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Securities Enforcement & Litigation Alert

In *Gabelli*, Supreme Court Holds SEC Enforcement to Strict Five-Year Limitations Period for Penalties; Will Another Shoe Drop in *Bartek*?

by Christian Bartholomew, Christopher Garcia and Layne Behrens

In *Gabelli v. SEC*, No. 11-1274, 2013 WL 691002 (U.S. Feb. 27, 2013), the Supreme Court unanimously adopted a bright-line rule that, in SEC enforcement cases where the SEC seeks civil money penalties, the five-year statute of limitations provided for in 28 U. S. C. §2462[1] begins to run when the violation occurs. In so doing, the Court rejected the SEC's argument that the limitations period should not begin to run until fraud is discovered or with reasonable diligence could have been discovered, holding instead that the SEC is not like private litigants and should be bound by the stricter accrual rule.

Although this is an important decision, its practical impact on the SEC's enforcement program may be somewhat limited. Indeed, the SEC has been operating under the five-year statute for many years and has not been reluctant, when it confronts substantial limitations issues during investigations, to seek and obtain tolling agreements. Moreover, the *Gabelli* decision applies only to penalties and not to SEC injunctions or similar relief, which the SEC views as equitable and hence not subject to any limitations period, including §2462 (a view the *Gabelli* defendants conceded). We stress, however, that the Court may soon consider whether §2462 applies to such relief in connection with the Fifth Circuit's decision in *SEC v. Bartek*,[2] which held that the injunction and officer-and-director bars sought in that matter were punitive and hence barred by §2462. The SEC filed a cert petition in *Bartek* literally two weeks before the *Gabelli* decision was issued, but asked the Court to hold the petition in abeyance pending resolution of *Gabelli*.[3] Now that the Court has decided *Gabelli*, it remains to be seen whether the SEC will pursue the *Bartek* petition, particularly given the tenor and holding of the *Gabelli* decision. In either event, the issue bears close watching.

The *Gabelli* Decision

The *Gabelli* decision arose out of an enforcement action the SEC brought in 2008 against Bruce Alpert and Marc Gabelli, employees of Gabelli Funds, LLC, a mutual fund investment adviser, for allegedly engaging in fraudulent market timing between 1999 and 2002. As is typical, the SEC's complaint sought civil money penalties in addition to an injunction and other relief. The defendants persuaded the district court to dismiss the SEC's complaint as untimely under §2462, but the Second Circuit reversed, agreeing with the SEC that the SEC was entitled to the benefit of the discovery rule, that is,

that the statute of limitations should not be deemed to accrue until the alleged fraud was discovered or could have been discovered through the exercise of reasonable diligence. Accordingly, because the SEC claimed that the alleged fraud was not discovered until September 2003, the Second Circuit permitted the matter to proceed.

In a unanimous opinion written by Chief Justice John Roberts, the Supreme Court reversed. After concluding that there was no support for a discovery rule in the text of the statute, the Court declined to "graft" such a rule onto the statute for three reasons. *First*, the Court explained that the purpose of the discovery rule is to preserve claims for individuals who do not know that they have been harmed and who cannot be expected to "live in a state of constant investigation" to ferret out whether they have been defrauded. The Court noted that the SEC is a different type of plaintiff in that its "very purpose is to root [] out [fraud], and it has many legal tools at hand to aid in that pursuit." According to Chief Justice Roberts, the "SEC as enforcer is a far cry from the defrauded victim the discovery rule evolved to protect." *Second*, the Court observed that penalties are punitive in nature but that the purpose of the discovery rule is principally to ensure that victims are made whole. *Lastly*, the Court declined to apply the discovery rule to §2462, because it would be difficult for courts to determine whether the SEC exercised reasonable diligence in uncovering fraud.

Impact of *Gabelli* on SEC Enforcement Efforts Going Forward

Gabelli is an important "brushback" pitch directed at the SEC's enforcement program, but its impact would appear to be somewhat limited for a number of reasons. Although the Court did not discuss the decision, the SEC has been bound by §2462 since the D.C. Circuit's 1996 decision in *Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996), which held that §2462 applied to an administrative censure imposed by the SEC. While it is true that *Gabelli* now limits the SEC to a "hard" five-year limitations period, the SEC has been operating under the *Johnson* ruling for more than 15 years and has rarely sought to rely upon the discovery rule. And, leaving aside §2462, SEC lawyers have long faced arguments from defendants in federal injunctive actions that the underlying conduct is too old and too attenuated to warrant the imposition of an injunction. It is therefore not surprising that, over the years, the Enforcement Division has sought to reduce the number of investigations involving old and older conduct. Recently, enforcement officials have indicated that they now engage in a rigorous review of any investigation that hits the two-year mark. Finally, where timeliness does become a real issue, the Enforcement Division has not been hesitant to seek and obtain tolling agreements with putative defendants. Indeed, it certainly seems possible that such agreements are already in place or soon will be in place for certain firms in connection with the 2008 financial crisis.

This is not to say, however, that the decision will have no impact. The Supreme Court has now said unequivocally that unless the SEC sues within five years of the violation, it cannot (absent a tolling agreement) obtain penalties. Thus, it seems likely that, under *Gabelli*, the SEC may not pursue some cases that it would have otherwise pursued, or may pursue those cases differently than it would have, *i.e.*, by pursuing only equitable relief. To the extent that the SEC is currently engaged in investigations involving older conduct where defendants have refused to execute tolling agreements, *Gabelli* changes the settlement calculus: the SEC will lack the leverage penalties offer and, in those cases, its bargaining position just got much weaker. We believe such cases will be rare.

However, as we noted at the outset, if the SEC pursues its petition in *Bartek* and the Court then finds that §2462 applies to SEC injunctions and officer-and-director bars, this could have a significant effect on the enforcement program. *Bartek* involved an options backdating investigation, in which the SEC sued the relevant issuer and two of its officers in 2008 (the same year the SEC brought the *Gabelli* action) for options backdating during 2000-2003. The district court found that both the injunction and the O&D bars were punitive and not remedial and therefore subject to §2462. The Fifth Circuit affirmed, holding that these

remedies failed to address past harm and would not prevent future harm "in light of the minimal likelihood of similar conduct in the future," and would be penal because they would have a "stigmatizing effect and long-lasting repercussions."[4] The SEC filed a petition for review with the Supreme Court on February 13, 2013, literally two weeks before *Gabelli* was issued, in which it asked the Court to reverse the Fifth Circuit, but also proposed that the petition be held until *Gabelli* was decided.[5]

Given the Supreme Court's strict reading of the language of §2462 in *Gabelli* (*e.g.*, its refusal to "graft" a discovery rule onto the statute), it is certainly possible and perhaps even likely that it will read the statute to apply only to monetary penalties, and will agree with the greater weight of authority that, because injunctions and the like are remedial, they are not covered by §2462.[6] Indeed, the *Gabelli* Court noted that the lower court had found that the injunction and disgorgement sought were not subject to §2462, and the SEC in its cert petition cited cases holding that injunctions (including O&D bars) are properly considered equitable in nature "because [their] purpose is to protect investors in the future from unfit professionals." However, given the Court's equally clear view that the SEC is an enforcement entity with a duty to carry out investigations in a timely fashion that is not to be compared with a private litigant, the Court could conclude that such remedies are in fact punitive and therefore governed by the five-year statute.

We stress, however, that the SEC has been grappling with these issues – *i.e.*, whether an injunction or other remedy is punitive or remedial – for many, many years, even in cases where there is no limitations argument. For example, in supporting its requests for obey-the-law injunctions, the SEC has long been required to establish that the defendant's conduct warrants such forward-looking relief and that the relief is, therefore, remedial and not punitive. In fact, the *Bartek* court reached its conclusion that the injunction and O&D bar were punitive because it found that the SEC had not made a sufficient record that such forward-looking remedies were warranted by the defendants' conduct and possible future conduct. It is therefore possible that, given the tone of and result in *Gabelli*, the SEC may withdraw its petition in *Bartek* on the theory that it simply applied a standard the SEC already, in substance, faces.

We will continue to monitor these issues closely and update you as appropriate.

1 §2462 provides as follows: "[e]xcept as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued if, within the same period, the offender or the property is found within the United States in order that proper service may be made thereon."

2 No. 11-10594, 2012 WL 3205446 (5th Cir. Aug. 7, 2012).

3 The SEC also sought review of the Fifth Circuit's decision that the SEC was not entitled to application of the fraud discovery rule. In light of the *Gabelli* decision, it would seem clear that the SEC will withdraw this part of the petition.

4 2012 WL 3205446, at *957. *Bartek* did not hold, and we are not aware of any court so holding, that disgorgement is subject to §2462.

5 The SEC's petition may be found at: http://149.101.146.50/osg/briefs/2012/2pet/7pet/2012-1000.pet.aa.pdf

6 *See, e.g., SEC v. Quinlan*, 373 F. App'x 581 (6th Cir. 2010) (finding injunction and O&D bar not subject to §2462).

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