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GABELLI V. SEC – US SUPREME COURT DECISION DEFINES SEC ENFORCEMENT TIME TABLE

With its decision in Gabelli v. SEC, The United States Supreme Court significantly compressed the ability of the Securities and Exchange Commission ("SEC") to bring enforcement actions for violations of the Investment Advisers Act.

The Investment Advisers Act makes it illegal for investment advisers to defraud their clients, and authorizes the SEC to seek civil penalties, but as per the general statute of limitations for civil penalty actions, the SEC has only five years to seek such penalties.

In Gabelli v. SEC, the court decided the statute of limitations for the SEC to seek civil penalties begins when the violation takes place, not when the violation was or should have been discovered.

While the court decision appears to be a win for Investment Advisers and Mutual Funds, the end result may be a more determined SEC bent on "beating the clock" of enforcement.

The heart of the SEC's argument in the case was the application of the "Discovery Rule," a common law doctrine that suggests that the statute of limitations begins, not at the time of the unlawful event, but rather from the time that the suing party became aware of the breech.

In its decision, the Supreme Court:

- Declines to extend the Discovery Rule to government civil penalty enforcement actions
- Asserts the discovery rule applies only to victims of the fraud itself, not government regulators seeking civil penalties; and
- Asserts regulatory agencies are subject to the standard rule, which initiates the standard of limitations upon the perpetration of the fraud.

The original case brought by the SEC against defendants Mark Gabelli, then portfolio manager for the Gabelli Global Growth Fund (" GGGF") and Bruce Alpert, then Chief Operating Officer of Gabelli Funds involved "Time Zone Arbitrage," a practice that takes advantage of the time difference between domestic markets and those abroad but that may harm overseas investors. The SEC alleged that Gabelli allowed an investor in the mutual fund they managed to engage in this type of market timing. The Commission alleged that Gabelli committed securities fraud by allowing such a practice while simultaneously representing to the mutual fund board of directors that market timing would not be tolerated.

On April 24, 2008, the SEC sued the defendants and alleged that Gabelli and Alpert knew of the investor's market timing but deliberately mislead GGGF's Board and shareholders in violation of the Securities and Exchange Act of 1934.

On August 17, 2010, the District Court dismissed the SEC's claims for failure to bring the suit within the five-year statute of limitations, and the SEC appealed.

On August 1, 2011, the Second Circuit reversed the District Court ruling accepting the SEC's argument that because the underlying violations involved fraud, the Discovery Rule applied, meaning that the statute of limitations did not begin until the SEC discovered the fraud.

On Feb 27, 2013, on appeal, the United States Supreme Court reversed the lower court and noted that it had never applied the Discovery Rule in a matter where the plaintiff is the government bringing an enforcement action for civil penalties..

One possible implication of this decision is the SEC is likely to seek "Tolling Agreements" from potential defendants or respondents to an enforcement action. A Tolling Agreement is an agreement to waive a right to claim that litigation should be dismissed due to the expiration of a statute of limitations.

The SEC's Enforcement Manual States:

"If the assigned staff investigating potential violations of the federal securities laws believes that any of the relevant conduct may be outside the five-year limitations period before the SEC would be able to file or institute an enforcement action, the staff may ask the potential defendant or respondent to sign a "tolling agreement." Such requests are occasionally made in the course of settlement negotiations to allow time for sharing of information in furtherance of reaching a settlement. By signing a tolling agreement, the potential defendant or respondent agrees not to assert a statute of limitations defense in the enforcement action for a specified time period. A tolling agreement must be signed by staff at the Assistant Director level or above. Tolling agreements may not be entered without the approval of the Director of Enforcement."

It may turn out respondents are more willing to sign such an agreement rather than face an aggressive SEC up against the clock set by this court decision. However, some firms may place themselves at risk when signing these agreements as some forms of liability insurance may be voided if such an agreement is signed.

The timing of this decision is impactful; five years have already passed since the financial collapse of 2008, leaving the SEC potentially unable to pursue enforcement actions that led to the collapse. Clearly, the full impact of this court decision is not fully known. It is likely, however, that the end result could be a more aggressive investigation of potential violations by the SEC.

For more information on these and other considerations, please contact us at info@jackolg.com, or (619) 298-2880. Also, please visit our website at www.jackolg.com.

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