PUBLICATIONS

SEC Injunctions: A New Standard?

October 15, 2019

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The remedy of choice for the SEC Enforcement Division has always been the statutory injunction. For many years the only remedy available to the Division was the obey-the-law statutory injunction. In the early days of the Division this often led to creative settlements such as those requiring the selection of independent directors and the creation of an audit committee, both novel ideas when rolled out in the 1970s. Over time Congress added remedies to the Commission's arsenal such as the penny stock bar and penalties. Nevertheless, the injunction prohibiting future violations of the statutory provisions violated remained the primary remedy, although many tended to focus on the amounts of money that a judgment requires be paid.

Since at least the 2017 decision in *Kokesh v. SEC,* 137 S.Ct. 1635, there have been questions about Commission remedies. There the High Court held that disgorgement in agency enforcement actions was subject to Section 2462 of Title 28 since it was a "penalty" within the meaning of the statute. The Court also reserved the question of whether the agency could in fact seek and obtain disgorgement since there was no statutory basis for such an award, a point lamented by certain Justices during the oral argument on *Kokesh.*

A related question was recently considered by the Third Circuit Court of Appeals in *SEC v. Gentile,* No. 18-1242 (3rd Cir. Sept. 26, 2019). There the Circuit Court considered a challenge to the imposition of a statutory injunction citing *Kokesh.*

The case

Guy Gentile is the owner of a broker-dealer in upstate New York. He is alleged to have been involved in two pump-and-dump market manipulations from 2007 to 2008. A criminal case was brought in 2012 which was ultimately dismissed as untimely. Since that dismissal Mr. Gentile has announced plans to expand his now Bahamas-based brokerage.

In doing so Mr. Gentile has made it clear that in his view he has not engaged in any wrongful conduct. The SEC filed an action which was ultimately dismissed in part as untimely. In reaching that conclusion the district court concluded that the entry of an injunction would constitute a penalty because the obey-the-law injunction would stigmatize him and the entry of a penny stock bar was a penalty since it would restrict his business in perpetuity without benefiting an victim.

The Circuit Court reversed and remanded the case to the lower court for reconsideration. The predicate for each remedy is statutory. Section 78u(d) of Title 15 empowers the Commission to seek an injunction when it appears that a person is violating a provision of the federal securities laws or is about to do engage in such conduct. A subsection of the same provision authorizes the SEC to request that the court preclude a person from participating in an offering of a penny stock. While this latter subsection does not use the word "injunction," it is clear that any order entered would in fact be an injunction.

The question on which the resolution of each issue turns is the circumstances under which the Commission is entitled to have an injunction – a court order – entered. While the questions initially arose in the context of a Section 1332 statute of limitations issue, the Circuit Court addressed the broader point of when the SEC can secure the entry of either a statutory obey-the-law injunction and/or a penny stock bar.

The Court began its analysis by reviewing the federal courts' historic equity jurisdiction. That mirrors the authority of the High Court of Chancery of England in 1789. It was at that time that Congress passed the first Judiciary Act. While there are "innumerable" statutes explicitly providing for injunctions, "unless Congress clearly states an intention to the contrary, statutory injunctions are governed by the same 'established principles' of equity that have developed over centuries of practice . . . This clear statement rule applies to regulatory statutes enforced by government agencies," the Court held. This historic injunctive process was designed "to deter, not punish." Stated differently, a "preventive injunction unsupported by that showing could not be 'fairly said *solely* to serve a remedial purpose,'" citing *Kokesh.*

In contrast, a properly supported injunction is designed solely to forestall future violations. It is "this prevention principle [that] most sharply distinguishes SEC injunctions from the disgorgement remedy at issue in *Kokesh*" that was found to constitute a penalty within the meaning of Section 1332, the Circuit Court found. This prevention of future violations is, absent other evidence, the guiding star for SEC injunctions.

The Court buttressed this conclusion with three key points. First, this purpose is consistent with the text of the statutes. Section 78u(d)(1) of Title 15, for example, states in part that the Commission can seek an injunction when it believes a person "'is engaged or is about to engage' in securities violations. . . " This text, along with that of subsection (d)(2) regarding penny stock bars, is wholly consistent with the traditional equitable principles that underlie the issuance of an injunction.

Second, this approach is consistent with the history of the Commission's injunctive authority. In the 1880's, for example, injunctions were usually issued in relatively narrow disputes over property. That changed over time as more conduct was regulated by injunction "through a rough analogy to public nuisance." The trend was then incorporated into state securities statutes which became the pre-cursor of the federal securities laws. The New York Martin Act was perhaps the best know example. There the statute empowered state regulators to seek an injunction to "stop" or "prevent" threatened violations while other sections were designed to "punish" violators.

Congress, in writing the federal securities laws, authored them against this backdrop, incorporating the basic principles into the statutes. As the Court stated: "Much like those authorized by blue sky laws, SEC injunctions were 'a classic example of modern utilization of traditional equity jurisdiction for the enforcement of congressionally declared public policy administered by a regulatory agency established for that purpose.'" (internal citations omitted). "These principles would be dishonored if courts aimed to inflict hardship instead of tailoring injunctions to minimize it. A preventive injunction must be justified by a substantial showing of threatened harm, assuring the court that the opprobrium and other collateral consequences that accompany it are out weighted by a demonstrated public need; retribution is not a proper consideration . . ." according to the Court. Indeed, the SEC has itself recognized this principle in cases such as *Saad,* Exchange Act Release No. 86751, 2019 WL 3995968 (Aug. 23, 2019)("if a sanction is imposed for punitive purposes as opposed to remedial purposes, the sanction is excessive or oppressive and therefore impermissible").

Finally, these principles are consistent with *Kokesh.* There the Court was careful to reserve the question regarding disgorgement, while focusing on deterrence, that is the traditional equitable principles which underlie SEC injunctions.

Here, in considering whether to grant the SEC's request for an injunction on remand the lower court should not rubber stamp the request of the agency. To the contrary, "if the court does not conclude that "the obey-the-law injunction sought here serves no preventive purpose, or is not carefully tailored to enjoin only that conduct necessary to prevent a future harm, then it should and must reject the Commission's request" the Circuit Court directed.

Comment

The Third Circuit opinion carefully traces the authority of the Commission to invoke its long standing remedy of the obey-the-law injunction. While many tend to focus on the number of cases brought and the amount of money awarded in judgments, it is the obey-the-law injunction and its collateral consequences which are often not readily visible, that is the Commission's most potent remedy.

In many instances parties and courts tend to view the SEC's request for an injunction as perfunctory, to be granted whenever a violation is established. *Gentile* demonstrates that this is not the proper approach. Rather, it is only when the SEC can establish the proper evidentiary base that the request should be granted. This means that if the Commission cannot demonstrate that the order is required to prevent future violations, it should not be granted. Stated differently, absent proper factual support, the request for an injunction is improper because its entry would be punitive and not protective or preventative.

In the future, the SEC and courts should be required to meet the *Gentile* test in requesting that a statutory injunction be entered. If the evidence is not before the court, the request should be denied. And of course, stay tuned for the Supreme Court's consideration of SEC disgorgement – an increasingly conservative Court is very likely to be troubled by the lack of statutory authority for such a remedy.