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Second Circuit Clarifies SEC Disgorgement Following NDAA Exchange Act Amendments

The United States Supreme Court has, in recent years, decided two cases concerning the authority of the Securities and Exchange Commission ("SEC") to seek disgorgement. In 2017, the Court held in *Kokesh* v. *SEC* that disgorgement is subject to the same five-year statute of limitations as other civil penalties under 28 U.S.C. § 2462.[1] Three years later, the Court held in *Liu* v. *SEC* that the SEC may seek disgorgement even though it is not explicitly authorized by the Securities Exchange Act of 1934 ("Exchange Act") and that, because disgorgement is an equitable remedy, disgorgement awards may not exceed a wrongdoer's net profits and generally must be paid to the wrongdoer's victims rather than to the U.S. Treasury.[2] Our firm memoranda discussing these two cases can be found here and here.

In response to these decisions, Congress amended the Exchange Act as part of the National Defense Authorization Act for Fiscal Year 2021 ("NDAA") so that it (i) explicitly authorizes the SEC to seek disgorgement and (ii) establishes a ten-year statute of limitations for SEC disgorgement claims.[3] This legislation gave rise to questions about whether the NDAA's express authorization of SEC disgorgement was intended merely to codify the Court's holding in *Liu* or to do something different. The United States Court of Appeals for the Fifth Circuit was the first court of appeals to address this question: in 2022 in *SEC* v. *Hallam*, the court of appeals rejected the view that the NDAA amendments merely codified *Liu*.[3] More recently, the United States Court of Appeals for the Second Circuit reached a different conclusion in *SEC* v. *Ahmed*,[4] creating a circuit split on this important question.

I. Factual and Procedural Background

From 2004 to 2015, Iftikar Ahmed was a General Partner at the venture capital firm Oak Management Corporation ("Oak"). Ahmed was responsible for identifying and recommending portfolio companies in which Oak might invest, and he stole over $65 million from Oak and ten of its portfolio companies. He was arrested on criminal insider-trading charges in April 2015.

In May 2015, the SEC brought an enforcement action against Ahmed for alleged violations of the Exchange Act, the Securities Act of 1933, and the Investment Advisers Act of 1940 (the "Advisors Act"). The SEC also named Ahmed's wife, three minor sons, and companies held in the family's name as the recipients of ill-gotten gains (the "Relief Defendants"). Seeking to freeze Ahmed's assets, the SEC moved for a preliminary injunction in the United States District Court for the District of Connecticut.

[1] 581 U.S. 455 (2017).

[2] 140 S. Ct. 1936 (2020).

[3] 42 F.4th 316 (5th Cir. 2022).

[4] No. 21-1686, 2023 WL 4219923 (2d Cir. June 28, 2023).

Preliminary Injunction

The district court granted the SEC's preliminary injunction motion in August 2015, freezing approximately $65 million for disgorgement, $9.3 million for potential prejudgment interest, and $44 million for potential civil penalties (for a total of $118.3 million).[5] The Relief Defendants appealed, and a Second Circuit panel affirmed the district court in a summary order.[6]

Summary Judgment, Permanent Injunction, and First Appeal

On the merits, the district court bifurcated the case, granted summary judgment for the SEC, and awarded a permanent injunction and approximately $42 million in disgorgement, $21 million in civil penalties, and $1.5 million in prejudgment interest.[7] In so doing, the district court (i) rejected Ahmed's argument that *Kokesh* barred disgorgement, (ii) denied an offset for the "carried interest" that Ahmed forfeited to Oak under his General Partnership Agreement, and (iii) adopted the "nominee" theory with respect to the assets held in the name of the Relief Defendants.[8]

Ahmed appealed to the Second Circuit, which held the case in abeyance pending the Supreme Court's decision in *Liu* v. *SEC*.[9] Then, soon after *Liu*, Congress enacted the NDAA, which amended the Exchange Act to (i) explicitly authorize the SEC to pursue disgorgement in civil actions, and (ii) extend the statute of limitations for "a claim for disgorgement" to "not later than 10 years after the latest date of the violation."[10] In light of the NDAA amendments to the Exchange Act, the SEC moved to remand for a recalculation of Ahmed's disgorgement obligation, which Ahmed opposed. A Second Circuit panel granted the SEC's motion and remanded "for a determination of Appellant's disgorgement obligation consistent with [the NDAA], and, if appropriate, entry of an amended judgment."[11]

Remand and Second Appeal

On remand, the district court found that the NDAA's ten-year statute of limitations (rather than *Kokesh*'s five-year statute of limitations) applied to Ahmed's disgorgement obligation and increased the obligation from approximately $42 million to roughly $64 million, with just under $10 million in prejudgment interest.[12] Ahmed and the Relief Defendants appealed, challenging the calculation of Ahmed's disgorgement obligation, including the court's failure to (a) exclude actual gains on the frozen assets as unduly remote from Ahmed's fraud, and (b) apply an asset-by-asset approach, under the nominee doctrine, to determine the ownership of particular frozen assets. The appeal also challenged the district court's retroactive application of the NDAA amendments.

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[5] Ruling and Order Granting Preliminary Injunction, *SEC* v. *Ahmed*, No. 15-cv-675 (JBA) (ECF 113) (D. Conn. Aug. 12, 2015).

[6] *SEC* v. *I-Cubed Domains, LLC*, 664 F. App'x 53 (2d Cir. 2016).

[7] *See Ahmed*, 2023 WL 4219923, at *3.

[8] *Id.* The nominee theory looks at who is the equitable owner of assets, regardless of who is the technical legal owner. Applying that theory here, the district court found that the frozen assets, for all intents and purposes, were equitably owned by Ahmed, even though he had transferred their legal title to the Relief Defendants. *Id.*

[9] *Id.*

[10] Pub. L. No. 116-283, § 6501(a)-(b), 134 Stat. 3388, 4625-26 (codified at 15 U.S.C. § 78u(d)(3), (7)–(8)). § 6501(b) also states that the amendments "shall apply with respect to any action or proceeding that is pending on, or commenced on or after, the date of enactment of this Act."

[11] *SEC* v. *Ahmed*, 2021 WL 1171712, at *1 (2d Cir. Mar. 11, 2021).

[12] *SEC* v. *Ahmed*, 2021 WL 2471526 (D. Conn. June 16, 2021).

II. Second Circuit's Decision

On June 28, 2023, the Second Circuit affirmed in part and vacated and remanded in part.

First, the Second Circuit affirmed the district court's calculation of Ahmed's disgorgement obligation, finding that the district court (i) accurately estimated net profits, (ii) reasonably declined to offset the "carried interest" forfeited by Ahmed to Oak upon his termination, and (iii) properly awarded prejudgment interest at the Internal Revenue Service's underpayment rate[13] for the period before the asset freeze. It also (a) vacated the district court's award of "actual gains" on the disgorged assets and (b) found the district court's nominee doctrine analysis, with respect to ownership of the frozen assets, inadequate because it failed to consider the ownership inquiry on an asset-by-asset basis.

Significantly, in so holding, the Second Circuit stated that the NDAA's amendment of the Exchange Act—which provided that the SEC "may seek, and any Federal court may order, disgorgement"—is a "belt and suspenders" clarification that the disgorgement contemplated by *Liu* is now available under the Exchange Act, rather than, as the Fifth Circuit held in *Hallam*, an "authoriz[ation]" of "legal 'disgorgement' apart from the equitable 'disgorgement' permitted by *Liu*."[14]

Having acknowledged that the NDAA did not supplant *Liu*, the Second Circuit found that the district court reasonably approximated net profits based on the difference between the sale and purchase prices involved in the tainted transactions. Because Ahmed failed to disclose his conflicts of interest in violation of the Advisers Act, the portfolio company purchases were "entirely tainted" and Ahmed's $14.4 million in profits from the transactions constituted his "net profits from wrongdoing" under *Liu*.[15] Ahmed unsuccessfully argued that, because Oak paid a price below market value, that difference in price should have been deducted from the disgorgement calculation.[16]

Ahmed also argued that the disgorgement amount should have been offset by the "carried interest" he had to forfeit, pursuant to his General Partner Agreement, to Oak upon his termination. The Second Circuit rejected this argument, finding that "[e]quity does not require an offset for the carried interest" because disgorgement "attempts to 'restor[e] the status quo' by 'tak[ing] money out of the wrongdoer's hands.'"[17] The Second Circuit also affirmed the district court's award of prejudgment interest at the IRS underpayment rate, finding that the "IRS underpayment rate was appropriate" because the rate "reflects 'use value'" and Ahmed "held the ill-gotten gains before the asset freeze."[18]

The Second Circuit also vacated the district court's award of "actual gains" on the disgorged assets, remanding with the instruction that the district court award "consequential gains on assets subject to disgorgement"

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[13] The IRS underpayment rate is used to calculate interest for those that do not pay their taxes, penalties, or additions to tax or interest by the due date.

[14] *Ahmed*, 2023 WL 4219923, at *6-7 & n.7 (quoting 15 U.S.C. §§ 78u(d)(7); *Hallam*, 42 F.4th at 341); *compare id.* at *6 (quoting *Liu*, 140 S. Ct. at 1947) ("The NDAA's text evinces no intent to contradict *Liu* or to strip disgorgement of 'limit[s] established by longstanding principles of equity' in favor of an unbounded 'legal' form of disgorgement.") *with Hallam*, 42 F.4th at 343 (questioning "whether equitable disgorgement has survived the 2021 Exchange Act amendments").

[15] *Ahmed*, 2023 WL 4219923, at *8.

[16] *Id.*

[17] *Id.* (quoting *Liu*, 140 S. Ct. at 1943).

[18] *Id.*

that are not "unduly remote from the fraud."[19] Likewise, the Second Circuit vacated the district court's finding that the Relief Defendants owned certain frozen assets "as mere nominees of Ahmed," finding that the district court's nominee doctrine analysis was inadequate because it failed to conduct the ownership inquiry on an "asset-by-asset" basis.[20]

Second, the appellate panel found that the district court properly gave the NDAA retroactive effect—that is, the district court did not err by applying the NDAA's expanded ten-year statute of limitations, rather than Kokesh's five-year limitations period, to Ahmed's disgorgement obligation. The Second Circuit emphasized that the NDAA itself stated that its disgorgement amendments "apply with respect to any action or proceeding that is pending" at the time of enactment.[21] Ahmed argued that he had a "vested and adjudicated limitation defense" because he relied on Kokesh's five-year statute of limitations, but the Second Circuit rejected this argument because Kokesh was decided two years after the SEC originally brought its action against Ahmed, so he "could not have had a reliance interest in Kokesh's statute of limitations."[22]

The Second Circuit also rejected Ahmed's argument that the district court's application of the NDAA to his disgorgement award violated the Ex Post Facto Clause of the United States Constitution. According to the panel, Ahmed did not provide—in light of Liu's statement that disgorgement is not "necessarily a penalty"—"the clearest proof" that § 78u(d)(7) disgorgement is "so punitive" as to "transform what has been denominated a civil remedy into a criminal penalty."[23]

III. Implications

In the wake of *Ahmed*, the law is clear in the Second Circuit that SEC disgorgement under 15 U.S.C. § 78u(d)(7) is the same disgorgement contemplated by *Liu*, which mandates that disgorgement awards not exceed a wrongdoer's net profits. Significantly, in so holding, the Second Circuit expressly declined to follow the Fifth Circuit, which held last year in *Hallam* that § 78u(d)(7) authorizes a form of SEC disgorgement distinct from that permitted by *Liu*. Given the circuit split and the Supreme Court's willingness in recent years to take up cases involving SEC disgorgement, it is possible that this issue is, at some point, going to be decided by the Supreme Court.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email authors Joel Kurtzberg (Partner) at 212.701.3120 or jkurtzberg@cahill.com; John MacGregor (Partner) at 212.701.3445 or jmacgregor@cahill.com; or Jason Rozbruch (Associate) at 212.701.3750 or jrozbruch@cahill.com; or email publications@cahill.com.

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[19] Consequential gains are gains that "result from a profitable investment, use, or other disposition of the [plaintiff's] property, distinct from the transaction by which the defendant was originally enriched." *Id.* at *14 (quoting 2 Restatement (Third) of Restitution and Unjust Enrichment § 53 cmt. d).

[20] *Id.* at *14-18.

[21] *Id.* at *11 (quoting Pub. L. No. 116-283, § 6501(b), 134 Stat. 3388, 4626 (2021)).

[22] *Id.* (emphasis in original).

[23] *Id.* at *12 (quoting *Liu*, 140 S. Ct. at 1946 (emphasis in original); *Smith* v. *Doe*, 538 U.S. 84, 92 (2003)).