

## CONGRESS CODIFIES SEC DISGORGEMENT REMEDY IN MILITARY SPENDING BILL

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The Securities and Exchange Commission (“SEC”) has long pursued disgorgement as a remedy for ill-gotten gains, and courts have awarded disgorgement under their power to grant “equitable relief.” However, because the Securities Exchange Act of 1934 (“Exchange Act”) did not expressly authorize the SEC to seek disgorgement, defendants have challenged the SEC’s authority to seek such equitable relief. Two recent Supreme Court decisions—*Kokesh v. S.E.C.* (2017) and *Liu v. S.E.C.* (2020)—meaningfully narrowed the SEC’s authority and practical ability to obtain broad disgorgement.<sup>1</sup> In *Kokesh*, the Supreme Court unanimously held that a claim for disgorgement constitutes a “penalty” and is thus subject to a five-year statute of limitations in 28 U.S.C.A. § 2462.<sup>2</sup> And in *Liu*, the Supreme Court

held, in a near-unanimous 8-1 ruling, that, while traditional equity principles authorize the SEC to seek disgorgement, that remedy is limited in three key respects: (i) it cannot be imposed on multiple wrongdoers under a joint-and-several liability theory; (ii) it is limited to net profits, deducting any legitimate expenses; and (iii) any disgorgement may only be sought for the benefit of victims of the defendant’s wrongdoing, rather than deposited into the United States Treasury.<sup>3</sup>

Early this year, Congress addressed these rulings by granting the SEC expansive authority to seek disgorgement. On January 1, 2021, Congress overrode a presidential veto and passed the National Defense Authorization Act (“NDAA”), the annual military spending bill passed each year since 1961.<sup>4</sup> Buried in this massive 1,400 page appropriations bill is an amendment to the Exchange Act that grants the SEC express statutory authority to seek disgorgement in federal district court,<sup>5</sup> expands the statute of limitations for disgorgement in certain scienter-based violations to 10 years,<sup>6</sup> and tolls the statute of limitations for disgorgement claims for periods of time that an offender spends outside the United States.<sup>7</sup>

While its inclusion in the NDAA may have been unexpected, the fact that Congress decided finally to codify the SEC’s disgorgement remedy should come as no surprise. As we previewed in our last article, SEC leadership had long urged Congress to adopt a statutory fix follow-



ing the Supreme Court's rulings in *Kokesh* and *Liu*; and indeed, Congress had proposed legislation to confer statutory disgorgement authority on the SEC even prior to *Liu*.<sup>8</sup> Still, while Congress has granted the SEC statutory authority to seek disgorgement, the scope of the remedy remains undefined and the precise contours of the remedy will inevitably result in substantial litigation.

### Section 6501 of the NDAA

Section 6501 of the NDAA, titled *Investigations and Prosecutions of Offenses for Violations of the Securities Laws*, applies to any action or proceeding pending on, or commenced after, January 1, 2021.<sup>9</sup> The amendment includes three key changes to the SEC's ability to seek relief.

*First*, the amendment codifies the SEC's right to disgorgement. Under Section 6501 of the NDAA, the SEC is authorized to seek "disgorgement . . . of any unjust enrichment by the person who received such unjust enrichment."<sup>10</sup> *Second*, the amendment includes a 10-year statute of limitations period for scienter-based violations, including Section 10(b) of the Securities Exchange Act of 1934, Section 17(a)(1) of the Securities Act of 1933, and Section 206(1) of the Investment Advisers Act of 1940.<sup>11</sup> For all other disgorgement claims, the SEC must bring a claim within five years of the conduct giving rise to the violation, consistent with the Supreme Court's ruling in *Kokesh*.<sup>12</sup> Section 6501 also lengthens to 10 years the statute of limitations for equitable remedies, including an injunction, bar, suspension, or cease and desist order.<sup>13</sup> *Third*, Section 6501 includes a tolling provision for periods of time that an offender spends outside the United States.<sup>14</sup>

These amendments to the Exchange Act were introduced into the NDAA late in the legislative process—only after the bill had passed both chambers and proceeded to conference committee.<sup>15</sup> During conference committee, these amendments were inserted in Title LXV of the NDAA, along with other "Miscellaneous" provisions relating to topics ranging from Treasury department studies on money laundering to studies on authoritarian regimes.<sup>16</sup> Members of both houses of Congress had previously introduced standalone bills aimed at addressing the Supreme Court's recent decisions relating to disgorgement, but neither bill made it out of the Senate Committee on Banking, Housing, and Urban Affairs.

The clear impetus for Section 6501 was the Supreme Court's recent decisions in *Kokesh* and *Liu*, as well as subsequent statements from SEC leadership complaining about the impact the rulings were having on the Commission's ability to return money to investors harmed by federal securities law violations. For example, even before the *Liu* ruling, then-SEC Chairman Jay Clayton expressed concern that the *Kokesh* ruling would prevent the SEC from recovering "substantial amount of losses . . . for retail investors as a result of Ponzi schemes and similar long-running, well-concealed frauds that are perpetrated by smooth talking 'investment professionals[],' " and he "welcome[d] the opportunity to work with Congress to address this gap in investor protection."<sup>17</sup> Even more recently, in his November 17, 2020, testimony before the Senate Committee on Banking, Housing, and Urban Affairs, then-Chairman Clayton noted that "[s]ince *Kokesh* was decided, more than \$1 billion in ill-gotten gains has been unavailable for possible distribution to harmed investors."<sup>18</sup>

### Practical Implications

Section 6501 directly addresses the Court's decision in *Kokesh*, making clear that the most serious securities violations—those that require proof of scienter—permit disgorgement for at least a 10-year period prior to the filing of charges, and for even longer periods where the statute is tolled because the offender is located outside the United States.<sup>19</sup> Whether and how this tolling provision might apply to multinational corporations located outside the United States and foreign issuers remains to be seen. In any event, Section 6501 undoubtedly strengthens the SEC's ability to recoup ill-gotten gains obtained by offenders involved in long running fraud schemes. But because the amendment only extends the statute of limitations for *scienter-based* claims, it could have the unintended consequence of incentivizing the SEC to “overcharge” more scienter-based violations where the Commission may otherwise have charged or agreed to settle with non-scienter based violations (such as Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933) in order to obtain larger disgorgement payments. In these circumstances, defendants may increasingly insist on litigation rather than resolution because many defendants—both individuals and corporations alike—are often unwilling to settle scienter-based fraud charges.

The amendment's impact on the holdings in *Liu* is less clear. While Section 6501 provides explicit statutory authority for the SEC to seek disgorgement, which affirms a central holding in *Liu*, it does not directly address the remainder of the holdings in *Liu*, which narrow the disgorgement remedy based on equitable principles.<sup>20</sup> Importantly, the amendments do not define the scope of the disgorgement remedy, other than to

state that the remedy applies to “any unjust enrichment by the person who receives unjust enrichment as a result of such violation.”<sup>21</sup> The continued application of the equitable limitations on disgorgement in *Liu* is therefore ripe for continued litigation and will require case law development.

Defendants will have strong arguments that codification of a “disgorgement” remedy without any clear definition or scope requires the application of equitable principles, including those enumerated in *Liu*.<sup>22</sup> After all, defendants will argue, if Congress' intent was to grant the SEC sweeping authority to bring disgorgement claims free from the restrictions in *Liu*, it could have done so explicitly. Defendants also will likely argue that, far from overriding the equitable limitations in *Liu*, the amendment, in fact, reaffirmed two key equitable limitations in *Liu*: (i) that use of the term “unjust enrichment” in describing available disgorgement supports continued deduction of legitimate business expenses from any disgorgement award; and (ii) that the statutory reference to disgorgement from “*the person* who receives unjust enrichment”—using the singular rather than the plural—affirms *Liu*'s prohibition against application of joint and several liability.

The SEC, by contrast, will have its own arguments that *Liu* no longer applies in light of the enactment of Section 6501. For example, the SEC may contend that Congress' codification of the disgorgement remedy renders it untethered from the “equitable relief” section of the Exchange Act and thus unbounded by the equitable limitations in *Liu*. And the SEC may, more specifically, argue that Section 6501 overrides the *Liu* limitation requiring any SEC disgorgement awards to be reserved for investors, which de-

rived from the Exchange Act's provision permitting the Commission to seek "any equitable relief that may be appropriate or necessary for the benefit of investors."<sup>23</sup> Section 6501, however, contains no similar requirement; to the contrary, it refocuses disgorgement with reference to an offender's "unjust enrichment," not investors' losses.<sup>24</sup> This leaves open an argument that disgorged funds could properly be shared with the Treasury and need not be tied to specific investor losses, as the Court held in *Liu*.

While it remains to be seen whether, and to what extent, the limitations in *Liu* apply to disgorgement, the NDAA's Section 6501 is a clear win for the SEC. For the first time, the Commission has express statutory authority to pursue disgorgement as a remedy and, in many cases, to remediate misconduct over a 10-year period or longer.

#### ENDNOTES:

<sup>1</sup>The authors previously discussed both the *Kokesh* and *Liu* rulings in *Wall Street Lawyer*, Vol. 24, No. 7, "*Liu v. SEC*: Supreme Court Cabins SEC Disgorgement Remedy."

<sup>2</sup>*Kokesh v. S.E.C.*, 137 S. Ct. 1635, 1639, 198 L. Ed. 2d 86, Fed. Sec. L. Rep. (CCH) P 99733 (2017).

<sup>3</sup>*Liu v. Securities and Exchange Commission*, 140 S. Ct. 1936, 1948-1950, 207 L. Ed. 2d 401, Fed. Sec. L. Rep. (CCH) P 100851 (2020).

<sup>4</sup>William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, H.R. 6395, 116th Cong. (2020) (NDAA), <https://www.congress.gov/bill/116th-congress/house-bill/6395>.

<sup>5</sup>NDAA § 6501(a)(1)(B) (to be codified at 15 U.S.C.A. § 78u(d)(3)(A)(ii)).

<sup>6</sup>NDAA § 6501(a)(3) (to be codified at 15 U.S.C.A. § 78u(d)(8)(A)(ii)).

<sup>7</sup>NDAA § 6501(a)(3) (to be codified at 15 U.S.C.A. § 78u(d)(8)(C)).

<sup>8</sup>The Securities Fraud and Investor Compensation Act, S. 799, 116th Cong. (2019); Investor Protection and Capital Markets Fairness Act, H.R. 4344, 116th Cong. (2019).

<sup>9</sup>NDAA § 6501(b).

<sup>10</sup>NDAA § 6501(a)(1)(B) (to be codified at 15 U.S.C.A. § 78u(d)(3)(A)(ii)).

<sup>11</sup>NDAA § 6501(a)(3) (to be codified at 15 U.S.C.A. § 78u(d)(8)(A)(ii)).

<sup>12</sup>NDAA § 6501(a)(3) (to be codified at 15 U.S.C.A. § 78u(d)(8)(A)(i)).

<sup>13</sup>NDAA § 6501(a)(3) (to be codified at 15 U.S.C.A. § 78u(d)(8)(B)). This addition is notable because before the amendment, such equitable remedies were not subject to any statute of limitations and the SEC could initiate civil injunctive proceedings for any historic violating conduct.

<sup>14</sup>NDAA § 6501(a)(3) (to be codified at 15 U.S.C.A. § 78u(d)(8)(C)) ("any time in which the person against which the action or claim, as applicable, is brought is outside the United States shall not count towards the accrual of that period.").

<sup>15</sup>H. Rept. 116-617, William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, Conference Report to Accompany H.R. 6395, 116th Cong. (2020), <https://www.congress.gov/congressional-report/116th-congress/house-report/617>.

<sup>16</sup>NDAA §§ 6506 (Treasury study and strategy on trade-based money laundering), 6508 (Treasury and Justice study on the efforts of authoritarian regimes to exploit the financial system of the United States).

<sup>17</sup>Jay Clayton, Chairman, SEC, Keynote Remarks at the Mid-Atlantic Regional Conference (June 4, 2019), <https://www.sec.gov/news/speech/clayton-keynote-mid-atlantic-regional-conference-2019>.

<sup>18</sup>Jay Clayton, Chairman, SEC, Testimony on "Oversight of the Securities and Exchange Commission" (Nov. 17, 2020), <https://www.sec.gov/n>

[ews/testimony/clayton-sec-oversight-2020-11-17](#).

<sup>19</sup>NDAA § 6501(a)(3) (to be codified at 15 U.S.C.A. § 78u(d)(8)(A)(ii), § 78u(d)(8)(B)).

<sup>20</sup>*Liu*, 140 S. Ct. at 1946.

<sup>21</sup>NDAA § 6501(a)(1)(B) (to be codified at

15 U.S.C.A. § 78u(d)(3)(A)(ii)).

<sup>22</sup>NDAA § 6501(a)(1)(B) (to be codified at 15 U.S.C.A. § 78u(d)(3)(A)(ii)).

<sup>23</sup>15 U.S.C.A. § 78u(d)(5) (emphasis added).

<sup>24</sup>NDAA § 6501(a)(1)(B) (to be codified at 15 U.S.C.A. § 78u(d)(3)(A)(ii)).