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Congress' Expansion Of SEC Disgorgement Was Irresponsible

By **Russell Ryan** (February 24, 2021, 3:25 PM EST)


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The U.S. Securities and Exchange Commission has long described itself as the investor's advocate, a motto coined in the late 1930s by William O. Douglas, the agency's third chairman and later a U.S. Supreme Court justice.[1] A more appropriate moniker for today's SEC might be the investor's collection agent.

Belatedly slipped into this year's 1,480-page, must-pass National Defense Authorization Act — which became law on New Year's Day after the lame-duck Congress overrode a presidential veto triggered by objections unrelated to the SEC — was a wholly impertinent provision that cements the agency's ill-suited role as governmental debt collector for private investor losses.[2]

This holiday gift to the SEC neutered two recent Supreme Court cases that had restricted the agency's power to obtain disgorgement of illicit gains from alleged securities law violators, a remedy that supplements its power to impose monetary penalties.

In June 2017, the court held in Kokesh v. SEC that disgorgement claims must, like penalty claims, be filed within five years of alleged wrongdoing.[3] And in June 2020 the court held in Liu v. SEC that disgorgement can't exceed a wrongdoer's net personal gains and generally must be returned to investors rather than deposited into the U.S. Department of the Treasury.[4]

Together these cases reined in decades of SEC overreach based on strained interpretations of earlier laws passed by Congress. They barred aged SEC cases where memories have often faded and evidence has gone missing, and they limited the agency's ability to force defendants to disgorge gains realized by others or gross receipts that should be offset by legitimate business expenses.

Most importantly, they inhibited the SEC's seemingly inexorable mission creep into the role of public debt collector for private interests.

The defense spending bill has now upended these sensible restrictions. It codifies the SEC's power to demand disgorgement while leaving that term undefined, enabling the SEC to revert back to dubious interpretations that Congress never intended.

Worse yet, it gives the SEC up to 10 years to sue for disgorgement and certain other sanctions, disregarding critical societal interests such as repose, protection from stale accusations, and certainty

about potential liabilities. SEC investigations are already too protracted and costly, and doubling their potential duration will only exacerbate the problem.

Given the last-minute rush to sneak this SEC provision through, it should surprise no one that the legislation is in certain respects both illogical and unintelligible.

For example, it allows the SEC up to 10 years to seek court injunctions to stop wrongdoing, but absent exceptional circumstances it's hard to believe any court would actually issue an injunction based on a violation that old.

And it's hard to decipher what it means to say that the SEC must file a case "not later than 10 years after the latest date of the violation that gives rise to the action or proceeding in which the Commission seeks the claim." That kind of legislative gobbledygook invites decades of unproductive litigation just to figure out what Congress meant.

But perhaps most frustrating about this legislative malfeasance is the wholly unquestioned premise behind expanding SEC disgorgement power — namely, that avenging private financial losses should be the SEC's burden in the first place. Perhaps it should be, but neither Congress nor the SEC has ever convincingly made that case.

SEC leaders nevertheless insist that returning losses to investors is now one of the agency's top enforcement priorities.[5] We can all agree that investment fraudsters should be held accountable and their victims compensated. But avenging private financial losses was not part of the SEC's original mission — for good reasons that remain pertinent today.[6]

To start, there's no shortage of private legal claims available against securities-law violators, nor private attorneys incentivized to pursue them. In most walks of life this is how disputes get resolved and liabilities assessed, with no expectation that a federal agency will assume the cost and burden of pursuing monetary compensation on behalf of those aggrieved.

In the securities law context, the public cost and burden is considerable, and the SEC's success rate modest. Proving and chasing down every penny of investor loss adds many months, if not years, to SEC enforcement proceedings, diverting limited staff resources from other cases and priorities.

SEC statistics show that these efforts generally return to investors less than a third of the disgorgement amounts the agency is awarded.[7] Faced with this predicament, the SEC recently created a whole new office dedicated to collecting monetary judgments and related matters. Congress might have reasonably asked whether public resources could be better deployed elsewhere.[8]

Tangible costs are not the only concern when public enforcement supplants private litigation. The SEC will never catch all bad guys, much less recover all victim losses. Cases go undetected or unprosecuted for many legitimate reasons. Moreover, SEC disgorgement is limited to the wrongdoer's net gain, which is often just a fraction of investor losses.

To the extent investors are deluded into a false complacency that the SEC will effectively insure them against losses, their vigilance will inevitably wane when evaluating investment risk, as will their incentive to pursue private remedies if fraud occurs, neither of which serves their best interest.

Also consider fairness and due process for those accused. The SEC has more leverage than private

litigants when threatening lawsuits and negotiating settlements, and courts have spared the agency from important legal and evidentiary burdens imposed on private plaintiffs.

For example, the SEC need not prove reliance on allegedly misleading statements nor substantiate disgorgement amounts with precision, and the agency already enjoys a longer statute of limitations than private plaintiffs. Serious congressional hearings might have carefully considered whether these protections accorded to defendants in private litigation should be cast aside whenever the SEC chooses to put its outsized thumb on the scale.

None of this proves that avenging private losses is beyond the SEC's legitimate mission. But a responsible Congress would have earnestly considered the public costs along with the feel-good private benefits before stealthily rushing this expansion of the SEC's mission into a gargantuan must-pass defense appropriations bill.

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[1] See, e.g., SEC Chairman William O. Douglas, Address at the Dinner of the Association of Stock Exchange Firms, at p.3 (May 20, 1938).

[2] William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, H.R. 6395, 116th Cong., 2d Sess., § 6501.

[3] 137 S. Ct. 1635 (2017).

[4] 140 S. Ct. 1936 (2020).

[5] See, e.g., Speech by SEC Chairman Jay Clayton, "Investor-Focused, Nimble and Vigorous Enforcement at the SEC," September 17, 2020.

[6] See generally Barbara Black, Should the SEC Be a Collection Agency for Defrauded Investors?, 63 Bus. Law. 317 (2008).

[7] See SEC 2020 Annual Report at 17-18 (tables reporting disgorgement amounts ordered each year with amounts "distributed to harmed investors").

[8] See SEC Press Rel. No. 2020-250 (Oct. 7, 2020).