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Court of Appeals Rejects Civil Fines for Unsuccessful Insider Trading

It is well settled that insiders trading on the basis of material non-public information may violate the federal securities laws, regardless of whether the trading nets a profit. However, as a result of the Second Circuit Court of Appeal's recent ruling in *SEC v. Rosenthal*, Docket Nos. 10-1204-cv (L); 10-1253 (con) (2d Cir. June 9, 2011), it appears that unsuccessful insider traders can escape monetary penalties in SEC enforcement actions.

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BACKGROUND

Two of the defendants in *SEC v. Rosenthal*, Amir and Ayal Rosenthal, pleaded guilty in 2007 to criminal charges alleging conspiracy to commit securities fraud in a multi-million dollar insider trading scheme. This scheme, which included five other friends and family members, was perpetrated in part by trading ahead of two proposed mergers. However, the proposed mergers never materialized and the defendants neither profited nor avoided losses on their illegal insider trading activity related to the mergers.

Following the defendants' criminal guilty pleas, the SEC instituted civil proceedings in the Southern District of New York alleging violations of, *inter alia*, Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 thereunder, and Section 17(a) of the Securities Act of 1933 by engaging in insider trading. Based on facts admitted by the defendants in their criminal plea allocutions, the Commission moved for partial summary judgment as to several insider trading violations and sought civil penalties pursuant to Section 21(d)(3) of the Exchange Act. Ultimately, the district court granted the SEC's motion and imposed "third tier" civil penalties pursuant to Section 21(d)(3) for insider trading violations relating to the failed mergers.^[1] However, as discussed below, Section 21(d)(3) penalties were not designed to be used in insider trading cases.

CIVIL PENALTIES AVAILABLE TO THE SEC

In 1984, Congress enacted the Insider Trading Sanctions Act ("ITSA"), which, for the first time, gave the Commission the authority to seek civil penalties in federal district court. Under ITSA, the Commission was permitted to seek civil penalties of up to three times the amount of profit gained or loss avoided from an insider trading violation. In 1988, Congress passed the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), which, among other things, amended the Exchange Act by adding Section 21A titled "Civil Penalties for Insider Trading." As under ITSA, Section 21A caps civil penalties for individuals at "three times the profit gained or loss avoided as a result of such unlawful purchase, sale, or communication."

In 1990, Congress enacted the Securities Law Enforcement Remedies Act and Penny Stock Reform Act of 1990 (the "Remedies Act"). The Remedies Act added Sections 21B and 21(d)(3) to the Exchange Act, which provided the Commission the ability to seek tiered civil penalties in non-insider trading cases, giving the Commission broad power to penalize any person who violates the federal securities law. Under Section 21(d)(3), there are three tiers of potential penalties. The highest "third-tier" penalty for an individual is \$120,000 per violation or the total pecuniary gain wrongfully obtained, whichever is greater. However, the plain language of Section 21(d)(3) only authorizes any civil penalties against a person who violates the Exchange Act "other than by committing a violation subject to a penalty pursuant to [Section 21A]."

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SECOND CIRCUIT'S DECISION IN SEC v. ROSENTHAL

On appeal, the defendants argued that Section 21A was the exclusive statute for imposing civil penalties for insider trading violations. However, as the Commission's brief in support of its motion for summary judgment pointed out, the defendants' insider trading violations relating to the mergers neither netted a profit nor avoided losses; thus the maximum fine under Section 21A would have been zero. Accordingly, the Commission argued that a fine should be imposed under Section 21(d)(3) (allowing for multi-tier penalties under the Remedies Act).

The crux of the Commission's argument was that, under the language of the statute, Section 21(d)(3) can be used to impose penalties unless a person is "subject to" a penalty pursuant to Section 21A. In this case, they argued, the defendants were never "subject to" a penalty under Section 21A because there was no penalty that could be imposed under that section. In other words, the Commission's interpretation of "subject to" meant that a defendant is only exempted from Section 21(d)(3) if he is "liable" for a penalty under Section 21A.

The Second Circuit rejected the SEC's interpretation, instead holding that "the most logical conception of the structure of Section 21A is that a defendant is "subject to" a penalty under that section as soon as he engages in insider trading activity that invokes the SEC's authority to bring charges, regardless of whether this activity ultimately ripens into profits or permits the avoidance of losses such that the penalty for the violation can be fixed at a non-zero sum." [Pp. 7-8.] According to the Court, the SEC's interpretation could lead to absurd results, as individuals who trade unsuccessfully on inside information could be penalized more severely than successful insider traders. Specifically, the Court noted:

...[I]t would be inconsistent with the statutory scheme, and absurd, to adopt the SEC's interpretation, which would permit a violator who made no profit to face a penalty of up to \$120,000 per violation, while a violator who profited by \$1000 would be exposed to a penalty of no more than \$3000.

The Court also found that the legislative history of Sections 21A and 21(d)(3) confirmed, among other things, that Section 21(d)(3) was intended to "fill a gap in the SEC's enforcement powers by addressing violations other than those 'described in' section 21A."

CONCLUSION

As the Second Circuit acknowledged, the *SEC v. Rosenthal* decision means that unsuccessful insider traders may be able to avoid civil penalties. However, as the Court noted, the decision does not prevent the SEC or DOJ from pursuing substantial enforcement actions. In fact, the defendants in *SEC v. Rosenthal* faced incarceration, criminal fines and an injunction. Nonetheless, SEC insider trading defendants should be aware of the Commission's limitations in imposing civil penalties for illegal, yet unsuccessful, insider trading activities.

This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney.

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