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Expanded SEC Remedies Under the National Defense Authorization Act

Codifying the SEC's Ability to Pursue Ill-Gotten Gains

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**EXPANDED SEC REMEDIES UNDER THE
NATIONAL DEFENSE AUTHORIZATION ACT**

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Gotten Gains

Sarah Levine
Joan McKown
Arielle Tobin

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AGENDA

- I. Introductions*
- II. Overview of enforcement remedies*
- III. Growth of Disgorgement as a remedy for the SEC over time*
- IV. Recent Supreme Court Cases*
- V. Defense Authorization Act*
- VI. What comes next?*

OVERVIEW OF ENFORCEMENT REMEDIES GENERALLY

- Injunction
- Cease and Desist Proceeding
- Disgorgement
- Penalties
- Officer and Director Bars
- Regulated Industry Bar
- 102(e) Bars – prohibit attorney or accountant from appearing or practicing before the Commission

All remedies are meant to provide General and Specific Deterrence from future violations.

GROWTH OF DISGORGEMENT AS A REMEDY

- **1933 and 1934 Acts:** Generally allow the SEC to seek equitable remedies
- **1971:** Courts recognize SEC's ability to deprive a wrongdoer of its ill-gotten gains
- **1978:** Courts start using term "disgorgement" in SEC matters
- **1990:** Remedies Act allows disgorgement in SEC administrative proceedings
- Disgorgement is neither restitution, what investors lost, nor a penalty
- As remedial relief, SEC long maintained no statute of limitations applied

GROWTH OF DISGORGEMENT AS A REMEDY

Year	Disgorgement	Penalties
1990	\$589M*	\$12.5M
2000	\$445M	\$43M
2010	\$1.8B	\$1.03B
2020	\$3.6B	\$1.1B

* In 1990, one person accounted for \$400M of the total.

DISGORGEMENT – ISSUES FOR DEFENDANTS

- Explosive growth in amounts sought
- Growth in types of cases where disgorgement is sought
- If there was no statute of limitations, SEC could seek disgorgement years after the alleged conduct

RECENT SUPREME COURT PRECEDENTS

- *Kokesh v. SEC*, 137 S. Ct. 1635 (2017).
- *Liu v. SEC*, 140 S. Ct. 1936 (2020).



KOKESH – BACKGROUND

- SEC sought monetary civil penalties, disgorgement, and an injunction.
- Kokesh found to have misappropriated \$34.9 million from 1995 to 2009.
- District Court determined 28 U.S.C. § 2462 - which imposes a five-year limitations period for “any civil fine, penalty, or forfeiture, pecuniary or otherwise” - barred civil monetary penalties.
 - But that § 2462 did not apply to disgorgement because disgorgement is not a “penalty” within the meaning of the statute.
- Tenth Circuit Court of Appeals affirmed, holding disgorgement is neither a “penalty” nor a “forfeiture.”

KOKESH – SUPREME COURT DECISION

- Supreme Court reversed, holding disgorgement is a “penalty” under § 2462 and therefore subject to five-year limitations period under the statute.
 - Disgorgement is imposed to redress a wrong to the public rather than a wrong to the individual.
 - Disgorgement is imposed as a deterrent.
 - Disgorgement is often not compensatory.

KOKESH – SUPREME COURT DECISION (CONT.)

- In a footnote, the Court called into question whether the SEC is allowed to obtain disgorgement at all in a civil action:

“Nothing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context[.] The sole question presented in this case is whether disgorgement, as applied in SEC enforcement actions, is subject to § 2462's limitations period.”

LIU – BACKGROUND

- Charles Liu and Xin Wang misappropriated around \$27 million in funds solicited from foreign nationals for construction of cancer-treatment center.
- District Court ordered disgorgement of the full amount Liu and Wang raised from investors, subtracting only the balance that remained in the corporate accounts for the project.
 - District Court did not deduct any business expenses from disgorgement award.
 - District Court ordered Liu and Wang jointly-and-severally liable.
- Ninth Circuit Court of Appeals affirmed.

LIU – SUPREME COURT DECISION

- Supreme Court held disgorgement is an authorized remedy for “equitable relief” under Section 21(d)(5) of the 1934 Act.
 - Although not a traditional equitable remedy, disgorgement serves the same essential purpose to prevent parties from profiting from wrongdoing.

LIU – SUPREME COURT DECISION (CONT.)

- Court imposed limitations on disgorgement:
 - Disgorgement “must do more than simply benefit the public at large by virtue of depriving a wrongdoer of ill-gotten gains” to be consistent with equitable principles and to satisfy the requirement of Section 21(d)(5) that the remedy be “for the benefit of investors.”
 - Court did not address SEC’s practice of depositing disgorgement funds with Treasury where infeasible to distribute funds to investors.
 - Remedy must generally be limited to profits received by each individual defendant, not imposed on a joint-and-several basis.
 - Collective liability can be imposed, however, for partners engaged in concerted wrongdoing.
 - Disgorgement cannot exceed the net profits. Legitimate expenses must be deducted.

HOW DID *KOKESH* AND *LIU* IMPACT THE SEC DISGORGEMENT POWERS?

- The SEC estimated it has had forgone \$1.1 billion in disgorgement since *Kokesh*:

“The *Kokesh* decision has had a significant impact, as many securities frauds are complex, well-concealed, and are not discovered until investors have been victimized over many years. The Division estimates that the *Kokesh* ruling has caused the Commission to forgo approximately \$1.1 billion dollars in disgorgement in filed cases. The actual impacts of *Kokesh* are likely far greater than this number reflects, however, because—since the *Kokesh* decision—the Division has shifted its resources to those investigations which hold the most promise for returning funds to investors. Thus, although the Division has seen some improvement this year in its effort to uncover, investigate, and bring cases as quickly as possible, it is likely that *Kokesh* will continue to impact our ability to recover for harmed investors in long-running frauds.”

- Division of Enforcement 2019 Annual Report

HOW DID *KOKESH* AND *LIU* IMPACT THE SEC DISGORGEMENT POWERS? (CONT.)

- The SEC reported that after *Liu*, it may seek to impose larger penalties to compensate for the loss of disgorgement:

“The Division continues to evaluate the impact of this decision and how the questions that the Court left open will affect us going forward. As a result, there have been and will continue to be changes in the balance between the penalties and disgorgement that the Division seeks and recommends to the Commission. Among other things, we may recommend higher penalties in some cases where the statutory scheme permits us to do so. The Division’s recommendations will be consistent with the Court’s decision, while continuing to seek the relief necessary to achieve our mission of protecting investors and maintaining market integrity.”

- Division of Enforcement 2020 Annual Report

WHAT DID *KOKESH* AND *LIU* MEAN FOR THE SEC AND DEFENDANTS?

- Five-year statute of limitations for disgorgement under 28 U.S.C. § 2462.
- Defendants could argue deduction of reasonable expenses from disgorgement awards.
- Disgorgement awards should generally be distributed to investors rather than deposited with Treasury.
- No joint and several liability.

NATIONAL DEFENSE AUTHORIZATION ACT (NDAA) FOR FISCAL YEAR 2021

- NDAA:
 - An annual, “must-pass” legislation specifying annual budget and expenditures for Department of Defense.
 - Was passed in January 2021 after House and Senate overrode a veto from former President Trump.
 - Included an amendment expanding authority for SEC to seek disgorgement and other remedies.
 - No prior public discussion of the amendment.
 - But the SEC made it clear to Congress it wanted statutory authorization for disgorgement.

NDAAs FY 2021– KEY TAKEAWAYS:

- Authorizes SEC to seek disgorgement in Federal District Court
- Allows disgorgement awards to be distributed to Treasury
- Ten-year limitation for disgorgement stemming from fraud
- Ten-year limitation for injunctions and cease and desist proceedings
- Five-year limitation for disgorgement stemming from non-fraud
- Indefinitely tolls statute while individuals are outside of United States
- Appears to limit disgorgement to net profits
- Appears to prohibit joint-and-several liability

WHAT COMES NEXT?

- What will be litigated?
- Will it change the cases where the SEC seeks disgorgement?
- Will it change how the SEC investigates?

WHAT CAN COMPANIES DO TO PROTECT THEMSELVES?

- Find problems before they become larger problems:
 - Whistleblower hotline
 - Robust internal audit
 - Credit for cooperation
- Negotiate amount of disgorgement
 - Experts
 - Time period
 - Conduct alleged



Questions?

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