



In Setback for the SEC, the Supreme Court Holds That Claims For Civil Penalties Must Be Brought Within Five Years Of The Alleged Offense

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In a significant setback last week for the Securities and Exchange Commission, the U.S. Supreme Court held that the SEC must bring claims seeking civil penalties within five years of when alleged securities violations occur, rejecting a ruling of the U.S. Court of Appeals for the Second Circuit that claims seeking penalties may be filed any time within five years of when the SEC learned about the conduct at issue or could have discovered it with reasonable diligence. Interpreting the general statute of limitations set out in Title 28, United States Code, Section 2462, the Supreme Court in *Gabelli v. Securities and Exchange Commission*, No. 11-1274, curtailed the application of the so-called “discovery rule” with respect to the statute of limitations in SEC enforcement actions, and in so doing greatly narrowed the SEC’s authority to seek civil penalties for conduct more than five years old.

THE HOLDING

The Investment Advisers Act of 1940, Title 15, United States Code, Sections 80b-6(1), (2) empowers the SEC to bring claims against and seek civil penalties from investment advisors for allegedly defrauding their clients.¹ Claims for penalties under the Investment Advisers Act are subject to the widely-applicable five year statute of limitations period under Title 28, United States Code, Section 2462, which states 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.”

Gabelli Funds was an investment advisor to the Gabelli Global Growth Fund (“GGGF”). Bruce Alpert was the chief operating officer of Gabelli Funds and Marc Gabelli was a portfolio manager at GGGF. In 2008 the SEC filed a complaint alleging that from 1999 until 2002, Alpert and Gabelli permitted a preferred investor to engage in so-called market timing in exchange for an investment in a Gabelli fund. This preferred investor earned rates of return of up to 185% while the rate of return for long-term investors in GGGF was negative.

In 2011, the Second Circuit reversed the District Court’s dismissal of the SEC’s civil penalty claim as time barred, agreeing with the SEC that even though the statute of limitations in Section 2462 requires that an action be brought from the “date when the claim first accrued,” the underlying claim sounded in fraud, entitling the SEC to the benefit of the “discovery rule.”

¹ Similar provisions also exist in Section 20 of the Securities Act of 1933, Title 15 U.S.C. § 77t, and Section 21 of the Securities Exchange Act of 1934, Title 15 U.S.C. § 78u.

Under the “discovery rule,” the statute of limitations does not begin to run “until that claim is discovered, or could have been discovered with reasonable diligence, by the plaintiff.” As a result, the Second Circuit held that, because the SEC did not discover the alleged fraud until 2003, the statute of limitations first began to run at that point, which was within five years of the 2008 filing of the claims at issue.

The Supreme Court disagreed, holding that the “most natural reading of the statute” is that the five-year clock begins to tick when a defendant’s allegedly fraudulent conduct occurs. In rejecting the application of the “discovery rule” to claims by the SEC seeking civil penalties in fraud cases, the Court explained that the “discovery rule” was intended to protect fraud victims who are prevented from even knowing about a possible claim due to the defendant’s deceptive conduct. While recognizing that the government had been able to successfully invoke the “discovery rule” in an earlier case, the Court observed that in that case -- *Exploration Co. v. United States*, 247 U.S. 435 (1918) -- the government had itself been a victim, as opposed to an enforcement agency seeking a civil penalty. The Court pointed out that the SEC’s “central mission” is to “investigate potential violations of the federal securities laws” and it has “many legal tools at hand to aid in that pursuit,” including the authority to require that broker dealers produce detailed trading information and that investment advisors produce books and records, as well as subpoena power and access to information from whistleblowers. In short, the Court held, the “discovery rule” was intended to protect the interests of private parties who, unlike the SEC, typically “do not live in a state of constant investigation.”

LOOKING AHEAD

On the one hand, the *Gabelli* decision is certain to increase pressure on the SEC and other civil enforcement agencies to uncover alleged fraud and file charges more quickly. It is also likely to accelerate and then bring a more rapid end to the filing of any new fraud charges stemming from the financial crisis, as many of the activities that could give rise to potential financial crisis charges are of course approaching or have passed their five year anniversaries. At the same time, however, the Supreme Court’s holding in *Gabelli* is somewhat limited in scope. It does not extend to claims by the SEC for disgorgement or in all likelihood conduct more than five years old that was part of a continuing course of conduct that includes acts within five years of the filing of the claims. And while some courts have held that requests by the SEC for officer and director bars are punitive in nature and thus subject to the five year statute of limitations in Section 2462, the Court in *Gabelli* did not address these forms of relief, and the SEC has long taken the position that only civil penalties are subject to Section 2462. Nor did *Gabelli* address cease and desist orders sought by the SEC, or whether the concept of equitable tolling of the statute of limitations is still valid. Finally, the Second Circuit’s holding in *Gabelli* that the SEC may benefit from the “discovery rule” had only been in place since 2011 and was not universally followed by other circuit courts. If nothing else, the Supreme Court’s decision last week is likely to prompt the SEC to seek more tolling agreements that suspend the statute of limitations in circumstances where the agency is aware of alleged misconduct within five years of that conduct but is not yet prepared to file charges.

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