# The Supreme Court Holds that the "Discovery Rule" Does Not Apply to SEC Enforcement Actions for Financial Penalties and Affirms the Dismissal of SEC Claims as Time-Barred

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In *Gabelli v. SEC*, No. 11-1274 (Feb. 27, 2013), a unanimous Supreme Court issued a much anticipated decision on the statute of limitations for civil enforcement actions in which the SEC seeks monetary penalties, fines or forfeiture.

The Court ruled that the "discovery rule" does not extend the 5-year statute of limitations set by 28 U.S.C. § 2462, which broadly applies to many penalty provisions in federal law. Thus, the district court properly dismissed as time-barred the SEC's claims for financial penalties against Marc Gabelli, the portfolio manager of Gabelli Global Growth Fund, and Gary Albert, the Chief Operating Officer of Gabelli Fund, LLC, which served as GCCF's adviser.

## Background

In 2008, the SEC brought a civil enforcement action against the Gabelli executives, alleging that between 1999 and 2002, they allowed a GCCF investor to engage in "market timing." The defendants moved to dismiss, arguing that the SEC alleged fraud only until August 2002 but did not file its complaint until April 2008, more than 5 years later. The district court agreed that the SEC's claims for financial penalties were time-barred. (The SEC then voluntarily dismissed the action so that it could promptly appeal.)

The Second Circuit reversed the district court, holding that the "discovery rule" applied because the SEC's allegations "sounded in fraud" and that, as a result, its claims were timely. Sitting by designation, District Judge Jed Rakoff, who famously rejected the SEC's settlement with Citigroup, authored the opinion for the appeals court.

## Supreme Court's Decision

Gabelli and Alpert appealed, and the Supreme Court reversed the Second Circuit, giving three different reasons for rejecting the SEC's argument that the discovery rule applies to civil enforcement actions seeking monetary penalties, fines or forfeiture.

### HISTORICAL REASONS

The Supreme Court noted that it could not find, and the SEC had not offered, any historical precedent in which courts had applied the discovery rule "where the plaintiff [was] not a defrauded victim seeking recompense, but [was] instead the Government bringing an enforcement action for civil penalties. Although the origins of the 5-year statute of limitations in § 2462 date back to the 1830s, the SEC failed to cite any case before 2008 in which a court "employ[ed] a fraud-based discovery rule in a Government enforcement action for civil penalties."

### EQUITABLE CONSIDERATIONS

Although a limitations period typically runs from when the plaintiff suffers an injury — for example, when the car crash happens or the contract is breached — the Supreme Court has long recognized that "something different [is] needed in the case of fraud, where a defendant's deceptive conduct may prevent a plaintiff from even *knowing* that he or she had been defrauded." That is not true for the SEC, however:

*The SEC . . . 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 a 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.*

The Supreme Court specifically mentioned many of the "tools" that the SEC frequently touts as critical elements of its enforcement arsenal, including the ability to issue subpoenas, pay monetary awards to whistleblowers, and enter cooperation agreements.

#### PRACTICAL PROBLEMS

Even if the Supreme Court had been inclined to extend the discovery rule to SEC enforcement actions, doing so would be fraught with practical problems. How would a court determine when the SEC knew or should have known of an alleged fraud? In private actions, the discovery rule looks to the "reasonably diligent" plaintiff, but what is a "reasonably diligent" government agency? Also, the government enjoys considerable privileges, including the attorney-client, deliberative process and law enforcement privileges, which could prevent a defendant (or a court) from inquiring into what the SEC knew and when.

## Chorus of Critics

The Supreme Court's decision was foretold, in a sense, by the chorus of critics who attacked the SEC's position. The many *amici curiae*, like the Justices, unanimously agreed that the discovery rule should not be extended. (Not a single amicus supported the SEC.) This consensus was all the more significant because the *amici* ran the gamut from former SEC officials to defense lawyers who represent clients in SEC enforcement actions; they also included industry groups, bar associations and a libertarian think tank.

At one end, the former SEC officials argued that applying the discovery rule would harm the SEC by subjecting the agency to "intrusive discovery," distracting its staff and exposing its investigative activities to public scrutiny. At the far end, the National Association of Criminal Defense Lawyers warned that carving out an exception to § 2462 would invite arbitrary and discriminatory enforcement actions against regulated entities and individuals based on allegations of misconduct from years ago.

Yet before *Gabelli*, other appeals courts had reached the same conclusion as the Second Circuit. For example, nearly 5 years ago, in *SEC v. Tambone*, a panel of the First Circuit applied the discovery rule, emphasizing the "self-concealing nature" of the fraud at issue. (*Tambone* also involved market timing.) The panel focused on when the SEC knew, or should have known, about the alleged misconduct. The *en banc* First Circuit later affirmed that aspect of *Tambone*. Now, *Gabelli* has effectively overruled it.

## Looking Ahead

Despite its unanimous decision, the Supreme Court hinted that, by statute, Congress *could* apply the discovery rule to SEC actions. But it also suggested such a legislative decision would run counter to the policies that statutes of limitations serve: promoting certainty and finality concerning potential claims and liabilities.

For more than 100 years, the Supreme Court has lauded statutes of limitations as "vital to the welfare of society" because they provide "security and stability in human affairs." Applying the discovery rule to SEC actions "would leave defendants exposed to Government enforcement action not only for 5 years after their misdeeds, but for an additional uncertain period into the future." Fortunately, after *Gabelli*, that is not the case.

It should be noted that *Gabelli* addressed only SEC actions for monetary penalties, fines or forfeiture, but not actions for disgorgement or injunctive relief. In its complaint against Gabelli and Alpert, the SEC also sought disgorgement and injunctive relief. The district court ruled that those claims were timely because § 2462 expressly refers to "action[s] . . . for the enforcement of any civil fine, penalty or forfeiture." Gabelli and Alpert did not challenge that decision before the Supreme Court. Moreover, even with regard to financial penalties, *Gabelli* does not preclude the SEC from entering agreements with investigated parties to toll the 5-year statute of limitations.

## Conclusion

Why was the SEC's position so roundly rejected in *Gabelli*? At bottom, the notion that the SEC needs the discovery rule to do its job fell on deaf ears. The SEC is, after all, the same agency that has publicly proclaimed:

*[W]e have to be as swift as possible. . . . Timeliness is critical. Corporate institutions are dynamic and ever-changing. People come and go. When a case is brought years after the conduct, the fines and penalties still hurt, but the opportunity to achieve a permanent change in behavior and culture is greatly reduced.*

In a world of rapidly changing, global markets, where millions of shares can be traded in a moment and complex financial products are constantly evolving, it seems reasonable for the Supreme Court to expect the SEC to stay one step ahead, not languish more than 5 years behind.

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