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Second Circuit Expands SEC Insider Trading Liability for Disgorgement

The Second Circuit recently expanded the ability of the Securities and Exchange Commission to obtain disgorgement in insider trading cases, holding that a defendant need not receive a direct benefit from the illicit trades in order to be liable for the disgorgement of another's profits. *SEC v. Contorinis*, No. 12-1723-cv (2d Cir. February 18, 2014). The opinion is a significant victory for the SEC and, if it stands, will allow the Commission to pursue hedge fund managers who trade illegally for the benefit of their funds.

BACKGROUND

Joseph Contorinis, a hedge fund manager at Jeffries & Co., obtained inside information on several occasions from an investment banker that he used to achieve \$7.3 million in gains for his fund, the Jeffries Paragon Fund. After a criminal jury trial, Contorinis was found guilty of one count of conspiracy to commit securities fraud and nine counts of securities fraud. The SEC, in a follow-on civil case, argued that Contorinis should disgorge the entire gain by the fund in addition to a civil penalty and an injunction against future securities law violations. The district court agreed; it imposed on Contorinis a \$7.3 million disgorgement order, as well as a \$1 million civil penalty and an injunction. Contorinis subsequently appealed the judgment.

HOLDING

The Second Circuit held that an insider trader who trades on behalf of another

person or entity using funds he does not own – and thus produces illegal profits that he does not personally realize – can nevertheless be required to disgorge the full amount of the illicit profit he generates from his illegal action. The Court reasoned that the lack of a personal benefit should not insulate a defendant from liability for the gains realized by another, and relied heavily on the fact that a tipper remains liable for the profits generated (or losses avoided) by all downstream tippees. According to the Court, “It would make little sense to allow the insider to escape disgorgement when he gives away not the proceeds of a trade predicated on his insider knowledge, but rather the knowledge itself to others who he knows will spin the information into gold by trading on it themselves.”

DISSENT

In a strong dissent, Judge Denny Chin explained that the panel's decision is inconsistent with the Second Circuit's recent decision in the parallel criminal case, *United States v. Contorinis*, 692 F.3d 136, 145–48 (2d Cir. 2012), which held that criminal forfeiture of ill-gotten gains is limited to a defendant's individual gain. (Judge Chin was also a member of the Second Circuit panel in the criminal case.) In Judge Chin's view, the remedy imposed by the district court was more penal in nature than equitable and thus went “beyond the permissible scope” of the disgorgement remedy.

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IMPACT

The *Contorinis* decision squarely implicates the question whether disgorgement, a purely equitable remedy, becomes penal when a malefactor uses inside information but does not personally profit from the illegal trading, and seems ripe for *en banc* consideration by the entire Second Circuit. Even the *Contorinis* panel recognized in a footnote that, “[c]ircuits which have considered related issues are mixed regarding the extent to which a party can be ordered to disgorge total gain from an unlawful act, when the party has not personally received the full benefit of the wrongdoing,” citing as an example *SEC v. Blatt*, 583 F.2d 1325 (5th Cir. 1978), in which the Fifth Circuit “vacated a district court’s order that individual, knowing participants in an illegal securities scheme [must] disgorge amounts beyond their personal gain.”

In the event the opinion stands, *Contorinis* represents a significant increase in the SEC’s ability to obtain disgorgement against hedge fund managers and others who illegally trade in the accounts of others but do not personally profit from the activity.

Please feel free to contact me if you have any questions regarding this advisory or any other SEC-related matter.

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