading was inappropriate because not every victim of the scheme testified as to his lack of authorization. The court found that, based on the evidence admitted and not challenged on appeal, the SEC did not need to elicit testimony from every affected customer to prove its suitability claim. The evidence submitted was sufficient to "make it more likely than not" that defendant had engaged in unauthorized trading in all thirteen accounts at issue.

Securities Act penalties. Fowler also argued that the penalties were excessive, exceeded the maximum permitted by statute, and violated the Fifth and Eighth Amendments. The Securities Act provides for three tiers of civil penalties, the highest of which is $100,000 for a natural person, adjusted for inflation, or the gross amount of pecuniary gain to a defendant as a result of the violation. The SEC adjusted the $100,000 to $150,000 due to inflation. The court found that each customer's account constituted a separate violation justifying each instance of the penalty. The appeals court upheld the district court's discretion in levying penalties. The court also found that the penalties fell within constitutional bounds. However, the court agreed to modify the disgorgement agreement because the parties agreed that the district court miscalculated; Fowler had been required to return more postage fees than he actually obtained.

The case is No. 20-1081-cv.

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