THE RELEVANCE OF DIRECT PROFIT IN ASSESSING REMEDIES IN INSIDER TRADING CASES

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On October 13, 2011, Raj Rajaratnam, a defendant found guilty of perpetrating a massive insider trading operation from his position as head of a hedge fund, was sentenced to eleven years in prison and ordered to pay $53.8 million in criminal forfeiture and an additional $10 million in criminal monetary penalties. *See United States v. Rajaratnam*, No. S-2:09 Cr. 01184-01 (RJH), 2011 WL 6259591 (S.D.N.Y. Oct. 20, 2011) ("*Rajaratnam I*"). Less than a month later, a different judge presiding over the SEC's parallel civil proceeding against Rajaratnam entered an injunction against him, prohibiting him from violating securities laws in the future, and ordered him to pay $92.8 million in civil penalties, an amount entirely separate and distinct from the criminal forfeiture and penalties. *See SEC v. Rajaratnam*, 822 F. Supp. 2d 432 (S.D.N.Y. 2011) ("*Rajaratnam II*"). According to Rajaratnam's filings in the SEC action, the monetary benefit he personally derived from his insider trading, as opposed to the benefit that accrued to the hedge fund and its investors, was $4.7 million. *Id.* at 435. Yet the combined forfeiture orders and penalties from the two cases amounted to $156.6 million – thirty-three times his personal benefit.

As the *Rajaratnam* case makes clear, insider traders may be exposed to multiple types of damages from different sources. This article will provide an overview of the different remedies that are available in insider trading cases brought by the SEC in district courts[1] and their respective rationales. It will then focus on the specific relevance of a defendant's direct benefit in the imposition of these various remedies.

Remedies and Rationales in SEC Civil Lawsuits for Insider Trading

The Securities and Exchange Commission ("SEC") has the discretion to seek several forms of relief against an insider trader. First, under Section 21(d)(1) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(d)(1), it may seek injunctive relief against the defendant, prohibiting him from future violations of the federal securities laws. Once the SEC demonstrates "a substantial likelihood of future violations," courts look to the following factors to determine whether or not to impose an injunction:

[1] This article marginally addresses criminal actions brought by the Justice Department for insider trading. It does not address SEC administrative proceedings or private civil lawsuits.

> the fact that the defendant has been found liable for illegal conduct; the degree of scienter involved; whether the infraction is an 'isolated occurrence'; whether defendant continues to maintain that his past conduct was blameless; and whether, because of his professional occupation, the defendant might be in a position where future violations could be anticipated.

SEC v. Cavanagh, 155 F.3d 129, 135 (2d Cir. 1998) (quoting *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 100 (2d Cir. 1978)).

Calling this type of injunction an "obey-the-law injunction," the Eleventh Circuit has cautioned district courts against formulating injunctions that simply track the somewhat general statutory language of the securities laws. *SEC v. Goble*, 682 F.3d 934, 948–954 (11th Cir. 2012). Rather, district courts should specify what conduct is prohibited so that the defendant has guidance on how to comply with the injunction. *Id.* This is necessary because this remedy has "grave consequences": *i.e.*, violating the injunction "subjects the defendant to contempt sanctions." *SEC v. Unifund SAL*, 910 F.2d 1028, 1040 (2d Cir. 1990). However, the SEC has downplayed the gravity of such an injunction because it is solely prospective and "presents no significant hardship to the defendant because compliance is just what the law expects." Memorandum of the Securities and Exchange Commission in Support of the Insider Trading Sanctions Act of 1982, H.R. Rep. No. 355, 98th Cong., 1st Sess. 24, reprinted in 1984 U.S. Code Cong. & Admin. News 2274, 2296 [hereinafter SEC Memo] (quotation omitted).

Another type of injunction that can be issued against an insider trader, which has more immediate and somewhat harsher consequences than an "obey-the-law injunction," is one that prohibits a defendant from acting as an officer or director of a public company in the future. 15 U.S.C. § 78u(d)(2). A court may order this injunction, either temporarily or permanently, "if the person's conduct demonstrates unfitness" for such a position. *Id.*

The SEC may also seek other forms of equitable relief under 15 U.S.C. § 78u(d)(5). Disgorgement of the profits a defendant realized through his securities fraud has been described as "the principal equitable remedy sought by the Commission." Ralph C. Ferrara *et al.*, *Hardball! The SEC's New Arsenal of Enforcement Weapons*, 47 Business Lawyer 33, 73 (1991); *see, e.g.*, *SEC v. Patel*, 61 F.3d 137, 139 (2d Cir. 1995). As in contexts other than insider trading, the "paramount purpose" of ordering disgorgement is not to compensate victims but "to make sure that wrongdoers will not profit from their wrongdoing." *SEC v. Tome*, 833 F.2d 1086, 1096 (2d Cir. 1987). Taking away the defendant's profit also "has the effect of deterring subsequent fraud." *SEC v. Cavanagh*, 445 F.3d 105, 117 (2d Cir. 2006). Here, too, however, the SEC has conceded that although disgorgement is a "useful equitable remedy," it "merely require[es] a defendant to return 'stolen goods' [and] does not penalize the defendant for his illegal conduct." SEC Memo at 2296.

Because of the perceived inadequacies of injunctions and disgorgement, Congress authorized an additional remedy when it passed the Insider Trading Sanctions Act of 1984 ("ITSA"), permitting the SEC to seek civil penalties for insider trading in an attempt to make such conduct truly unprofitable. 15 U.S.C. § 78u-1(a). ITSA specifically provides that this penalty is in addition to the previously mentioned remedies rather than in place of them. *Id.* § 78-u1(d)(3). Legislative history for the act repeatedly explains that giving the SEC an additional remedy in the form of a penalty was necessary to genuinely deter potential insider traders. *See* H.R. Rep. No. 355, 98th Cong., 1st Sess. 2, reprinted in 1984 U.S. Code Cong. & Admin. News 2274, 2275 [hereinafter House Report].

ITSA provides that the court shall determine the amount of the penalty "in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase, sale, or communication." 15 U.S.C. § 78u-1(a)(2). Thus, a court may choose to impose the maximum penalty, no penalty at all, or a penalty within that range. The act defines "profit gained" or "loss avoided" as "the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information." *Id.* § 78u-1(e). The SEC may not bring an action to collect the penalty more than five years after the date of the unlawful purchase or sale. *Id.* § 78u-1(f). Courts have considered the following factors in determining whether or not to impose a civil penalty and, when choosing to impose a penalty, the amount of the penalty:

> (1) the egregiousness of the violations; (2) the isolated or repeated nature of the violations; (3) the defendant's financial worth; (4) whether the defendant concealed his trading; (5) what other penalties arise as the result of the defendant's conduct; and (6) whether the defendant is employed in the securities industry.

SEC v. Sargent, 329 F.3d 34, 41 (1st Cir. 2003) (citations omitted).

Relevance of Direct Profit to Calculation of Remedies

Calculating the amount of disgorgement or civil penalty to be imposed on an insider trader who passes along confidential information to a tippee raises the question of whether the tipper's direct profit should be the sole basis for the calculation or whether the tippee's profit should be imputed to the tipper as well. The same question applies when the insider trader uses confidential information to trade directly on behalf of another person or entity. We discuss several cases as examples.

First, in considering the civil penalty, we return to the *Rajaratnam* case. In the SEC's civil enforcement action, Rajaratnam emphasized that his personal profits, separated from the profits of the hedge fund and its investors, was $4.7 million. *Rajaratnam II*, 822 F. Supp. 2d at 435. He argued that this should be the base figure from which to calculate a civil penalty. *Id.* The court rejected this argument because ITSA's statutory text, which defines profit as "profit gained or loss avoided as a result of such unlawful purchase, sale, or communication," does not indicate that profit should be limited to the defendant's direct gain. *Id.* In addition to this reason, the court construed the defendant's argument as an "evasion, in effect, of [his] responsibility, for the wrongdoing he committed." *Id.* Because the defendant was responsible for the entire amount of profit, even though it did not all accrue to him, it was fair to use $30.9 million as the base figure. The court did so, imposing the maximum treble penalty of $92.8 million in part due to the defendant's role as head of the hedge fund, his enormous net worth, and the "huge and brazen nature" of his scheme, which "netted tens of millions of dollars and continued for years." *Id.* at 434, 436.

Similarly, the court in *SEC v. Kinnucan* calculated and imposed the maximum treble penalty against the defendant by using the profits of his tippees as the base figure. 9 F. Supp. 3d 370, 377 (S.D.N.Y. 2014). The defendant, president of a corporation "purportedly engaged in the business of providing to its clients legitimate research about publicly traded technology companies," passed along material, nonpublic information to clients of his company. *Id.* at 372–73 (quotation omitted). In deciding on the maximum penalty, the court noted that the defendant's "conduct was egregious, evinced a high degree of scienter, and involved recurrent conduct over a period of two years." *Id.* However, there was no evidence that he personally gained *any* monetary profits from the inside information. *Id.* at 373.[2] Nevertheless, without any discussion about the relevance of this fact, the court calculated that the tippees' profits and avoided losses totaled $1.58 million and trebled that figure to impose a $4.75 million civil penalty against the defendant. *Id.* at 373, 377. The rationale of the court in *Rajaratnam II* for considering profits beyond the defendant's personal gain, *i.e.*, that the statutory text does not suggest otherwise and the entire profit can be attributed to the defendant's wrongdoing, could have been applied with equal force in *Kinnucan*, and the court apparently did not find the defendant's lack of monetary benefit to be relevant to the penalty imposed.

In contrast, the court in *SEC v. Ginsburg* specifically considered the fact that the defendant had not personally traded or profited from his inside information

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[2] The court's decision did not specify whether the defendant benefited in a non-pecuniary way, but the fact that he passed the information to clients of his company suggests that such benefit was possible.

in determining that the maximum civil penalty for insider trading was not warranted. No. 99-8694-CV-RYSKAMP, 2002 WL 1835810, *5 (S.D. Fla. July 8, 2002). The defendant's brother and father profited a total of $1.8 million from the defendant's tips and the SEC sought the maximum treble penalty of $5.4 million based on their profits. *Id.* at *1, 5. Of course, if the penalty were to be calculated based solely on the defendant's personal profit, it would have been zero. The court imposed a $1 million penalty, implying that the defendant's monetary gain (or lack thereof) was not the sole basis for determining the penalty and that tippees' profits could be considered. *Id.* at *5. However, the court considered the defendant's lack of monetary benefit relevant: The court rejected the SEC's request to impose a $5.4 million penalty in substantial part because the defendant did not personally trade or profit from his tips. *Id.*[3] In effect, the court considered the defendant's lack of direct profit as a factor in determining the amount of the civil penalty, in addition to the six factors listed in *Sargent*. The other relevant factors in imposing the $1 million penalty were the "seriousness" of the defendant's conduct and his "substantial net worth." *Id.*

Perhaps it is unsurprising that some courts consider profit beyond the defendant's direct gain when calculating the civil penalty. The penalty's sole purpose is to punish, and increasing the permissible range of the penalty by including the profit of others, for which the defendant is responsible, is simply a way to increase the penalty. More surprising, however, is when courts calculate disgorgement, which is not intended to be punitive, based on profit beyond the defendant's personal gain.

In *SEC v. Contorinis*, by a 2-1 majority, a panel of the Second Circuit affirmed an order that the defendant, an insider trader who traded on behalf of a fund of which he was co-manager, disgorge the fund's profit of $7.2 million, even though the defendant's personal benefit was limited to $427,000 as an increase in compensation due to the fund's improved performance. 743 F.3d 296, 300 (2d Cir. 2014) ("*Contorinis I*"). The court analogized this case, where the insider trader traded directly on behalf of the fund, to the tipper-tippee context, where the tipper passes along material, nonpublic information to the tippee, who when trades based on the information. *Id.* at 302–03. In the tipper-tippee context, the court has previously permitted orders that the tipper disgorge the benefit of the tippee. *Id.* Here, the court said, "the case for disgorgement is stronger" because, rather than simply passing on confidential information for a tippee to use as he sees fit, the defendant

[3] The court also appeared to harbor significant doubt about the defendant's guilt, although a jury convicted him, suggesting that it was "plausible" that the defendant's brother and father traded based on their substantial knowledge of the specific industry and based on public knowledge, rather than any tipping by the defendant. *Id.* at *2.

"controlled the size and timing of the trades" and was directly responsible for the fund's profits.[4] Additionally, the defendant gained in non-monetary ways: He "enhanced his reputation and increased the likelihood of his receiving future benefits as a fund manager." *Id.* at 303–04.

The *Contorinis* decision reflects a direct challenge to the traditional concept of disgorgement. As discussed above, disgorgement is not intended to be a punitive remedy. Yet, as Judge Chin pointed out in dissent from the *Contorinis* majority, an order disgorging an insider trader of profits beyond his personal gain is clearly punitive. *Id.* at 309–10. This incongruity is highlighted by Contorinis' parallel criminal case for the same conduct. In *U.S. v. Contorinis*, a different, unanimous panel of the Second Circuit held that the district court erred in ordering criminal forfeiture by the defendant of the fund's total profit because the defendant could not be made to forfeit that which he never had. 692 F.3d 136, 145–47 (2d Cir. 2012) ("*Contorinis II*").[5] Criminal forfeiture, the court said, "focuses on the disgorgement by a defendant of his ill-gotten gains" and thus "is usually based on the defendant's actual gain." *Id.* at 146 (quotation omitted). Judge Chin, dissenting in Contorinis' civil appeal, noted that "conceptually [disgorgement and criminal forfeiture] are largely the same" and thus the majority's decision is "inconsistent" with the Second Circuit's prior decision in the criminal case. *Contorinis I*, 743 F.3d at 310. The curious (and somewhat inconsistent) result from the two proceedings was that the criminal forfeiture, which is intended to be punitive, was limited to the defendant's actual gain, while disgorgement, which is purportedly not punitive, was extended to capture profits beyond the defendant's actual gain.

There is a second way in which this decision appears to convert disgorgement into a punitive remedy. Rather than seeking to disgorge the entire amount of profit from Contorinis, the SEC could have sought and the district court could have ordered the fund itself to disgorge its own profits, as the majority acknowledged. *Id.* at 304 n.4. Thus, there was no real reason to force Contorinis to disgorge more than he had "swallowed," other than to punish him.

One final, surprising aspect of the decision in *Contorinis I* is the order to pay prejudgment interest on the entire disgorgement amount. *Id.* at 307–08. Ordering prejudgment interest "is intended to deprive the wrongdoer of the benefit of holding the illicit gains over time by reasonably approximating the cost of borrowing such gain from the government." *Id.* at 308 (citation omitted). Because the defendant did not actually hold $7.2 million and therefore did

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[4] Perhaps consideration of this point, which might be characterized as the foreseeability of others' profits, could be incorporated into the civil penalty multi-factor analysis as well. Limiting the civil penalty and disgorgement by a principle of foreseeability would more reasonably approximate a defendant's culpability beyond his personal monetary gain.

[5] Notably, Judge Chin, who dissented in the civil case, also sat on the panel for the criminal case.

not benefit from it, the court's decision to apply prejudgment interest on that entire amount seems odd. The majority's response to Contorinis' objection to this order is simply that "[w]hether or not a party personally enjoyed the gains from the illegal action does not alter [the] principle" that prejudgment interest "usually tracks the amount that the party is ordered to disgorge." *Id.*

We have previously explained that Congress found it necessary to create a civil penalty in order to truly deter potential insider traders because injunctions and disgorgement were not punitive. The *Contorinis I* decision raises the question: If disgorgement orders can capture profits that are beyond a defendant's personal gain, sometimes in the amount of millions of dollars, is a separate civil penalty to penalize the defendant really necessary?

Considering Settlement With the SEC

We have seen how an insider trader can be subject to multiple types of damages that may greatly exceed his personal profit from his illegal conduct. Even a defendant who did not personally obtain *any* profit can be exposed to millions of dollars in damages. Counsel for such a defendant should consider the SEC's cooperation and settlement policies and practices to determine whether settlement can spare his client from having to pay enormous damages.

When defendants cooperate with the SEC in investigations and enforcement actions, the SEC may choose to "facilitat[e] and reward[]" such cooperation through a "wide spectrum of tools" that range from "taking no enforcement action to pursuing reduced charges and sanctions in connection with enforcement actions." *Policy Statement of the Securities and Exchange Commission Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions*, Rel. No. 34-61340 (Jan. 19, 2010). Practitioners may be aware of an informal "1-1" settlement policy that the SEC has implemented in insider trading cases that it deems appropriate: The defendant agrees to pay disgorgement and a civil penalty equal to the amount of disgorgement, rather than disgorgement and a civil penalty of three times the disgorgement that would be possible under ITSA.

For example, in a 2012 insider trading case, the SEC required one settling defendant, who passed along inside information but did not personally profit from it, to pay disgorgement of his tippee's profit and a civil penalty in an amount equal to the disgorgement. By settling, the defendant avoided the possibility of paying a maximum treble penalty based on the tippee's profits. More remarkably, a second settling defendant, who received the inside information *and* profited from it, was required to pay disgorgement of his profit and a penalty actually reduced from the disgorgement amount due to his "extensive cooperation" with the SEC. Press Release, SEC, SEC Charges Three in North

Carolina With Insider Trading (Sept. 20, 2012). Thus, settling and/or cooperation with the SEC can significantly reduce an insider trader's exposure to damages. More examples following this settlement model can be found on the SEC's website.

Counsel for alleged insider traders should be aware of the potential for multiple and enormous damages, and equally mindful of the possibility of avoiding the maximum treble penalty by cooperating and settling with the SEC.