Client Alert

This Client Alert discusses a recent unanimous Supreme Court ruling on the five-year statute of limitations for the SEC to bring civil suits for securities fraud.

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Supreme Court Limits Amount of Time SEC Has to File Civil Fraud Suits

In a unanimous ruling on February 27, 2013, the Supreme Court in *Gabelli v. SEC* held that the five-year statute of limitations for the SEC to bring a civil suit seeking penalties for securities fraud against investment advisers begins to run when the fraud occurs, not when it is discovered.

In *Gabelli* the SEC brought a civil enforcement action in 2008 under the Investment Advisers Act against the portfolio manager of a mutual fund and the chief operating officer of the fund's investment adviser. The Act authorizes the SEC to bring enforcement actions and seek civil penalties against investment advisers who violate the Act, or individuals who aid and abet such violations. The complaint alleged that the defendants, from 1999 until 2002, allowed a fund investor to engage in exploiting the time delay in the mutual fund's daily valuation system, known as "market timing", and then misrepresented the fact to the fund's investors.

The SEC must file suit seeking civil penalties "within five years from the date when the claim first accrued" pursuant to the general statute of limitations that governs many provisions throughout the U.S. code, i.e. 28 U.S.C. § 2462. The SEC argued that "accrued" incorporated the fraud discovery rule, which allowed the statute of limitations to begin only when the SEC knew or reasonably should have known of the fraud.

The Court rejected the SEC's reliance on the fraud discovery rule as inconsistent with the Court's 160-year practice that limited the application of the rule to defrauded plaintiffs. The Court further clarified that "[they] have never applied the discovery rule in this context, where a plaintiff is not a defrauded victim seeking recompense, but instead the government bringing an enforcement action for civil penalties." Gabelli at 6.

The Court reasoned that the purpose of the discovery rule "exists in part to preserve claims of victims who do not know they are injured and who reasonably do not inquire as to any injury." Gabelli at 7. Moreover, the SEC is not a usual plaintiff that relies on apparent injury to seek relief but rather the SEC's central mission is to investigate potential violations of security laws and that the SEC has many tools to help facilitate this purpose. Gabelli at 8.

Further, the Supreme Court also pointed out that applicability of a "knew or reasonably should have

known" standard would pose difficulties when applied to the government or agencies who have "hundreds of employees, dozens of offices, and several levels of leadership." Gabelli at 9. Such application would leave uncertainty of when a statute of limitations would begin, allowing for claims to be brought by the SEC for an unforeseeable time in the future.

The SEC has been criticized in the past that it takes too long to notice when a fraud is occurring, and if it does take notice it cannot bring suit in a reasonable time. The Court's decision could be used in support of this view, and the ruling has clearly limited the SEC's civil enforcement actions under the general provision to a rigid five-year statute of limitations beginning from when the fraud occurred. The result of *Gabelli* will likely spur policy changes in the SEC to move towards a real-time enforcement model as well as to increase the speed in which the agency acts in its investigations and overall time spent preparing for litigation.

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