United States Supreme Court Limits Time for SEC to Bring Civil Penalty Actions

In a unanimous decision reversing the Court of Appeals for the Second Circuit, the United States Supreme Court yesterday limited the ability of the Securities and Exchange Commission ("SEC") to bring enforcement actions for civil penalties for fraud, requiring that such actions be brought within five years of the fraud and not -- as the SEC had argued -- within five years of the SEC's discovery of the fraud.[1]

I. Background

The Investment Advisers Act of 1940 (the "Act") makes it illegal for an investment adviser "to employ any device, scheme, or artifice to defraud any client or prospective client" or "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[2] The SEC is authorized to bring enforcement actions against investment advisers who violate the Act, or individuals who aid and abet such violations.[3] As part of such enforcement actions, the SEC may seek civil penalties.[4] The general statute of limitations for civil penalty actions -- 28 U.S.C. § 2462 -- provides that the SEC has five years to seek such penalties.[5] The question before the U.S. Supreme Court in *Gabelli* v. *Securities and Exchange Commission* was whether the five-year statute of limitations begins to run from the fraud or from when the fraud is discovered.

Gabelli Funds, LLC, is an investment adviser to a mutual fund formerly known as Gabelli Global Growth Fund ("GGGF"). Petitioners were Gabelli Funds' chief operating officer and the former portfolio manager of GGGF. In 2008, the SEC brought a civil enforcement action against the petitioners, alleging that from 1999 to 2002 the petitioners had allowed one GGGF investor to engage in "market timing" in the fund in exchange for making an investment in a hedge fund run by one of the petitioners.[6] According to the SEC, petitioners allegedly did not disclose the investor's market timing or the *quid pro quo* agreement, and instead banned others from engaging in market timing and made statements indicating that the practice would not be tolerated. The SEC alleged that petitioners aided and abetted violations of the Act, and it sought civil penalties for the violations alleged. The District Court for the Southern District of New York dismissed the SEC's civil penalty claim as time barred under the five-year statute of limitations.[7] But the Second Circuit reversed, holding that because the underlying violations sounded in fraud, the "discovery rule" applied to the statute of limitations and that "[u]nder the discovery rule, the statute of limitations for a particular claim does not accrue until that claim is discovered, or could have been discovered with reasonable diligence, by the plaintiff."[8] The Supreme Court disagreed and reversed.

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[1] *Gabelli* v. *Securities and Exchange Commission*, 568 U.S. __, No. 11–1274, slip op. (Feb. 27, 2013). Citations to the Court's opinion are to the slip opinion available at http://www.supremecourt.gov/opinions/12pdf/11-1274_aplc.pdf.

[2] 15 U.S.C. §§ 80b–6(1), (2).

[3] 15 U.S.C. § 80b–9(d).

[4] 15 U.S.C. §§ 80b–9(e), (f) (2006 ed. and Supp. V).

[5] 28 U.S.C. § 2462 provides: "Except as otherwise provided by Act of Congress, 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 if, within the same period, the offender or the property is found within the United States in order that proper service may be made thereon."

[6] Slip. op. at 2-3.

[7] *Securities and Exchange Commission* v. *Gabelli*, No. 08 CV.3868(DAB), 2010 WL 1253603 (S.D.N.Y. Mar. 17, 2010).

[8] *Securities and Exchange Commission* v. *Gabelli*, 653 F.3d 49, 59 (2d Cir. 2011).

II. Supreme Court's Decision

The Supreme Court held that the "most natural reading" of the statute of limitations is that "the five-year clock begins to tick" when the allegedly fraudulent conduct occurs.[9] Observing that this "standard rule" has governed since the 1830s, the Court stated that "[t]his reading sets a fixed date when exposure to the specified Government enforcement efforts ends, advancing 'the basic policies of all limitations provisions: repose, elimination of stale claims, and certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities.'"[10] According to the Court, statutes of limitations "are intended to promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared,"[11] and "even wrongdoers are entitled to assume that their sins may be forgotten."[12]

The Court rejected the SEC's argument that the "discovery rule," which is an exception to the standard rule in fraud cases delaying the start of the statute of limitations period until the plaintiff discovered the cause of action, should apply.[13] The Court stated that it had never applied the discovery rule where the plaintiff was not a defrauded victim seeking recompense, but instead was the Government bringing an enforcement action for civil penalties. "Despite the discovery rule's centuries-old roots, the Government cites no lower court case before 2008 employing a fraud-based discovery rule in a Government enforcement action for civil penalties. . . . The Government was also unable to point to any example from the first 160 years after enactment of this statute of limitations where it had even asserted that the fraud discovery rule applied in such a context."[14]

While acknowledging the importance of the discovery rule to protect private parties who may not know they have been the victims of fraud, the Court stated that the same conclusion does not apply in governmental enforcement actions for civil penalties. "The SEC, for example, is not like an individual victim who relies on apparent injury to learn of a wrong. Rather, a central 'mission' of the Commission is to 'investigat[e] potential violations of the federal securities laws.' SEC, Enforcement Manual 1 (2012). Unlike the private party who has no reason to suspect fraud, the SEC's very purpose is to root it out, and it has many legal tools at hand to aid in that pursuit."[15]

Citing a case from 1805, the Court observed that "Chief Justice Marshall used particularly forceful language in emphasizing the importance of time limits on penalty actions, stating that it 'would be utterly repugnant to the genius of our laws' if actions for penalties could 'be brought at any distance of time.' *Adams* v. *Woods*, 2 Cranch 336, 342 (1805)."[16] According to the Court, "grafting the discovery rule onto § 2462 would raise similar concerns. It would leave defendants exposed to Government enforcement action not only for five years after their misdeeds, but for an additional uncertain period into the future. Repose would hinge on speculation

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[9] Slip. op. at 4.

[10] *Id*. at 5, quoting *Rotella* v. *Wood*, 528 U.S. 549, 555 (2000).

[11] *Id*., quoting *Railroad Telegraphers* v. *Railway Express Agency, Inc.*, 321 U.S. 342, 348–349 (1944) (internal quotation marks omitted).

[12] *Id*., quoting *Wilson* v. *Garcia*, 471 U.S. 261, 271 (1985) (internal quotation marks omitted).

[13] *Id*. at 6.

[14] *Id*.

[15] *Id*. at 8.

[16] *Id*. at 9.

about what the Government knew, when it knew it, and when it should have known it."[17] The Court therefore held that "[a]pplying a discovery rule to Government penalty actions is far more challenging than applying the rule to suits by defrauded victims, and we have no mandate from Congress to undertake that challenge here. . . . Given the lack of textual, historical, or equitable reasons to graft a discovery rule onto the statute of limitations of § 2462, we decline to do so."[18]

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Gail Johnston at 212.701.3071 or gjohnston@cahill.com.

[17] *Id*.

[18] *Id*. at 11.

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