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Mutual Fund Executive Wins Summary Judgment in Widely-Publicized SEC Enforcement Action

SEC Claims for Penalty, Injunction Barred by Limitations — Disgorgement Claim Bounced for Insufficient Evidence

A federal judge in New York granted summary judgment this week to Mayer, Brown, Rowe & Maw LLP client Lewis E. Daidone and a co-defendant in a widely followed enforcement action brought by the Securities and Exchange Commission (SEC or Commission).

The court ruled that the statute of limitations on the Commission's penalty and injunctive claims was not tolled due to alleged fraudulent concealment, and the claims were therefore time-barred, and further ruled that the disgorgement claim failed for lack of evidence. The ruling came on the eve of an anticipated one-month jury trial.

Daidone is the former Chief Financial Officer and Treasurer of the Smith Barney mutual funds, which were advised by Citigroup Asset Management (CAM). In 1999, at CAM's suggestion, the funds appointed a Citigroup affiliate as their transfer agent. The SEC alleged that CAM violated antifraud provisions of the Investment Advisers Act of 1940 in connection with that appointment, and that Daidone had aided and abetted the violations alleged against CAM.

The SEC sought more than one million dollars in penalties and disgorgement from Daidone. It also sought an "obey-the-law" injunction against further violations.

Earlier, in response to the defendants' pre-answer motions to dismiss, Judge Richard Conway Casey, U.S. District Court for the Southern District of New York, rejected the SEC's arguments that its claims were timely because effects of the transaction lingered into the statutory period, and that the limitations period did not begin to run until all the facts making up the claim for relief had been "discovered." The court denied the motions to dismiss, however, based on the SEC's allegation that the underlying conduct was inherently self-concealing.

The Commission's pleadings alleged that "the fraud was concealed" until a former CAM "employee first told the staff of the wrongdoing on September 30, 2003." At summary judgment, the court concluded that that this allegation was false in a pivotal way. The supposed whistle-blower, in fact, informed the SEC of nothing that had not been disclosed to the funds' boards. "This information," the court concluded, "was not concealed."

With fraudulent concealment rejected, Judge Casey then examined the SEC's claim for a monetary penalty. He ruled that the penalty was barred by the five-year limitation period that 28 U.S.C. §2462 provides for government suits "for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise."

Importantly, Judge Casey also concluded that the obey-the-law injunction sought against Daidone was punitive and, therefore, subject to §2462. Subject to certain exceptions, injunctions as creatures of equity are generally not subject to legal statutes of limitations. Judge Casey nevertheless joined his voice to a rising judicial chorus recognizing that the painful collateral consequences of obey-the-law injunctions make them punitive and, thus, within the statute's coverage.

Finally, Judge Casey ruled that the SEC had failed to come forth with admissible evidence that Daidone had profited, legally or otherwise, from the matters in suit, and granted summary judgment dismissing the SEC's prayer for disgorgement.

Judge Casey's opinion offers practitioners important lessons concerning claims of fraudulent concealment. During discovery, defendants should be thinking about how they will show that the underlying conduct was not inherently self-concealing and that the plaintiff was not duly diligent. Plaintiffs likewise need to concentrate during discovery on how they will carry the burden of establishing the elements of fraudulent concealment. It will not suffice for any plaintiff at summary judgment, as it did not suffice for the SEC in this case, "simply [to] rehash[ ] the underlying allegations of fraud and [to] label[ ] them as self-concealing." Counsel in enforcement cases also need to think during discovery about the equitable relief the prosecuting agency seeks. In this case, the SEC could point to no ill-gotten gains because there were none, but in closer cases agency counsel need to identify illegal profits during discovery and defense counsel need to find solid evidence to explain any unevenness in their clients' incomes.

The Commission has 60 days to appeal to the United States Court of Appeals for the Second Circuit.

The case is *SEC v. Jones and Daidone*, 05 Civ. 7044 (RCC) (S.D.N.Y.). Mayer Brown Washington office partners Richard J. Morvillo and Peter H. White and New York office counsel Michael O. Ware represented Mr. Daidone.