February 27, 2013

Supreme Court: Statute of Limitations in SEC Fraud Cases Begins to Run When Fraud Occurs, not When Discovered

By Kelley A. Howes and Jay G. Baris

The Supreme Court today ruled that in an SEC action to recover civil penalties, the five-year statute of limitations begins to run when fraud occurs, not when it is discovered. The Court held in *Gabelli et al. v. Securities and Exchange Commission* that the "discovery rule" does not apply to an SEC enforcement action sounding in fraud.

The Supreme Court's unanimous decision is sure to set the SEC scrambling to beat the clock in enforcement cases.

The general statute of limitations for civil penalty actions (28 U.S.C. §2462) gives plaintiffs, including the SEC, five years "from the date when the claim first accrued" to bring a case. The so-called "discovery rule," a long-standing exception to the general rule that allows plaintiffs to bring a case five years after *discovering* the fraud, is "based on the recognition that . . . in the case of fraud . . . a defendant's deceptive conduct may prevent a plaintiff from even *knowing* that he or she has been defrauded." In *Gabelli*, the SEC argued that the discovery rule should apply not only in the case of a defrauded private plaintiff but also in an enforcement action brought by the government.

The Court rejected this argument, agreeing that there should be a fixed date for when potential exposure to enforcement proceedings must end: "even wrong-doers are entitled to assume that their sins may be forgotten."

The discovery rule exists in part, the Court said, "to preserve the claims of victims who do not know they are injured and who reasonably do not inquire as to any injury. Usually when a private party is injured, he is immediately aware of that injury and put on notice that his time to sue is running. But when the injury is self-concealing, private parties may be unaware that they have been harmed."

Not so, the Court said, when the plaintiff is the government suing for civil penalties. Unlike a garden-variety individual plaintiff suing for damages, the SEC has many tools at hand to aid in its efforts: requirements for investment advisers to turn over books and records at any time; subpoena power; authorization to pay monetary awards to whistleblowers; and the ability to offer "cooperation agreements" to violators of the federal securities laws. In addition, in a civil penalty action, the SEC is seeking to enforce a punishment. It is not seeking recompense or a return to the status quo.

The *Gabelli* case arose out of the mutual fund market timing scandal. Two senior officers of a fund's investment adviser allegedly allowed an institutional investor to market time the fund in exchange for "parking" assets in a hedge fund managed by the investment adviser. Neither the alleged market timing nor the *quid pro quo* agreement was disclosed to other investors in the fund, and the fund precluded other investors from engaging in market timing. As a result of the agreements, the investor allegedly earned rates of return of up to 185%, while long-term investors in the fund received a return of "no more than negative 24.1 percent." Although the conduct in question ended in August 2002, the SEC did not file its enforcement case until 2008.

In reversing the Second Circuit's decision to apply the discovery rule in this case, the Supreme Court said, "we have never applied the discovery rule . . . where the plaintiff is not a defrauded victim seeking recompense, but is instead the Government bringing an enforcement action for civil penalties." Indeed, despite the length of time the discovery rule has been extant in private fraud actions, the SEC was unable at oral argument to point to a single lower court case applying the discovery rule in an enforcement case.

The Court said that reading the statute of limitations to include the discovery rule for an enforcement action sounding in fraud would leave potential defendants exposed for an uncertain time period. Moreover, repose of the statute would turn on what the SEC knew, when it knew it, and when it should have known it. The Supreme Court acknowledged the particular challenges in making this determination, not the least of which is "when does 'the Government' know of a violation?"

Registered entities, public companies, auditors, and market participants in general can breathe a sigh of relief that there is now some certainty regarding how long a potential enforcement action seeking penalties can be hanging over their heads. The SEC enforcement staff, for its part, will review its inventory of investigations. The staff will want to quickly consider whether any investigations have been effectively time-barred, whether to quickly seek tolling agreements to preclude the inevitable statute of limitations arguments, and whether cases involving facts that are several years old should be investigated with a heightened sense of urgency. Whatever the decisions on these issues, this defeat for the SEC will cause the enforcement staff to begin making difficult decisions regarding the path forward.

Client Alert.

CONTACT:

Investment Management

Kelley A. Howes
(303) 592-2237
khowes@mofo.com

Securities Litigation, Enforcement + White-Collar Criminal Defense

Joel C. Haims
(212) 468-8238
jhaims@mofo.com

Jordan Eth
(415) 268-7126
jeth@mofo.com

Carl H. Loewenson, Jr.
(212) 468-8128
cloewenson@mofo.com

Kayvan B. Sadeghi
(212) 336-4149
ksadeghi@mofo.com