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A legal update from Dechert's White Collar and Securities Litigation Group

Court Affirms Five-Year Statute of Limitations on Actions Brought by SEC for Civil Penalties and Punitive Injunctions under Investment Advisers Act

On February 26, 2007, Judge Richard C. Casey in the Southern District of New York granted summary judgment against the Securities and Exchange Commission (the "SEC" or "Commission") in *SEC v. Thomas W. Jones and Lewis E. Daidone*, No. 05 Civ. 7044 (RCC) (S.D.N.Y. Feb. 26, 2007), dismissing claims brought by the SEC for civil penalties and an injunction as time-barred.

Significantly, Judge Casey held that, with respect to an injunction under the Investment Advisers Act of 1940 (the "Advisers Act"),[1] the SEC is required to "go beyond the mere facts of past violations and demonstrate a realistic likelihood of recurrence," and that the absence of such proof "would indicate that the requested injunction is not aimed at protecting the public from future harm, but more likely aimed at punishing Defendants," and is therefore subject to the five-year statute of limitations period of 28 U.S.C. § 2462. The court also dismissed the SEC's disgorgement claims because the SEC failed to provide evidence sufficient to allow the court to determine a reasonable approximation of defendants' compensation causally connected to the alleged violations.

The court's decision is subject to appeal, and an SEC spokesperson announced that the agency is considering that alternative. Unless reversed, the decision may place meaningful hurdles in the SEC's path in situations where it is pursuing "forward-looking" relief. The decision suggests that the punitive nature of such relief mandates a balancing of equitable considerations, and that the granting of such relief is not automatic, even if the SEC proves that the defendant violated the law. Further, the court's reasoning should apply to other forward-looking remedies that have punitive aspects, such as officer and director bars, and to administrative remedies such as cease-and-desist orders and associational bars or suspensions.

The SEC's Complaint

On August 8, 2005, the SEC sued the former CEO and CFO of Citigroup Asset Management ("CAM"), a business unit of Citigroup, Inc., Thomas W. Jones and Lewis E. Daidone, respectively (together "Defendants"), for aiding and abetting alleged violations by CAM of § 206 of the Investment Adviser Act of 1940 ("Advisers Act").[2] Section 206 is the anti-fraud provision of the Advisers Act, and among other things, makes it unlawful for any investment adviser to employ any device, scheme, or artifice

[1] While the Securities Act of 1933 and the Securities Exchange Act of 1934 permit the SEC to seek an injunction "[w]henever it shall appear to the Commission that any person *is engaged or about to engage* in acts or practices constituting a violation," (Section 21(d)(1) of the Exchange Act and Section 20(b) of the Securities Act), as Judge Casey pointed out, the Advisers Act also permits injunctions against any person who "has engaged" in a violation of the Advisers Act. 15 U.S.C. § 80b-9(d).

[2] On May 31, 2005, the SEC entered a settled administrative order censuring Smith Barney Fund Management and Citigroup Global Markets for CAM's activities, and ordering disgorgement of $109,004,551 plus prejudgment interest and a civil penalty of $80,000,000. *Exchange Act Release No. 51761, Investment Advisers Act Rel. No. 2390 (May 31, 2005).*

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to defraud any client or prospective client, to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client, or to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. In connection with CAM's decision in 1999 to use a particular third-party transfer agent, the SEC alleged that "the materials provided to the Fund's boards—primarily prepared by Daidone and reviewed by Jones—did not disclose CAM's leveraging of the Fund's [transfer agent] business to obtain reciprocal business and revenue guarantees benefiting only Citigroup."

Actions for Civil Money Penalties Subject to "Catch-All" Five-Year Period of Limitations; Absent Proof of Undiscoverable Deception, Period of Limitations Will Not Be Tolled Pursuant to Doctrine of Fraudulent Concealment

In dismissing the SEC's action for civil penalties and an injunction, Judge Casey relied principally on the applicability of the five-year statute of limitations period of 28 U.S.C. § 2462. Because the Advisers Act does not contain a limitations period, Judge Casey found "to the extent the SEC's claims are subject to a statute of limitations, the catch-all limitations period in 28 U.S.C. § 2462 applies." Under § 2462, any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise" is barred "unless commenced within five years from the date when the claim first accrued." 28 U.S.C. § 2462.

Judge Casey found that the SEC's claim for civil money penalties "is unquestionably a penalty and, as such, is subject to the five-year limitations period of § 2462." In opposing the motion for summary judgment on the claim for civil penalties, however, the SEC argued that a tolling of the statute of limitations was warranted pursuant to the doctrine of fraudulent concealment. To prevail on its claim, the SEC was required to demonstrate that:

- Defendants concealed the existence of the cause of action
- It did not discover the alleged wrongdoing until some point within five years of commencing the action
- Its continuing ignorance was not attributable to lack of diligence on its part

The SEC did not assert that Defendants took affirmative steps to conceal the alleged fraud, and instead relied on an assertion that "the fraud alleged here was one of non-disclosure and inherently self-concealing."

Judge Casey summarily rejected the SEC's argument:

> *Here, the Commission has not met its burden to demonstrate that Defendants' alleged deception was unknowable and hence self-concealing. Moreover, the Commission fails to cite a single securities case applying the self-concealing fraud doctrine to toll a statute of limitations. The Commission provides no argument and offers no facts that suggest Defendants' alleged misrepresentations or omissions were unknowable.*
>
> *To the contrary, evidence in the record suggests that the alleged misrepresentations and omissions at issue were discoverable.*

The court discussed, among other things, a memorandum to the Fund's board that described details of the transfer agent relationship. The court found that:

> *The Commission had access to much or all of this information through the Fund's prospectuses, registration statements and the Commission's own investigatory authority. . . . Thus, while Defendants' allegedly fraudulent acts of misrepresentation may not have been affirmatively disclosed to the Commission, the record does not support a finding that they were incapable of being known.*

This last point is interesting: The SEC's enforcement staff usually argues that the examination staff's failure to detect the allegedly illegal conduct that is under investigation is of no moment. Judge Casey's reasoning suggests that such failures have consequences. Finding that "the Commission's conclusory assertion of self-concealing fraud is insufficient to sustain its claim for civil penalties," Judge Casey granted summary judgment to Defendants on the SEC's claims for civil penalties.

Punitive Injunctions Barred by § 2462 Unless Action is Commenced within Five Years

In addition to civil money penalties, the SEC also sought to enjoin Defendants from committing future violations of Section 206 of the Advisers Act. In opposing the motion for summary judgment, the SEC claimed that the injunction was not subject to the statute of limitations. As stated above, § 2462 makes clear that any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise" is barred "unless commenced within five years from the date when the claim first accrued." 28 U.S.C. § 2462. What is less clear is the scope and meaning of the word "penalty." As Judge Casey noted, many courts "have determined that § 2462 does not apply to equitable relief that seeks to undo prior damage or protect the public from future harm." In dismissing the SEC's claims, however, Judge Casey clarified that "[i]n light of the relevant case law, the ordinary meaning of 'penalty,' and the clear language of § 2462, the Court holds that the limitations period in § 2462 applies to civil penalties and equitable relief that seeks to punish, but does not apply to equitable relief which seeks to remedy a past wrong or protect the public from future harm."

Here, Judge Casey found that the SEC "has adduced no positive proof aside from Defendants' past alleged wrongdoing to suggest 'some cognizable danger of recurrent violation.'" The Commission's exclusive reliance on Defendants' past conduct, he said, was insufficient to demonstrate the need for a permanent injunction. Judge Casey also found that the passage of several years since the alleged misconduct, apparently without incident, "further undercuts the Commission's assertion that Defendants pose a continuing risk to the public." Moreover, he said, there were collateral consequences associated with an injunction, holding that "these collateral consequences indicate that the requested injunction would carry with it the sting of punishment."

In conclusion, Judge Casey found that "the Commission has not offered facts that suggest the requested injunction is aimed at protecting the public from future harm . . . [and], [w]hen viewed together with the severity of potential collateral consequences for Defendants should a permanent injunction issue in this case, the Commission's requested relief can only be characterized as a penalty." Accordingly, the court found that the requested injunction was subject to the five-year limitations period of § 2462 and must be dismissed as untimely.

The court's holding that the entry of an injunction has punitive elements has implications beyond the statute of limitations issue, and may suggest that the government bears a heavy burden when it seeks not just to compensate victims or protect markets but to punish wrongdoers. In light of the court's reasoning, the SEC should no longer assume that an injunction necessarily will follow whenever it proves an underlying violation. The Commission cannot meet its burden through a recitation of the possibility of future violations, but must affirmatively demonstrate that defendants acted with a high degree of scienter, have a meaningful opportunity for additional wrongful conduct, and possess other, similar attributes.[3] In this light, Judge Casey's opinion is another example of the judiciary limiting the SEC's traditional practice of pursuing injunctive relief almost by rote.[4]

SEC's Disgorgement Claim Not Subject to Five-Year Period of Limitations, But Was Dismissed Because SEC Failed to Provide Evidence of a Reasonable Approximation of Defendants' Compensation Causally Connected to the Alleged Violations

The court ruled that the SEC's claim for disgorgement was not subject to the five-year statute of limitations period in § 2462 because the primary purpose of disgorgement is to deter future fraud by depriving violators of their ill-gotten gains, but nonetheless dismissed the claim for lack of sufficient evidence as to the amount of those ill-gotten gains.

The SEC sought disgorgement of the "amount of money by which Defendants were enriched as a result of their alleged misrepresentations and omissions relating to the transfer agent proposal." Specifically, the SEC sought to recover compensation paid to the

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3 *See*, *e.g.*, *SEC v. Holschuh*, 694 F.2d 130, 144 (7th Cir. 1982); *SEC v. Kimmes*, 799 F.Supp. 852 (N.D. Ill, 1992), *aff'd.*, *SEC v. Quinn*, 997 F. 2d 287 (7th Cir., 1993).

4 *See*, *e.g.*, *SEC v. Smyth*, 430 F.3d 1225, 1233 fn. 14 (11th Cir. 2005) (noting that the Eleventh Circuit "has held repeatedly that 'obey the law' injunctions are unenforceable" and admonishing that "[a]n injunction must be formed so that the enjoined know exactly what conduct the court has prohibited and what steps they must take to conform their conduct to the law").

Defendants. But, as Judge Casey pointed out, "the Commission [was] unable to set forth any evidence of specific profits subject to disgorgement." Instead, the only evidence the SEC put forth included "statements from Daidone's supervisors that his compensation was based on how he performed on significant projects, that the transfer agent initiative was a large project, and that his compensation in 1999 might have been affected by the initiative," and "Jones's own testimony that his boss was a 'very performance-oriented person, and had a reputation that if you did a good job, he paid you well.'"

Significantly, the court noted that the SEC was "unable to provide the Court with any guideposts for determining the proper amount of Defendants' compensation subject to disgorgement." Judge Casey continued: "Although the Court need only determine a reasonable approximation of Defendants' compensation causally connected to the alleged violations before ordering disgorgement, the Commission has provided no evidence which would allow the Court to do so."

Accordingly, the court dismissed the SEC's disgorgement claims.

Practice group contacts

If you have questions regarding the information in this legal update, please contact one of the attorneys listed, or the Dechert attorney with whom you regularly work. Visit us at www.dechert.com/securities.

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