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U.S. Supreme Court Clarifies Scope of 5-Year Statute of Limitations in SEC Enforcement Proceedings

Yesterday, in *Gabelli* v. *Securities and Exchange Commission*, No. 11-1274, the United States Supreme Court clarified that the 5-year statute of limitations applicable to SEC enforcement actions that seek financial penalties begins to accrue when the alleged violation occurs, not when the SEC discovers the violation. This decision may have implications not only for SEC enforcement actions, but for other government proceedings seeking a civil fine, penalty, or forfeiture.

Statutory Background

SEC enforcement actions are subject to a 5-year statute of limitations, which provides that "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." 28 U.S.C. § 2462. Although this statutory limitations period has been in effect in its current form since 1948, the meaning of the term "accrued" had been subject to controversy in the courts.

The Gabelli Case

In *Gabelli*, the SEC charged the chief operating officer and former portfolio manager of an investment adviser with secretly allowing a favored investor to "market time" a mutual fund, while publicly stating that the fund did not tolerate market timing. Among other things, defendants argued that the SEC's complaint seeking a civil penalty under the Investment Advisers Act of 1940 was untimely. The district court dismissed the SEC's civil penalty claim as time-barred because the alleged violations occurred between 1999 and August 2002, and the complaint was not filed until April 2008.

Reversing the district court's dismissal, the Second Circuit held that a "discovery rule" applies to violations that sound in fraud, and thus the limitations period did not accrue until the SEC's claim was "discovered, or could have been discovered with reasonable diligence." *SEC* v. *Gabelli*, 653 F.3d 49, 59-60 (2011). Because the SEC alleged that it did not discover the fraud until September 2003 – within five years of the filing of the complaint in April 2008 – the Second Circuit reinstated the SEC's penalty claim.

The Supreme Court's Decision

In a unanimous opinion penned by Chief Justice Roberts, the U.S. Supreme Court rejected the Second Circuit's application of the "discovery rule." First, the Supreme Court observed that the most natural and historically accepted reading of the term "accrued" is based on when the violation occurred, not when it is

discovered. Second, the Supreme Court recited policy reasons favoring a "fixed date" when exposure to government enforcement efforts must end. According to the Court, a bright-line standard promotes repose, eliminates stale claims, reduces loss of evidence, and provides certainty to the parties. Third, the Supreme Court anticipated problems with judicial administration of a discovery rule in the government enforcement context. Since government agencies can have hundreds of employees, dozens of offices, and several levels of leadership with overlapping responsibilities, courts may be hard pressed to define the relevant actor(s), weigh competing agency priorities or resource allocations, and determine when the "government" reasonably should have discovered the violation. The assertion of governmental or other privileges by the enforcement agency would make this task even more formidable.

Importantly, the Supreme Court distinguished government enforcement proceedings from actions brought by private plaintiffs. In the private context, an exception for claims that sound in fraud has been recognized where the deceptive conduct is self-concealing and prevents the plaintiff from even learning of its own injury. In the SEC enforcement context, the plaintiff is not a defrauded victim seeking compensation for its own loss, but rather a government agency imposing a penalty that punishes and stigmatizes wrongdoers.[1] In further contrast to ordinary litigants, the SEC is charged with the express mission and armed with extensive public resources to uncover fraud.

Implications of Gabelli

Gabelli provides a significant safeguard against the possibility of open-ended SEC enforcement actions seeking a civil fine, penalty or forfeiture more than five years after the relevant conduct occurred. This decision is especially noteworthy because the limitations period set forth in § 2462 is a "catch-all" that applies not only to the SEC, but to other government agencies seeking to impose civil penalties under a statute that does not contain its own limitations period.

In other ways, the scope of this decision may be more limited. First, *Gabelli* does not purport to affect the application of the "discovery rule" in private securities actions. Second, even in the agency enforcement context, *Gabelli* does not directly govern claims for disgorgement or injunctions because those remedies were not before the Supreme Court. Although some courts have held that remedial measures such as officer-and-director bars and permanent injunctions carry the sting of punishment and can constitute a "penalty" as applied to a particular set of facts, the SEC takes the sweeping position that there is no time limit at all for enforcement actions seeking equitable relief. *Gabelli* leaves unsettled whether proceedings seeking equitable relief will be subject to the 5-year limitations period when a defendant can persuade the court that the effect of the relief sought is more punitive than remedial. Third, *Gabelli* does not address the viability of other equitable doctrines that may toll the limitations period, such as where a defendant

[1] The Supreme Court did not address the fact that the SEC may distribute penalty proceeds to injured investors through a "Fair Fund" under Section 308(a) of the Sarbanes-Oxley Act. In this respect, SEC penalties may not be exclusively punitive.

takes affirmative steps to fraudulently conceal the underlying violation. Because the SEC disclaimed reliance on equitable tolling in *Gabelli*, the Supreme Court expressly left this issue open. Nevertheless, the reasoning of the decision, coupled with the categorical language of the statute it interpreted, may call into question the viability of equitable tolling in the enforcement context.

Going forward, it is unclear how *Gabelli* will affect the SEC's enforcement program. One possible implication is that the staff may become more diligent about requesting tolling agreements earlier in the life cycle of the investigation. Another possible implication is that the staff may be forced to complete its investigations more quickly. Any such developments would be consistent with the policy instituted by the SEC's most recent Director of Enforcement that tolling agreements will be used only "as an exception, not the rule."[2]

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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[2] See Robert Khuzami, Director, Division of Enforcement, U.S. Securities and Exchange Commission, Speech by SEC Staff: "Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement" (Aug. 5, 2009), available at http://www.sec.gov/news/speech/2009/spch080509rk.htm.