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Gabelli v. SEC: The Supreme Court Limits the Statute of Limitations for SEC Actions

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In a recent unanimous decision, the U.S. Supreme Court held that the Securities Exchange Commission (SEC) has five years from the date when an alleged fraud begins – *not* from the date when the SEC uncovers the fraud – to bring an action seeking penalties. It is likely this decision will have a large-scale impact, including an impact on D&O insurers, by spurring the SEC to complete its investigations and bring enforcement actions sooner rather than later.

The case, *Gabelli, et al. v. Securities and Exchange Commission,* No. 11-1274, which was argued on January 8, 2013 and decided on February 27, 2013, involved a portfolio manager and the chief operating officer at the investment firm Gabelli Funds, LLC (Gabelli). The government alleged that between 1999 and 2002, Gabelli gave preferential treatment to a single investor, allowing this client to engage in "time zone arbitrage" or "market timing," which is an investment practice that capitalizes on the time difference between the financial markets in the United States and those abroad. Specifically, as a result of the difference between the markets' closing times, investors can buy or sell securities based on events in a foreign market before those events affect prices in the U.S. market. While investors who engage in "time zone arbitrage" profit, this practice can greatly harm international investors.

In 2008, the SEC sued Gabelli in federal district court in New York for securities fraud under various federal statutes, and, among other remedies, sought a fine against Gabelli for "aiding and abetting" fraud in the violation of the Investment Advisors Act of 1940. Gabelli moved to dismiss, arguing, in part, that the claim for civil penalties was untimely because the SEC had exceeded the five-year statute of limitations: the SEC alleged in the complaint that the "market timing" occurred up until August 2002, but the complaint was not filed until April 2008. The district court agreed with Gabelli.

The Court of Appeals for the 2nd Circuit reversed the district court and ruled that the SEC had *not* exceeded the statute of limitations because the limitations window in fraud cases does not open when the violation happens, but rather, only when the SEC has reason to know a violation has occurred. In other words, according to the 2nd Circuit, fraud claims are governed by the "discovery rule," pursuant to which a claim "accrues" when the plaintiff knew or should have known of a fraud.

Chief Justice Roberts, who authored the opinion for the unanimous Supreme Court, reversed the Court of Appeals' ruling and expressly held that, with respect to 28 U.S.C. § 2462, which requires the SEC to bring enforcement actions seeking penalties within five years, the limitations period begins to run when the fraud occurs, not when the fraud is discovered. Chief Justice Roberts explained that the so-called "discovery rule," which extends the statute of limitations for certain private plaintiffs, was created to ensure that victims of fraud who do not know they are injured are still able to bring their claims after they have discovered, or reasonably should have discovered, their injuries. According to the Chief Justice, the SEC represents "a different kind of plaintiff" because, unlike the general public, who "do not live in a state of constant investigation … looking for evidence that we were lied to or defrauded[,]" the SEC's "central 'mission'" and "very purpose is to root [fraud] out, and [the SEC] has many legal tools at hand to aid in that pursuit." In other words, because the SEC, unlike a private individual, is always on the lookout for fraud, the SEC should not profit from a rule created to benefit those who are likely unaware a fraud has occurred until years later.

\Chief Justice Roberts further explained that because the SEC, in bringing an action against and seeking penalties from the alleged fraudulent actors, "intend[s] to punish, and label defendants as wrongdoers," if the Court were to allow the SEC to rely on the discovery rule, it would "leave defendants exposed … not only for five years after their misdeeds, but for an additional uncertain period in the future." The chief justice noted that the effect of this ruling may be that certain wrongdoers go unpunished.

The decision is significant because it should encourage the SEC to be more vigilant as well as more efficient in completing investigations and filing actions within the five-year window. Initially, this may result in more actions being filed to avoid the time-bar. In the long run, however, the need for greater efficiency by the SEC in conducting investigations may reduce the cost of responding to prolonged discovery. This should benefit companies, their executives and their insurers. Moreover, insurers should be able to underwrite policies with more confidence that at least certain SEC claims cannot be commenced after expiration of the five-year period.

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