

SEC Disgorgement Authority Would Expand in National Defense Authorization Act

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The National Defense Authorization Act approved by Congress last week would extend to 10 years the time for the SEC to file disgorgement claims for scienter-based violations. It also would toll the limitations period while a party is outside of the United States. As of this writing, the bill awaits the President's signature.

The Backdrop of Liu and Kokesh

As we discussed in a previous [client memorandum](#), the Supreme Court in *Kokesh v. Securities and Exchange Commission* held that SEC disgorgement claims are subject to the five-year statute of limitations in 28 U.S.C. §2462 because they constitute a “penalty.” An open question following *Kokesh* was whether the SEC had authority at all to pursue disgorgement in federal court. As we explained in a [client memorandum](#), the Court answered that question earlier this year in *Liu v. Securities and Exchange Commission* by upholding the SEC’s authority subject to three limiting principles:

- Disgorged funds usually must be returned to the victims. The Court said it need not address whether disgorgement might be permissible when it is impractical to distribute funds;
- The Court expressed doubt as to whether disgorgement may be sought against multiple individuals via a joint and several liability theory;
- The Court held that because the remedy is limited to “net” profits, legitimate business expenses generally must be deducted from a disgorgement award.

National Defense Authorization Act - H.R. 6395

After H.R. 6395 passed the House and Senate and was in Conference Committee earlier this month, portions of Sen. Mark Warner’s (D-VA) Illicit Cash Act (S. 2563)¹ were added to the bill. The bill emerged from Committee with newly added Section 6501, intended to address certain aspects of the Supreme Court’s rulings in *Kokesh* and *Liu*.² On December 11, 2020, after passing the Senate by a vote of 84-13, H.R. 6395 was presented to the President. The President has threatened to veto the bill for unrelated reasons, although the bill passed both the House and Senate with sufficient votes to override a veto.

If H.R. 6395 becomes law, the bill will amend the SEC’s disgorgement authority in two significant ways.

¹ Introduced and referred to Senate Committee on Banking, Housing, and Urban Affairs September 26, 2019.

² *Kokesh* and *Liu* have previously drawn congressional attention. See Investor Protection and Capital Markets Fairness Act, H.R. 4344, 116th Cong. (2019) (providing that “any Federal court may grant . . . disgorgement in the amount of unjust enrichment.”) (passed House Nov. 18, 2019); 165 Cong. Rec. 8929 (daily ed. Nov. 18, 2019) (“[*Kokesh*] was a boon to white collar criminals . . . [e]ven worse, the SEC is currently in litigation before the Supreme Court over whether it even has the authority to obtain disgorgement for investors.”).

First, it will extend the statute of limitations for SEC disgorgement claims to 10 years, but only for scienter-based claims.³ For all other claims, the statute of limitations would remain at five years consistent with the holding in *Kokesh*.

Second, it will toll the statute of limitations for any disgorgement claim while “the person against which the action or claim” is brought is outside of the United States.

In addition to these changes, the bill also codifies the Supreme Court’s holding in *Liu* that the SEC has authority to seek disgorgement in federal district court actions. The bill does not, however, directly address the limiting principles that the Court outlined in *Liu*. Because the bill does not expressly overrule these principles, which the Court said are inherent in the concept of disgorgement, we expect that courts will continue to apply them under the general “prior-construction principle”: “Congress should be presumed to have been aware of the scope of ‘disgorgement’ as interpreted by [] courts and as having incorporated the . . . prevailing meaning of the term into its subsequent enactments.”⁴

Practical Implications

The most significant implication of the bill is that it doubles the statute of limitations for disgorgement in the most serious cases—those alleging intentional fraud. Because the extension applies only to disgorgement, not penalties, the impact will be focused on cases involving long-term conduct that potentially could result in sizeable disgorgement claims.

The other change impacts a modest group of cases—those involving a person that is out of the country. The provision would be helpful to the SEC in these matters because the SEC previously has been unsuccessful in arguing for tolling of the statute of limitations. For example, the Supreme Court has held that the statute of limitations should not be tolled during the time when the SEC could not have reasonably discovered a fraud. See *Gabelli v. Securities and Exchange Commission*, 568 U.S. 442 (2013). The Supreme Court held instead that the standard rule applied as to government authorities, meaning that the statute of limitations period begins when the alleged violation occurs, not when the SEC discovered it or reasonably could have. See *id.*

The full text of the bill, H.R. 6395, is available [here](#).

Prior Davis Polk client memoranda discussing the *Liu* case can be found [here](#) and [here](#).

³ As recited in the bill, this includes “(I) section 10(b); (II) section 17(a)(1) of the Securities Act of 1933 (15 U.S.C. 77q(a)(1)); (III) section 206(1) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–6(1)); or (IV) any other provision of the securities laws for which scienter must be established.”

⁴ *Liu v. SEC*, 140 S.Ct. 1936, 1947 (2020).

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