

[Securities Regulation Daily Wrap Up, TOP STORY—1st Cir.: SEC seeks to persuade court not to let bankruptcy trustee pry open pre-Kokesh disgorgement order, \(May 16, 2019\)](#)

Securities Regulation Daily Wrap Up

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By [Mark S. Nelson, J.D.](#)

The SEC urged the First Circuit to reject an effort by the bankruptcy trustee for F-Squared Investment Management, Inc. to re-open a 2014 disgorgement order that was part of F-Squared's agreement to settle fraud charges brought by the SEC.

The SEC recently urged the First Circuit to affirm a district court decision finding that the lower court lacked subject matter jurisdiction to hear a suit filed by the bankruptcy trustee for F-Squared Investment Management, Inc. claiming that the Supreme Court's 2017 *Kokesh* opinion required the re-opening of a 2014 SEC administrative order requiring F-Squared to pay \$30 million in disgorgement. The *Kokesh* opinion, holding that disgorgement was a penalty for purposes of a federal limitations period, has already pressured the SEC to bring certain cases faster in order to avoid losing the opportunity to obtain disgorgement. The F-Squared trustee now brings a parallel claim that it should be allowed to re-open a pre-*Kokesh* disgorgement order, for which a decision in its favor could have even wider implications for the SEC (*Jalbert v. SEC*, May 14, 2019).

F-Squared [settled](#) the SEC's fraud charges in December 2014 and admitted key findings. The SEC had alleged that F-Squared advertised its AlphaSector product using flawed data that suggested the possibility of outsized returns. AlphaSector employed a sector-specific, algorithmically-driven method for choosing which equity ETFs would be included in the AlphaSector portfolio (i.e., a sector rotation strategy). The Settlement considered F-Squared's remedial acts while also imposing various undertakings. With respect to penalties, F-Squared was censured, required to pay a civil money penalty of \$5 million, and ordered to pay disgorgement of \$30 million, the latter item being the subject of the trustee's district court suit.

The district court opinion. The trustee's claims in the F-Squared suit are not unlike the claims recently made by SEC respondents who sought to get federal district courts involved in curbing the SEC's use of administrative proceedings on Appointments Clause grounds. Ultimately, the *Lucia* case came to the Supreme Court via the statutory appeals route Congress prescribed in the federal securities laws and the justices held that the SEC's administrative law judges were in fact not constitutionally appointed. Before the *Lucia* decision, however, the Supreme Court denied certiorari in similar cases not brought via the statutory appeals route; federal appeals courts likewise had rejected claims that such cases were deserving of district court jurisdiction (although a few district courts did briefly entertain Appointments Clause claims).

The district court in the F-Squared case (*Jalbert v. SEC*, August 22, 2018, Saylor, D.) made several key findings: (1) the SEC had explicit authority to impose disgorgement, which led the court to reject the trustee's argument that it was unclear if that authority extended to disgorgement as a remedy or disgorgement as a penalty; (2) F-Squared waived judicial review, which led the court to reject the trustee's arguments that (a) the waiver applied only to direct appeals but not collateral appeals, and (b) that there was a mutual mistake of law pursuant to which the SEC and the F-Squared assumed the SEC's authority to impose a punitive form of disgorgement; and (3) Congress created a judicial review procedure in which an SEC respondent may appeal an adverse administrative ruling to a federal appeals court, but not to a federal district court.

On this last point, the district court noted that multiple Supreme Court decisions have upheld Congressional power to strip district court jurisdiction over appeals from agency decisions where there is a fairly discernable statutory scheme and the claims involved are of a type Congress intended to be channeled through the statutory

procedure. Generally, in order for an agency respondent to get a case into district court (as opposed to following the petition for review route specified by statute following a final agency decision), the respondent typically will have to show that his factual situation is so dire that preclusion would deny him meaningful judicial review, the matter is wholly collateral, and the matter is beyond the agency's expertise.

Courts that have decided such cases often observe that the facts are so extreme that the respondent is essentially being asked to "bet the farm" to pursue a case in the district court. For example, in the Supreme Court's *McNary* and *Free Enterprise* decisions the respondents would have had to surrender for deportation or deliberately break a PCAOB rule, respectively, to get a district court's attention. In both *McNary* and *Free Enterprise*, the Supreme Court said that such draconian measures by a respondent were unnecessary.

Briefing in the First Circuit. The SEC began its brief by reiterating that the [Securities Enforcement Remedies and Penny Stock Reform Act of 1990](#) gave it explicit authority to impose disgorgement in administrative proceedings. The agency also noted that the Supreme Court itself had explained that *Kokesh* was intended to decide only the narrow question of whether the limitations period in 28 U.S.C. §2462 applied to SEC enforcement actions (it did because disgorgement was, for this purpose, a "penalty" within the meaning of the limitations statute). The SEC also noted the questions left open by *Kokesh*, such as the authority of federal courts to order disgorgement (legislation would make this authority explicit—See [S. 799](#)).

The SEC also urged the appeals court to follow the district court's reasoning about the statutory scheme envisioned by Congress under which an aggrieved party would appeal an adverse Commission order to the relevant federal appeals court. According to the SEC, the federal securities laws make it fairly discernable that Congress intended for the trustee's claim to be channeled through the statutory process. As a result, the trustee cannot go directly to the district court because it will not be denied meaningful judicial review by following the statutory process, the trustee's claims are not wholly collateral to the underlying administrative proceeding, and the subject matter of the claim is within the SEC's expertise to interpret the laws applicable to it.

Moreover, the SEC asserts numerous additional bases for affirming the district court's dismissal. For one, the SEC said that even if the district court had jurisdiction, dismissal would still be appropriate because the federal securities laws provide an adequate remedy in court and F-Squared already had knowingly waived judicial review. The SEC further urged that the trustee not be allowed to challenge only part of the Commission's order, that structural separation of powers claims—like other constitutional claims—can proceed through the statutorily prescribed appeals process, and that the court should not allow for retrospective consideration of the trustee's claims because—in part—public policy favors settlements.

The trustee for F-Squared, by contrast, argued in its brief that the SEC's policy of seeking disgorgement in administrative cases amounted to a form of "self-help" designed to avoid going to Congress for additional authorities. The trustee argued that the SEC, despite having explicit authority under the Penny Stock Reform Act to impose disgorgement, cannot do so in a manner that would function like a penalty as opposed to being purely remedial, the latter being the only form of disgorgement the trustee said the SEC may pursue. The trustee asserted that this distinction gives rise to its claim that the disgorgement order against F-Squared violates structural separation of powers principles.

In *Kokesh*, the justices said the "hallmarks" of a "penalty" are that the penalty imposed seeks redress for the violation of a public law and the penalty is meant to promote deterrence. With respect to the recipient of the disgorgement, the justices said it makes a difference whether the recipient is the Treasury or fraud victims: "When an individual is made to pay a noncompensatory sanction to the Government as a consequence of a legal violation, the payment operates as a penalty" (citation omitted). The trustee noted that the disgorgement imposed against F-Squared was to be paid to the Treasury.

Lastly, the trustee argued that the Administrative Procedures Act allows an aggrieved person to bring claims against a federal agency that has taken actions outside of its prescribed authorities. According to the trustee, that means an aggrieved person may go to the federal district courts for a remedy and that the federal securities laws would not pre-clude this result.

The case is No. 18-2043.

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Companies: F-Squared Investment Management, Inc.; F2 Liquidating Trust

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