SEC Is Misguided On Disgorgement From Portfolio Managers

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Under the leadership of Chair Mary Jo White and Director of Enforcement Andrew Ceresney, the U.S. Securities and Exchange Commission has aggressively stepped up its efforts to prosecute insider trading by institutional portfolio managers in the funds that they manage.

In these cases, the SEC typically seeks disgorgement (i.e., the total amount of profits gained and losses avoided) from defendants regardless of whether the portfolio manager personally received or benefited from these funds. The SEC also seeks civil penalties based on institutional, as opposed to personal, gain. But despite the SEC’s insistence on such broad disgorgement and civil penalty calculations, recent decisions — resting on a strong precedential foundation — call the SEC’s strategy into question.

Disgorgement is an SEC remedy designed to prevent the wrongdoer from unjustly profiting from fraud. On the other hand, civil penalties for insider trading, authorized by Section 21A of the Securities Exchange Act of 1934 in an amount “not to exceed three times the profit gained or loss avoided,” are meant to punish. Because both disgorgement and civil penalties are measured by illicit gain or avoided loss, the SEC, as part of its insider trading enforcement program, has sought to hold portfolio managers liable for gains and avoided losses realized solely by the hedge funds or institutionalized trading platforms through which they traded.

Until 2014, no appellate court had considered the measure of disgorgement when a portfolio manager commits insider trading but the gains and avoided loss benefit the portfolio’s investors. The Second Circuit tackled this issue in 2014 in SEC v. Contorinis. The defendant, a managing director at Jeffries & Co., traded on nonpublic information disclosed by an acquaintance at UBS. Contorinis made the illegal trades on behalf of the Jeffries Paragon Fund — for which he was co-manager and had investment control — and not with his personal assets. As a result of these trades, the Paragon Fund realized profits of $7.3 million and avoided losses of $5.3 million. The U.S. Department of Justice and the SEC both charged Contorinis with securities fraud.

After a criminal jury trial, Contorinis was convicted of securities fraud and ordered to forfeit $12.6 million (the total amount of realized profits plus avoided losses). On appeal, a Second Circuit panel rejected this amount because “criminal forfeiture penalties are usually based on the defendant’s actual gain.” In this way, criminal forfeiture and disgorgement serve the same purpose: to deprive wrongdoers of the ill-gotten gains they personally receive. The district court then determined that Contorinis’s
personal profit only totaled $427,875, which represented his compensation traceable to the illegal trades.

In the related SEC action, the district court ordered that Contorinis disgorge $7.2 million (Paragon’s profits less trading commissions). In the civil appeal, a separate Second Circuit panel (and contrary to the earlier criminal panel) upheld the $7.2 million disgorgement figure, despite Contorinis’s argument that he never personally realized these gains. This Second Circuit panel compared Contorinis’s actions to a tipper, who is legally responsible for a tippee’s insider trading gains. The panel also noted Contorinis’s significant investment control over the fund. The Second Circuit, however, acknowledged that other courts have disagreed with an institutional measure of disgorgement in individual enforcement actions, citing the Fifth Circuit’s 1978 decision in SEC v. Blatt, among others.

In Blatt, the Fifth Circuit limited disgorgement in an SEC enforcement action to “the amount of the fee realized by each defendant for his assistance in executing the fraud” because “disgorgement is remedial and not punitive.” As the Fifth Circuit recognized, “[a]ny further sum would constitute a penalty assessment.”

A 2015 Georgia federal district court opinion applied the Blatt decision to insider trading by a portfolio manager and explicitly declined to follow the approach from the civil appeal in Contorinis. In SEC v. Megalli, the district court rejected the SEC’s argument that a portfolio manager, Megalli, should be responsible for disgorging over $2.7 million in profits gained and losses avoided by his employer. Ultimately, the district court ordered Megalli to disgorge $19,790, the portion of his bonus traceable to the illegal trading.

In arguing for the $2.7 million amount, the SEC cited the Second Circuit’s civil holding in Contorinis, specifically its comparison of a portfolio manager to a tipper. Although the Georgia court did not address this point, the Contorinis analogy does not apply to portfolio managers. When an insider tips a third party with nonpublic information in the expectation that the tippee will trade on that information, the tipper and the tippee act in concert, and the tippee is not innocent. A portfolio manager who relies on material nonpublic information to trade via an institutional platform merely confers a financial benefit on an innocent third party, the fund’s investors. He neither acts in concert with portfolio investors, nor does he possess or control the fund’s profits.

The Georgia district court’s decision to follow Blatt and limit liability only to a portfolio manager’s personal insider trading gains is highly significant. As a practical matter, courts rarely impose a civil penalty in excess of disgorgement. Indeed, in fully 87 percent of the insider trading judgments entered in SEC enforcement actions from 2010 to 2014, the civil penalty was either less than or equal to disgorgement; and if less than disgorgement, the civil penalty was often zero.

As noted above, however, because disgorgement is equitable and a civil penalty is punitive, the SEC, in furtherance of its aggressive enforcement policy, has taken the position that the amount of illicit gain and losses used to assess a civil penalty need not match the amount the SEC has sought in disgorgement. This includes use of an institutional measure of gain in the assessment of a civil insider trading penalty against an individual portfolio manager.

This strategy is misguided because courts routinely cap a civil penalty (if any) by reference to disgorgement and Exchange Act Section 21A expressly states that liability for a civil penalty is confined to “the person” who committed an insider trading violation. Because Congress confined civil penalty liability to “the person” who commits an offense, it is unlikely that Congress also contemplated taxing
that individual for profits flowing to innocent third parties that he never realized or controlled. Indeed, in the statute’s legislative history, the drafters repeatedly cited solely the violator’s profit, not third party gain, as the measure of liability.

And in practice, courts routinely exercise discretion to limit civil penalties in SEC enforcement actions solely to an individual offender’s personal gain. In SEC v. Scolaro and SEC v. Cardillo, for example, separate courts in the Southern District of New York entered civil penalties against portfolio managers at Diamondback Capital and Galleon Management amounting to merely a fraction of the funds’ illegal profits.

Emboldened by the Second Circuit’s civil opinion in Contorinis, the SEC will undoubtedly continue its efforts to hold individual portfolio managers liable for institutionalized insider trading profits. The legal and equitable basis for saddling individuals with disgorgement and civil penalty assessments fixed to institutional gain is shaky, however. Ill-gotten gain in the context of institutionalized trading means personal profit, as recognized by hundreds of civil judgments in SEC insider trading actions and by Congress in drafting and enacting Exchange Act Section 21A.

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