Supreme Court: Discovery Rule Does Not Apply to SEC Enforcement Actions for Civil Penalties Under Investment Advisers Act

On February 27, 2013, the United States Supreme Court clarified in *Gabelli v. Securities & Exchange Commission* the time period in which the SEC must bring an enforcement action that seeks civil penalties. The Court held that the five-year statute of limitations begins to tick when the fraud occurs, not when it is discovered, reversing the Second Circuit's finding that the "discovery rule" delays the running of the statute of limitations until the SEC has discovered or reasonably could have discovered the fraud. While *Gabelli* specifically addressed violations under the Investment Advisers Act, the opinion suggests that it could have wide-reaching application to other SEC enforcement actions. Most notably, causes of action related to the financial crisis that accrued in 2007 are time-barred absent a tolling agreement or other exception, and the clock is ticking on actions that accrued in 2008.

Background

The Investment Advisers Act makes it illegal for investment advisers to defraud their clients and authorizes the SEC to bring enforcement actions seeking civil penalties from advisers who do so.

Under the federal "catch-all" statute of limitations for civil penalty actions, which applies because there is no specific statute of limitations for SEC enforcement actions, the SEC has five years to bring such an action "from the date when the claim first accrued."

In *Gabelli*, the SEC brought an enforcement action against a mutual fund's portfolio manager and the chief operating officer of its investment adviser in 2008 based on alleged conduct that took place from 1999 to 2002. According to the SEC, the defendants allowed one of the fund's investors to engage in "market timing" of the fund, which is a strategy whereby an investor can take advantage of timing differences in a fund's reported value and the real value of the assets it holds. While market timing, standing alone, is not illegal, it can harm long-term investors in a fund. Here, the alleged violation was an undisclosed *quid pro quo* arrangement whereby the defendants permitted certain investors in the fund to engage in market timing in exchange for their investments in a hedge fund run by one of the defendants, while representing to other investors that such conduct was strictly prohibited.

The District Court dismissed the SEC's civil penalty claim as time-barred, invoking the five-year statute of limitations period. The Second Circuit reversed, finding that the "discovery rule" applied since the claim sounded in fraud, and therefore the statute of limitations did not begin to run until the claim was discovered, or with reasonable diligence could have been discovered, by the SEC.

The Supreme Court's Decision in *Gabelli*

In a unanimous decision written by Chief Justice Roberts, the Supreme Court reversed. The Court held that the most natural reading of the statute of limitations provision is that the five-year clock on the SEC's claim begins to run when a defendant's allegedly fraudulent conduct occurs. The Court emphasized that this reading sets a fixed date when exposure to government enforcement efforts ends, advancing the policies of repose and certainty behind all limitations provisions.

The Court then specifically rejected the argument that the "discovery rule" should apply. The Court noted that while the "discovery rule" generally applies to fraud claims, it has not previously been held to apply where the plaintiff is not the defrauded victim but rather is the government bringing an action for civil penalties. The Court drew a distinction between private parties, who "do not live in a state of constant investigation," and therefore may be unaware of a claim, and the SEC, whose very purpose is to investigate and root out fraud and which has many legal tools available to aid in that pursuit. The Court also emphasized that this action involved the imposition of penalties rather than compensation to victims.

Implications and Limitations of *Gabelli*

While *Gabelli* only specifically addressed the statute of limitations in SEC enforcement actions for civil penalties under the Investment Advisers Act, it is likely to have a much broader application. As the Court noted, the statute of limitations provision at issue is "not specific to the Investment Advisers Act, or even to securities law; it governs many penalty provisions throughout the U.S. Code." Thus, courts will likely find that the strict five-year statute of limitations applies, without the benefits of the "discovery rule," to other enforcement actions for civil penalties by the SEC and other federal agencies.

However, the reach of *Gabelli* may also be limited, as indicated by two footnotes in the opinion:

- First, the Court noted that the only issue before it was the statute of limitations applicable to actions for civil penalties, and not to actions for injunctive relief and disgorgement.
- Second, the Court limited its holding to the "discovery rule," indicating that other tolling doctrines may be available, including if the defendant takes additional steps to conceal its fraudulent conduct.

While the Court did not take a position on either of these issues, there may be room for the SEC to argue that a strict five-year statute of limitations is inapplicable under certain circumstances.

The SEC is now more likely than ever to aggressively seek tolling agreements. While *Gabelli* suggests a measure of repose for those facing scrutiny for older conduct, individuals who are targets of SEC investigations may still be hesitant to refuse an SEC request for a tolling agreement, particularly where the alternative may be to face an accelerated enforcement action by the SEC, which is now under pressure to bring such actions in a more timely manner.

Authors Vincent A. Sama, Jonathan Green, Daphne Morduchowitz and Joseph Clark are all lawyers in Kaye Scholer's Securities & Derivatives Litigation practice. For more, visit our website.

Chicago +1.312.583.2300	Frankfurt +49.69.25494.0	London +44.20.7105.0500
Los Angeles +1.310.788.1000	New York +1.212.836.8000	Palo Alto +1.650.319.4500
Shanghai +86.21.2208.3600	Washington, DC +1.202.682.3500	West Palm Beach +1.561.802.3230

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