Milbank

Litigation

Beijing Frankfurt Hong Kong London Los Angeles Munich New York São Paulo Singapore Tokyo Washington, DC

March 5, 2013

SEC HELD TO FIVE-YEAR STATUTE OF LIMITATIONS FOR CIVIL PENALTY CLAIMS

On February 27, 2013, in *Gabelli v. Securities and Exchange Commission*,[1] a unanimous Supreme Court rebuffed an effort by the Securities and Exchange Commission to expand the limitations period for civil penalty claims beyond the five-year period set by statute. The SEC argued that its penalty claim accrued when it discovered the misconduct, and not when the misconduct occurred. The Court disagreed, holding that such a "discovery rule," used in private actions for damages, does not apply to Government actions for penalties.

While the *Gabelli* decision could increase the number of SEC cases brought this year that relate to the nearly five-year-old financial crisis, the holding will probably not impact the SEC's enforcement agenda significantly since it does not squarely apply to claims for equitable relief, such as injunctions and disgorgement. In addition, while the SEC will still be able to obtain penalties in settled actions based on older conduct, *Gabelli* may work to reduce such penalties. More significant for the SEC is that the broad reasoning of *Gabelli* suggests that the Court may not endorse the SEC's view that there is no statute of limitations for equitable relief.

Background

In April 2008, the SEC brought two actions charging that an investor in a Gabelli mutual fund had received favorable treatment that was not disclosed to other investors: (1) a settled administrative proceeding against Gabelli Funds, LLC, an investment advisor headed by Mario Gabelli; and (2) a contested action filed in the Southern District of New York against a portfolio manager, Mario Gabelli's son, as well as the chief operating officer of Gabelli Funds, LLC. These matters were among the last of many SEC actions in the last decade involving active buying and selling of shares in mutual funds to allegedly exploit short-term pricing inefficiencies, a practice often referred to as "market timing" that was brought to light by then Attorney General Eliot Spitzer on September 3, 2003. The SEC alleged that the Gabelli defendants had permitted one of the mutual fund's investors to engage in active trading in the fund's shares as a *quid pro quo* for the investor's agreement to keep money in a hedge fund run by one of the defendants. According to the SEC, this favored treatment was highly profitable to the investor, but was secret, and not disclosed to other shareholders or the fund's board, so the SEC did not discover the fraud until late 2003.[2]

For further information about this Client Alert, please contact:

James G. Cavoli
212-530-5172
jcavoli@milbank.com

Dorothy Heyl
212-530-5088
dheyl@milbank.com

Robert Lindholm
212-530-5131
rlindholm@milbank.com

You may also contact any member of Milbank's Litigation Group. Contact information can be found at the end of this Client Alert. In addition, if you would like copies of our other Client Alerts, please visit our website at www.milbank.com and choose "Client Alerts" under "News."

This Client Alert is a source of general information for clients and friends of Milbank, Tweed, Hadley & McCloy LLP. Its content should not be construed as legal advice, and readers should not act upon the information in this Client Alert without consulting counsel.
© 2013, Milbank, Tweed, Hadley & McCloy LLP. All rights reserved.

Attorney Advertising. Prior results do not guarantee a similar outcome.

1 *Gabelli v. S.E.C.*, No. 11-1274, slip op. (Feb. 27, 2013).

2 Complaint at ¶¶ 46-47, *S.E.C. v. Gabelli*, No. 08 CV 3868 (DAB), 2010 WL 1253603 (S.D.N.Y. Mar. 17, 2010), *available at* www.sec.gov/litigation/complaints/2008/comp20539.pdf.

In the federal court action, the SEC sought to enjoin the individual defendants from future violations, and to obtain disgorgement of their allegedly ill-gotten gains (plus prejudgment interest) and a civil monetary penalty under Section 209(e) of the Investment Advisers Act. As to one of the individual defendants, the SEC also charged a violation of the Securities Act of 1933 and the Securities Exchange Act of 1934, and sought a monetary penalty under those statutes as well.[3]

The defendants moved to dismiss the complaint on various bases, including that the claim for civil penalties was barred by the five-year statute of limitations in 28 U.S.C. § 2462, which states that, unless Congress provides otherwise, "an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture" must be "commenced within five years from the date when the claim first accrued."

In March 2010, District Judge Deborah Batts dismissed most of the SEC's claims, including the claim for penalties on the ground that it was time-barred.[4] She also dismissed the injunctive claims, finding that there was no reasonable basis for anticipating future violations by the two individuals, both then former employees of Gabelli Funds, LLC. She left standing the SEC's claim for disgorgement of any unlawful profits, determining that it was not time-barred. (This was a Pyrrhic victory for the SEC, however, given that Gabelli Funds, LLC had already disgorged the profits relating to market timing, and any "profit" made by the individual defendants as a result of the alleged conduct was small.)

Both sides appealed to the United States Court of Appeals for the Second Circuit: the SEC challenged, among other things, the holding as to penalties and injunctive relief, and the defendants challenged the holding as to disgorgement.[5] District Court Judge Jed Rakoff, sitting by designation, authored an opinion that handed the SEC a complete victory. The Second Circuit, relying on *Merck & Co. v. Reynolds*,[6] held that the penalty claim accrued only when the SEC discovered it; it also held that it was improper to rule out injunctive relief as a matter of law at the motion-to-dismiss stage. The defendants appealed the Second Circuit's holding on the penalty (but not the other relief) to the Supreme Court, which agreed, in September 2012, to hear the case.

The Supreme Court Decision

The Court unanimously reversed the Second Circuit's decision. In the opinion, Chief Justice Roberts framed the issue simply: "whether the five-year clock begins to tick when the fraud is complete or when the fraud is discovered." The Court found that the "most natural reading" of 28 U.S.C. § 2462 is that "a claim based on fraud accrues—and the five-year clock begins to tick—when a defendant's allegedly fraudulent conduct occurs." It also noted that "we have never applied the discovery rule in this context, where the plaintiff is not a defrauded victim seeking recompense, but is instead the Government bringing an enforcement action for civil penalties."

But rather than resolve the question based solely on the plain reading of the statute, the Court also pointed to the policy favoring sharp clarity in the reading of statutes of repose, which are "intended to 'promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared.'" The Court found such an approach to be "vital to the welfare of society," adding that "even wrongdoers are entitled to assume that their sins may be forgotten."

---

3 In the settled administrative proceeding, Gabelli Funds, LLC agreed to disgorge unlawful profits totaling $9,700,000 (plus prejudgment interest of $1,300,000), and to pay a civil monetary penalty of $5,000,000, for a total payment of $16,000,000. *See* Gabelli Funds LLC, Investment Advisers Act Release No. 2727, Investment Company Act Release No. 28253 (Apr. 24, 2008), *available at* www.sec.gov/litigation/admin/2008/ia-2727.pdf.

4 *S.E.C. v. Gabelli*, No. 08 CV 3868 (DAB), 2010 WL 1253603 (S.D.N.Y. Mar. 17, 2010).

5 *S.E.C. v. Gabelli*, 653 F.3d 49, 56 (2d Cir. 2011).

6 130 S. Ct. 1784 (2010).

The Court distinguished *Merck v. Reynolds* and an earlier case in which the Government was itself the victim of fraud, *Exploration Co. v. United States*,[7] explaining that in an enforcement action the Government is in a very different posture from "the defrauded victim the discovery rule evolved to protect." The difference, the Court reasoned, stems from the Government's role in detecting fraud and its superior ability to do so. Unlike private citizens, who "do not live in a state of constant investigation," and "do not typically spend [their] days looking for evidence that we were . . . defrauded," the SEC's "central mission" is to root out fraud, and it has many tools to do so.

The Court also explained that the monetary penalties sought by the SEC are different in kind from monetary damages sought by private plaintiffs. Penalties are intended to punish culpable individuals, the Court held, "not to extract compensation and restore the *status quo*." Quoting Chief Justice John Marshall, Chief Justice Roberts wrote that it "would be utterly repugnant to the genius of our laws" if actions for penalties could "be brought at any distance of time." He added that, as a practical matter, it would be extremely difficult to determine precisely when "the government" came to learn of something.

Implications

The Court's rejection of the "discovery rule" for monetary penalties in SEC enforcement actions is obviously a favorable development for many would-be defendants, particularly financial institutions and public companies as to whom the SEC seeks ever increasing penalties. Had the Court adopted the SEC's position, for example, the SEC could have sought penalties against the Gabelli defendants based on trades dating all the way back to 1999. Nonetheless, the SEC seems to be downplaying the significance of the decision, recently noting that "we do not expect an immediate impact on our ability to successfully hold violators accountable for their misconduct."[8]

While the Court's decision in *Gabelli* on statutes of limitation was limited to interpreting 28 U.S.C. § 2462, it could have wider application should the Court also decide that SEC injunctions and/or disgorgement are effectively "penalties," and thus subject to the same time bar. Two weeks before *Gabelli* was decided, the SEC sought Supreme Court review of the Fifth Circuit's decision in *SEC v. Bartek*,[9] a case involving options back-dating.[10] In *Bartek*, the appeals court had ruled *against* the SEC on the same issue that was appealed to the Court in *Gabelli*, as well as on the important question left open by the Court in *Gabelli*: whether injunctions, including officer-and-director bars, are subject to the same time bar as actions for penalties. In an unpublished opinion, the Fifth Circuit affirmed a district court summary judgment decision in favor of the defendants, holding that SEC claims for equitable relief were effectively penal in view of their "severity and permanent nature." Given the Court's decision in *Gabelli*—that actions for penalties are time-barred if brought more than five years after the conduct—the SEC has even more reason to seek reversal of the *Bartek* decision. But the broad language in *Gabelli* on the virtues of repose and the SEC's duty to investigate may cause the SEC to rethink their appeal in *Bartek*, since an adverse decision from the Court on the penal nature of injunctions and disgorgement would change a long-standing SEC practice of reaching back well beyond five years in injunctive actions seeking disgorgement.

Conclusion

The holding in *Gabelli* could well reduce the penalty amounts sought by the SEC in settlement discussions involving older conduct, by confining the bases for penalties to conduct that occurred within the five years prior to the filing of an action, and/or five years prior to the execution of a tolling agreement, to the extent that an action has not yet been filed. This will affect not only new cases, but currently pending actions and investigations, as the SEC will no longer be able to recover such penalties in litigated matters and may thus be willing to restart settlement talks at new, lower levels for the penalty portion of the settlement.

---

7 247 U.S. 435 (1918).

8 Dina ElBoghdady, *Supreme Court defines time limits for SEC to pursue civil cases*, Feb. 27, 2013, Wash. Post, *available at* http://articles.washingtonpost.com/2013-02-27/business/37331446_1_john-nester-sec-spokesman-discovery-rule.

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

10 Petition for Writ of Certiorari, *S.E.C. v. Bartek*, No. 12-1000, 2013 WL 543280 (Feb. 13, 2003).

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any member of our Litigation and Arbitration Group listed below.

New York

Wayne M. Aaron	212-530-5284	waaron@milbank.com
Thomas A. Arena	212-530-5828	tarena@milbank.com
Sander Bak	212-530-5125	sbak@milbank.com
James N. Benedict, *Chair*	212-530-5696	jbenedict@milbank.com
James G. Cavoli	212-530-5172	jcavoli@milbank.com
Christopher E. Chalsen	212-530-5380	cchalsen@milbank.com
Scott A. Edelman, *Firm Vice Chairman*	212-530-5149	sedelman@milbank.com
Christopher J. Gaspar	212-530-5019	cgaspar@milbank.com
David R. Gelfand	212-530-5520	dgelfand@milbank.com
Joseph S. Genova	212-530-5532	jgenova@milbank.com
Douglas W. Henkin	212-530-5393	dhenkin@milbank.com
Michael L. Hirschfeld	212-530-5832	mhirschfeld@milbank.com
Robert C. Hora	212-530-5170	rhora@milbank.com
Lawrence T. Kass	212-530-5178	lkass@milbank.com
Atara Miller	212-530-5421	amiller@milbank.com
Sean M. Murphy	212-530-5688	smurphy@milbank.com
Daniel Perry	212-530-5083	dperry@milbank.com
Stacey J. Rappaport	212-530-5347	srappaport@milbank.com
Richard Sharp	212-530-5209	rsharp@milbank.com
Alan J. Stone, *Practice Group Leader*	212-530-5285	astone@milbank.com
Errol B. Taylor	212-530-5545	etaylor@milbank.com
Fredrick M. Zullow	212-530-5533	fzullow@milbank.com

Washington, DC

David S. Cohen	202-835-7517	dcohen2@milbank.com
Robert J. Koch	202-835-7520	rkoch@milbank.com
Andrew M. Leblanc	202-835-7574	aleblanc@milbank.com
Michael D. Nolan	202-835-7524	mnolan@milbank.com

Los Angeles

Linda Dakin-Grimm	213-892-4404	ldakin-grimm@milbank.com
Robert J. Liubicic	213-892-4525	rliubicic@milbank.com
Jerry L. Marks	213-892-4550	jmarks@milbank.com
Mark Scarsi	213-892-4580	mscarsi@milbank.com

London

Tom Canning	44-20-7615-3047	tcanning@milbank.com
Charles Evans	44-20-7615-3090	cevans@milbank.com
Julian Stait	44-20-7615-3005	jstait@milbank.com