

## F-Squared Was Wrong Test Case For SEC Disgorgement

By **Chris Villani**

Law360, Boston (August 28, 2018, 5:42 PM EDT) -- A recently dismissed putative class action was the wrong test case to challenge the U.S. Securities and Exchange Commission's ability to seek disgorgement penalties, according to securities attorneys, who say a set of facts that fits more closely with the U.S. Supreme Court's landmark *Kokesh* decision could still deal a blow to the SEC's disgorgement power.

The liquidation trustee for F-Squared Investment Management LLC's bankruptcy estate unsuccessfully tried to convince a Massachusetts federal judge that the high court's **ruling last year** in *Kokesh v. SEC*, combined with past holdings that limit the SEC to collecting penalties specifically authorized by statute, amounted to nearly \$15 billion in illegally collected disgorgement penalties.

But **the case fell short** last week on several fronts, particularly because F-Squared had waived its appellate rights by settling and because the matter was originally handled in an administrative proceeding, in which disgorgement is expressly permitted by 1990 Penny Stock Reform Act. Securities attorneys say a better test case would be one without a settlement and one based on judicially created disgorgement.

"It really comes down to the waiver; F-Squared had executed the traditional SEC settlement documents and, in the course of doing so, waived its right to challenge the disgorgements," said Gary S. Matsko, a shareholder at Davis Malm & D'Agostine PC. "The right case would be a case brought in federal court where the SEC sought and obtained disgorgement of profits or however they measured it on top of a civil penalty, so it's in the court, relying on judicially created disgorgement, and is based on facts that don't include a waiver or other issues."

The attack on the SEC's disgorgement power stems from the *Kokesh* decision, in which the court held that disgorgements are punitive in nature and therefore subject to a five-year statute of limitations, rather than potentially reaching back indefinitely. Attorneys have latched on to a footnote written by Justice Sonia Sotomayor that said, "Nothing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context."

"The footnote is a tea leaf," Matsko said. "Some people are reading that as saying, 'If you brought the right case in front of us, maybe we would say we don't agree that this judicially created disgorgement is appropriate.'"

Dan O'Connor, one of the co-chairs of Ropes & Gray LLP's securities enforcement practice in Boston, added, "You don't put in footnotes like that unless at least some members of the court have serious questions about the SEC's ability, in the first instance, to gather disgorgements."

O'Connor, a former SEC trial attorney, said he thinks the commission is concerned about the challenges to its disgorgement policies stemming from *Kokesh*.

"Their doomsday scenario is they no longer have the ability to collect disgorgements," O'Connor said. "Their bread and butter is disgorgement and penalties, and I think there is a strong argument that there is no statutory authority for the SEC's ability to gather disgorgement and that's what the Supreme Court seemed to point out."

In dismissing the suit brought by the F-Squared trustee, U.S. District Judge F. Dennis Saylor IV took note of the many hurdles these particular claims faced, several of which had little or nothing to do with the *Kokesh* ruling.

"The SEC has explicit statutory authority to enter disgorgement orders in administrative proceedings,"

Judge Saylor wrote in his Aug. 22 order. "FSquared entered into a binding settlement with the SEC in which it expressly waived judicial review. ... Congress has created a process for judicial review of SEC orders in administrative proceedings, and that process does not involve the federal district courts."

"I think the settlement made it too complicated an issue to explore," said Eleonora Zlotnikova, a securities attorney at Sam P. Israel PC. "Here we had a voluntarily entered settlement agreement that both parties understood and entered into with presumably full knowledge of what they were signing and the terms of the settlement."

"I think it made it more difficult for the court to sort of get into the issue of disgorgement and come out in the way the trustee wanted it to because then it would serve to challenge all SEC settlements that had some kind of disgorgement provision," she added.

Zlotnikova said a "clean case" litigated through the courts would be a better way to tackle the issue. O'Connor agreed, saying a "live case" or one on appeal would allow the judge to consider the merits, rather than being handcuffed by jurisdictional issues. Fellow securities lawyer John F. Sylvia of Mintz Levin Cohn Ferris Glovsky and Popeo PC said he reads Kokesh as setting a strict five-year statute of limitations on disgorgements with the high court acknowledging the punitive aspect of the payments. But Kokesh left some wiggle room, Sylvia added.

"The unanswered question is, if you have an SEC enforcement action litigated to an adverse judgement against a defendant and one of the remedies sought as a result was, in addition to penalties, disgorgement," he said, "that's an issue Kokesh in a footnote left open, does the SEC have the authority to seek disgorgement as a remedy?"

Matsko added the footnote "could read as, 'We are not entirely persuaded this judicially created disgorgement is appropriate, we are not saying it is, we are not saying it ain't.'"

Any ambiguity in Kokesh seems to apply only to disgorgement in civil enforcement proceedings, as opposed to the SEC administrative enforcement proceedings. In the latter, disgorgement is specifically authorized by Congress, something Judge Saylor harped on **during oral arguments** on the motion to dismiss the F-Squared case.

"It's in the statute," the judge told counsel for the trustee, repeating and slowing his words for emphasis. "It's in, the, statute."

Courts drawing the clear line in the sand could lead the SEC to think twice about where it wants to bring these types of cases, Sylvia said.

"If there is an open question, whether [disgorgement] is available in an enforcement proceeding, would that motivate the SEC to bring more in an administrative forum?" he said. "I am not sure, since it's an open issue, the SEC is going to be deterred from bringing actions in federal court seeking disgorgement. They have done that for decades, and many are settled, and to the extent there is any unjust gain, disgorgement is always part of the settlement."

Still, Sylvia said it is an "interesting open issue, until the courts speak definitively."

Matsko said it's fair to ask why the SEC would ever choose the civil litigation route, as the commission can enjoy a "home-court advantage" in its own administrative proceedings and disgorgement is specifically authorized there by black-letter law.

"They may have a feeling some cases have a jury appeal and they do lose some in front of their administrative law judges," he said. "Maybe they think there is greater deterrent value in having a federal verdict as opposed to something coming out of the administrative agency."

O'Connor added that pursuing cases through administrative courts only, while technically possible, "is clearly not where [the SEC] wants to be" in terms of enforcement.

Counsel for F-Squared's trustee declined to comment.

Representatives for the SEC did not respond to comment requests.

The F-Squared trustee is represented by Alex Lipman, Ashley L. Baynham, Chelsea A. Mullarney, Justin S. Weddle, Selbie L. Jason, Stephen A. Best, Sharon I. Dwoskin and William R. Baldiga of Brown Rudnick LLP.

The SEC is represented by Matthew S. Ferguson, John B. Capehart, Melinda Hardy and Morgan E.A. Bradylyons.

The case is Jalbert v. Securities and Exchange Commission, case number 1:17-cv-12103, in the U.S. District Court for the District of Massachusetts.

--Editing by Brian Baresch and Alanna Weissman.