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U.S. Supreme Court Agrees To Hear Arguments On Gabelli Market-Timing Case

Gabelli v. Securities and Exchange Commission (11-1274)

Potential Landmark Case Regarding the Application of a Discovery Rule to Securities Fraud Cases

On September 25, 2012, the United States Supreme Court agreed to hear an appeal in the SEC's market-timing case against two Gabelli Funds executives. The Court's decision to hear the appeal may result in a significant ruling that determines how long the SEC may wait before bringing civil charges for securities fraud.

Synopsis

Gabelli raises an issue of statutory construction regarding the accrual of claims governed by 28 U.S.C. § 2462, the statute of limitations applicable to civil penalty actions brought by the government. Specifically, the Supreme Court agreed to address the statute of limitations period applicable to SEC enforcement actions and determine whether a discovery rule should be incorporated into § 2462 that would operate to toll the accrual of the SEC's charges.

In its complaint, the SEC accused Marc J. Gabelli, a former portfolio manager at Gabelli Funds and Bruce Alpert, the former chief operating officer of the firm, of permitting one of their clients to engage in market timing trades in the Gabelli Global Growth Fund ("GGGF") between 1999 and 2000. Gabelli Funds is an investment adviser to GGGF, a mutual fund registered under the Investment Company Act. The practice at issue, mutual fund market timing, was the subject of much regulatory scrutiny last decade. The practice generally involves frequent, short-

term trades made with the intention of exploiting market or pricing inefficiencies, ultimately at the expense of other investors.

The SEC alleged that Gabelli and Alpert ("Petitioners") did not disclose to GGGF's Board of Directors or other GGGF shareholders that their client was market timing. Instead the executives continued to allow their client to engage in market timing trades even after personally addressing the GGGF Board about the dangers associated with the practice. According to the SEC's complaint, the client's market timing unfairly favored that client over all other GGGF investors and caused dilution of GGGF's assets. Finally, the SEC alleged that because of the secretive nature of the Petitioners' wrongdoing and the affirmative misrepresentations made to GGGF's Board and shareholders, the SEC did not discover the alleged fraud until late 2003. Although the complaint alleges violative conduct from 1999 to 2000, the SEC did not file its complaint until 2008.

The Court first applied the five year statute of limitations set forth by 28 U.S.C. § 2462 to SEC actions in *Johnson v. SEC*. It held that § 2462 applied to SEC proceedings brought under section 15(b) of the Exchange Act of 1934 which seek to censure and suspend a securities supervisor.¹ The issue in *Johnson* was whether the SEC proceeding, which resulted in the imposition of sanctions, was "an action, suit, or proceeding for the enforcement

¹ *Johnson v. SEC*, 87 F.3d 484, 492 (D.C. Cir. 1996).

of any civil fine, penalty, or forfeiture, pecuniary or otherwise” within the meaning of 28 U.S.C. § 2462.² The Court confirmed that indeed it was, finding that the sanctions imposed a punishment for the violation of a standard within the Exchange Act, and therefore qualified as a “penalty” within the meaning of § 2462.³

Since *Johnson*, courts have applied statute of limitations periods to securities actions in various contexts, resulting in divergent outcomes. In 2010, the Supreme Court addressed the issue with regard to private securities fraud actions, holding that the two-year limitations period applicable to claims under Rule 10b-5 does not accrue until investors actually discover, or when a reasonably diligent investor would have discovered, “facts constituting the violation.”⁴ In a 2009 decision, the Seventh Circuit suggested that either the discovery rule or equitable tolling could apply to allegations brought by the SEC that are subject to § 2462.⁵ And the Supreme Court recently held that the plain language of a statutory limitations period controlled private actions brought against corporate insiders based on the purchase and sale of the issuer’s securities under 16(b) of the Exchange Act.⁶ The Court rejected the court

of appeals’ adoption of a tolling provision into statutory text which clearly provided that the controlling accrual date was the date any profit was realized.

Petitioners in *Gabelli* moved to dismiss the SEC’s claim arguing that the claim “first accrued” as early as September 1999, when it could have initially been brought and could not have accrued later than August 2002, when the alleged conduct ended.⁷ The district court agreed, holding that the five year limitations period in 28 U.S.C. § 2462 governed civil monetary penalties sought by the SEC and that the discovery rule did not apply to claims subject to the limitations of § 2462. The Second Circuit Court of Appeals reversed, holding that a discovery rule should be read into § 2462 for all claims that “sound in fraud.”⁸ The Second Circuit went on to hold that *Gabelli* and *Alpert* failed to show that a reasonably diligent plaintiff would have discovered the alleged fraud before September 2003. The Second Circuit’s holding, according to the Petitioners, contributes to an alleged circuit split with respect to the issue of interpreting the limitations period for government penalty actions set forth in § 2462. In their Petition for Certiorari, *Gabelli* and *Alpert* re-emphasize that the SEC’s complaint sought penalties against Petitioners for conduct that had ended more than five years before the SEC brought suit and which the SEC had been aware of for more than five years before it brought suit.⁹

² *Id.* at 486.

³ *Id.* at 492.

⁴ *Merck & Co. v. Reynolds*, 130 S. Ct. 1784 (U.S. 2010). Although the statute at issue, 28 U.S.C. 1658(b), contained a discovery rule, the court relied on background principles that generally govern the application of statute of limitations provisions to fraud claims.

⁵ See *SEC v. Koenig*, 557 F.3d 736 (7th Cir. Ill. 2009). In considering a claim that an SEC penalty action was untimely where the defendant had misstated his company’s biannual statements and lied to the company’s auditors to conceal this fraud, the court held based on principles that were “apt to be called equitable tolling,” but could also be called a discovery rule, that the SEC sufficiently alleged the defendant’s concealment of conduct to permit the SEC to go forward with its penalty claim.

⁶ *Credit Suisse Secs. (USA) LLC v. Simmonds*, 132 S. Ct. 1414 (U.S. 2012). The court considered whether the applicable two-year limitations period began to run upon the filing of the disclosure statement required by the insider or, as the statute

specified, within two years after the date such profit was realized.

⁷ In August 2002, *Gabelli* and *Alpert* allegedly caused their client to reduce its ownership in GGGF and to cease its market timing activity. *Alpert v. SEC*, 2011 U.S. Briefs 1274, 5a (U.S. Apr. 20, 2012).

⁸ *Alpert v. SEC*, 2011 U.S. Briefs 1274, 20a (U.S. Apr. 20, 2012).

⁹ *Alpert v. SEC*, 2011 U.S. Briefs 1274 (U.S. Apr. 20, 2012).

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In *Gabelli* the Court has an opportunity to clarify a split in authority concerning whether the SEC can bring an enforcement action more than five years after learning of the conduct at issue.

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Conclusion

In *Gabelli*, the Supreme Court has the opportunity to clarify the issue of whether a discovery rule applies to delay accrual of an SEC claim subject to the five year statute of limitations in 28 U.S.C. § 2462. The Court's upcoming decision could have a significant impact on the future of the SEC's investigative processes, the speed with which it conducts investigations and its decisions whether or not to file charges. ■

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