

DEFENSE BILL SIGNIFICANTLY BOLSTERS SEC'S DISGORGEMENT AUTHORITY

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Introduction

The National Defense Authorization Act ("NDAA") became law on January 1, 2021 after Congress overrode a presidential veto of the legislation. While the NDAA appropriates funds for defense-related activities and the then-President objected to the legislation based primarily on collateral issues like liability for online content, the Act also will have a significant impact on securities law enforcement. The legislation included language that significantly bolsters the power of the Securities and Exchange Commission ("SEC") to obtain disgorgement of ill-gotten gains from securities law violators who are unjustly enriched. This is a reversal of fortune for the SEC, which has lost a string of recent notable court cases that curtailed its disgorgement authority.

Summary

The NDAA's SEC-friendly provisions both solidify the agency's authority to obtain disgorgement through its enforcement actions and provide a materially longer statute of limitations in which the SEC can file these actions. First, Section 6501 of the NDAA amends Section 21(d) of the Securities Exchange Act of 1934 ("Exchange Act") to expressly authorize the SEC to obtain disgorgement as a remedy for violations of the securities laws. Prior to this amendment, the Exchange Act authorized the SEC to seek "any equitable relief that may be necessary or appropriate,"¹ and courts routinely awarded the agency disgorgement as an equitable remedy. But this longstanding practice was hampered by two recent Supreme Court opinions, *Kokesh v. SEC* and *Liu v. SEC*.

In *Kokesh*, the Supreme Court unanimously ruled that disgorgement constituted a "penalty" rather than "equitable relief" and was therefore subject to the five-year statute of limitations applicable to other civil penalties.² Three years later in *Liu*, the Court refined its *Kokesh* holding, stating that the SEC could seek disgorgement as a form of equitable relief, but the remedy had to fall within the "bounds of traditional equity practice."³ The Court interpreted this to mean that (1) the disgorged amount must be limited to profits from the violative conduct, net of expenses; (2) the SEC could not pursue disgorgement from multiple parties under joint-and-several liability; and (3) disgorged funds must be returned to investors, rather than deposited in the U.S. Treasury. With the NDAA

amendments, the Exchange Act now explicitly authorizes the SEC to seek disgorgement “of any unjust enrichment [from] the person who received such unjust enrichment as a result of” violating the securities laws, and includes no restriction on the funds being recovered for investors rather than the government.⁴

Second, Section 6501 extends the statute of limitations to seek disgorgement for scienter-based violations from five years to ten years. While the default limitations period for disgorgement actions remains five years, the extended statute of limitations applies broadly to violations under Section 10(b) of the Exchange Act, Section 17(a)(1) of the Securities Act, and Section 206(1) of the Investment Advisors Act. The amendment also extends that the statute of limitations for other “equitable remedies,” including injunctions, bars, suspensions and cease-and-desist orders, to ten years.

Conclusion

The impact of the NDAA amendments will be borne out over time. It now appears, though, that the NDAA restores and strengthens the SEC’s ability to seek disgorgement in federal courts, overturning by statute restrictions those courts imposed in recent years. The new Exchange Act provisions eliminate a legal objection (and litigation risk) that defendants had successfully pressed with the SEC staff and courts, stripping away one of defense counsel’s explicit or implicit bargaining chips. And buoyed by the ability to operate under a longer time horizon, it seems likely that the SEC may prioritize enforcement of scienter-based violations. What follows in these matters will presumably be investigations that take longer and are more expensive for defendants, as the staff seeks information from a longer historical time period to reach as many potential violations as possible. Because the amendments affect not only future, but also current SEC investigations of past conduct, they may be subject to several potential legal challenges, including defendants challenging the SEC on the basis of alleged *ex post facto* application. The defense bar – and defendants – will gain more insight into the provisions’ impact as a new (as yet unknown) SEC Enforcement Director marshals the enhanced tools to implement enforcement priorities of a reconstituted Commission.

1. 15 U.S.C. § 78u(d)(5); see *Liu v. SEC*, 140 S. Ct. 1936, 1940–41 (2020).

2. *Kokesh v. SEC*, 137 S. Ct. 1635 (2017).

3. *Liu*, 140 S. Ct. 1936 (2020).

4. NDAA § 6501(a).

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