Law360

Night Of The Living SEC Injunction

By Matthew Newman and Lauren Randell (October 30, 2019)

Just in time for Halloween, a decision by the U.S. Court of Appeals for the Third Circuit raises the specter that conduct once considered time-barred can return from the dead to haunt defendants in the securities industry.

Matthew Newman

The case, U.S. Securities and Exchange Commission v. Gentile, further deepens a circuit split that could mean the U.S. Supreme Court will step in to decide whether the SEC may seek injunctions over conduct that occurred long ago.[1]

Conduct from 2008 faces consequences in 2016.

Lauren Randell

The FBI busted Guy Gentile in 2012 for two alleged pump-and-dump schemes, which he had stopped participating in by 2008. Facing criminal wire fraud charges, Gentile accepted a prosecutor's offer he couldn't refuse: Cooperate in good faith, and the government would consider dropping the charges.

For three years, Gentile reportedly excelled as an informant, helping the FBI ensnare dozens of white collar targets through surreptitious recordings, and protecting investors from being duped out of hundreds of millions of dollars.

Gentile had hoped his efforts would completely unwind the charges against him, but things went south in 2015, as prosecutors insisted that he plead guilty to a felony. Although the plea agreement would call for no prison time, Gentile demanded a non-felony disposition and rejected the agreement.

A federal grand jury ultimately indicted Gentile in March 2016 for securities fraud, and the SEC simultaneously brought a civil enforcement action against him in federal court.

Are injunctions penalties?

Gentile challenged both the criminal and civil charges as time-barred, based on the apparently undisputed fact that his participation in the schemes had ended in 2008 — a full eight years before he was slapped with the criminal indictment and parallel SEC action. The U.S. District Court for the District of New Jersey agreed, dismissing first the criminal indictment, and then the SEC's suit.

The U.S. Department of Justice initially noticed an appeal, but then dropped it. That marked the end of the criminal charges, but unlike the DOJ, the SEC fully pursued an appeal on the civil side, and found a receptive audience at the Third Circuit.

The primary question was whether SEC injunctions are penalties, meaning they would be subject to the five-year statute of limitations in Title 28 of U.S. Code Section 2462 under the Supreme Court's landmark 2017 Kokesh v. SEC decision.[2]

Kokesh had addressed the SEC's separate disgorgement remedy (i.e., requiring the defendant to give up wrongfully earned profits), and concluded that disgorgement is a penalty and, therefore "must be commenced within five years of the date the claim accrues."[3]

In light of Kokesh, the SEC abandoned civil money penalties and disgorgement in Gentile's case, and instead sought two nonmonetary remedies not addressed in Kokesh: (1) an obey-the-law injunction that prohibits Gentile from committing securities fraud in the future; and (2) a bar that prohibits Gentile from participating in any penny stock offering.

If the injunctions that the SEC sought against Gentile were similarly deemed a penalty, then by waiting eight years to sue him, the SEC would be out of luck.

Applying Kokesh, the district court had ruled that the injunctive remedies were penalties, and the SEC's 2016 action was therefore untimely. The Third Circuit disagreed, though, and held that "SEC injunctions that are properly issued and valid in scope are not penalties and thus are not governed by § 2462."[4]

In other words, SEC injunctions that are "properly [issued] only to prevent harm — not to punish the defendant" are not subject to the five-year statute of limitations.[5]

The Supreme Court is likely to step in again.

The Third Circuit's opinion adds to a growing geographical split in how courts handle time limits on SEC injunctions. While the U.S. Court of Appeals for the Eleventh Circuit previously reached the same conclusion in a pre-Kokesh opinion, the U.S. Court of Appeals for the Fifth Circuit came out the other way in a nonprecedential opinion, and several other circuits have declined to definitively answer the question.

As the circuit split deepens and becomes more defined, the Supreme Court may decide to take up the issue and clarify how far Kokesh goes.

On a practical level, the Third Circuit's decision will further embolden the SEC to investigate and bring enforcement actions for stale conduct that would otherwise be untouchable.

Although Kokesh prevents the SEC from seeking disgorgement and other types of penalties after the five-year mark, Gentile and the Eleventh Circuit's similar opinion means the SEC can now seek industry bars and other types of injunctions for conduct that occurred at virtually any time in the past.

As the Gentile court recognized, though, SEC injunctions might not be punitive in nature, but they "come with serious collateral consequences."[6]

SEC injunctions can lead to severe reputational harm, and "when a court bans a defendant from his industry, it imposes what in the administrative context has been called the 'securities industry equivalent of capital punishment.'"[7]

Securities defendants need clarity, especially given the high cost of defending an SEC case — even one the agency ultimately loses. And while Gentile's saga now continues back in the district court on other issues, everyone else in the securities world is on warning that past conduct may come back to haunt you.

Matthew E. Newman is an associate and Lauren R. Randell is a partner at Buckley LLP.

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[1] SEC v. Gentile, 939 F.3d 549 (3d Cir. 2019).

[2] Kokesh v. SEC, 137 S. Ct. 1635 (2017).

[3] Id. at 1639.

[4] Gentile, 939 F. 3d at 562.

[5] Id. at 556.

[6] Id. at 566.

[7] Id. (quoting Saad v. SEC, 718 F.3d 904, 906 (D.C. Cir. 2013)).