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WHITE-COLLAR CRIME
A SPECIAL REPORT

The financial consequences of insider-trading cases

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Counsel advising professional money managers on the dangers of insider trading must consider the dramatic and wide-ranging financial consequences of a criminal conviction, be it by trial verdict or plea. The government has refocused its use of the financial weapons at its disposal, and recent developments in restitution and forfeiture threaten to multiply the financial risk.

Securities fraud may give rise to at least six types of financial exposure: criminal forfeiture, a criminal fine, disgorgement to the U.S. Securities and Exchange Commission, SEC penalties, restitution to victims and private civil actions. The cumulative impact of these independent consequences can be devastating.

• *Forfeiture*. The civil forfeiture statute, 18 U.S.C. 981, allows the government to forfeit "any property constituting, or derived from, proceeds the person obtained directly or indirectly" from specified criminal conduct. The relevant offenses include securities fraud by reference.

While securities fraud is subject to forfeiture under the civil statute, nominally "civil" forfeiture is incorporated in criminal proceedings by 28 U.S.C. 2461(c), which allows the government to seek an order of forfeiture as part of a criminal judgment.

• *Fines*. A court may impose a fine under 18 U.S.C. 3571 as part of a criminal sentence. For insider trading, the fine will generally be capped at $250,000, but the court has discretion under § 3571(d) to impose an "alternative" fine of up to double any gain from the offense or any loss to a third party.

• *Disgorgement*. Criminal insider-trading prosecutions will usually be paired with an SEC action. The SEC has authority to seek disgorgement of profits from the criminal conduct, because it "would severely defeat the purposes of the Act if a violator of Rule 10b–5 were allowed to retain the profits from his violation." *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir. 1971). In practice, criminal forfeiture and SEC disgorgement may be offset when they are overlapping.

• *Penalties*. Section 21A of the Securities Exchange Act of 1934, 15 U.S.C. 78a, authorizes the SEC to bring an action in federal district court seeking the imposition of a civil penalty for insider trading. The statute provides that the amount of the penalty "shall not exceed the greater of $1,000,000, or three times the amount of the profit gained or loss avoided as a result of…[the] violation."

• *Restitution*. The Mandatory Victims Restitution Act, 18 U.S.C. 3663A, and the restitution procedures provision, require the court to order restitution to identifiable victims of the offense when sentencing a defendant convicted of a crime committed by fraud or deceit. The order must be in the "full amount of each victim's losses…without consideration of the economic circumstances of the defendant."

• *Private actions*. Private causes of action may be available to the manager's institutional employer. In addition, the counterparties to any insider trading may have a cause of action under §§ 10(b) and 20A of the Exchange Act against the trader. Remedies are limited to actual gains and losses and are reduced by any disgorgement to the SEC.

Several features of insider trading in an institutional context complicate the picture. First, such insider trading will often involve much larger sums than small-bore insider trading by unaffiliated individuals. Second, the gain, or loss avoided, will generally flow in the first instance to investors rather than to the manager. The manager's personal profit will derive from fees earned or his or her own investment in the fund. Third, the manager's employer may incur substantial expenses relating to the allegations of wrongdoing. Most institutions will respond to an SEC or criminal probe by conducting a costly internal investigation, related representations, and cooperation with the government.

RECENT EXAMPLES

With the recent spate of federal insider-trading prosecutions, especially in the Southern District of New York, the law is evolving. Regarding forfeiture, in 2010, a lower court found a professional money manager liable for forfeiture of the entire amount of his fund's gain despite the fact that almost all of the gain inured to the benefit of third-party investors and not the manager himself. The U.S. Court of Appeals for the Second Circuit, however, recently held that a narrower approach should be followed in this situation.

In *U.S. v. Contorinis*, No. 09-cr-1083, slip op. (S.D.N.Y. December 22, 2010), the district court ordered forfeiture of the entire amount of loss avoided by the fund. The court found the defendant-portfolio manager, Joseph Contorinis, liable for the $13 million in losses avoided by his fund. The Second Circuit reversed, holding that the defendant could not be forced to forfeit profits that he himself never possessed and "to which [he] was never entitled." *U.S. v. Contorinis*, 692 F.3d 136 (2d Cir. 2012). The court ruled that proceeds that "go directly to an innocent third party and are never possessed by the defendant" are not subject to forfeiture.

The panel left it to the district court to determine the amount the defendant personally benefited from this scheme, identifying salary, bonus, dividends and equity in the fund as potential sources of individual gain. So although the benefit to the fund is no longer a basis for forfeiture, a defendant's compensation and appreciation could well be subject to forfeiture proceedings.

The traditional $250,000 cap on criminal fines may also be changing: In *U.S. v. Gupta*, the court imposed an alternative $5 million fine on the tipper defendant. Transcript, *U.S. v. Gupta*, No. 11-cr-907 (S.D.N.Y. October 24, 2012); see also *U.S. v. Rajaratnam*, No. S-2:09 Cr. 01184-01, 2011 WL 6259591 (S.D.N.Y. October 20, 2011) (imposing a fine of $10 million).

As to disgorgement, the gain subject to forfeiture and the disgorgement claimed by the SEC may substantially overlap. But here another decision from the Contorinis case is significant. See *SEC v. Contorinis*, No. 09-cv-1043, 2012 WL 512626, at *5 (S.D.N.Y. February 3, 2012). The scheme in *Contorinis* resulted in $12.6 million in benefit to the fund, including $7.3 million in profits. The defendant suggested that the disgorgement of those profits would represent a double recovery in light of the forfeiture order.

The court ordered disgorgement of the $7.3 million, subject to the SEC's concession that any forfeiture ultimately awarded would be credited against this amount. Although the decision is on appeal, it appears that the Contorinis opinion on forfeiture could be effectively undone by its ruling on disgorgement.

Moreover, the SEC penalties may run to three times the disgorged amount. *SEC v. Contorinis* may offer comfort to defendants on that score; the court ordered $1 million in penalties rather than the maximum allowable—$21 million—that the SEC had requested. But the amount of the penalty award is discretionary, and the possibility remains for combined forfeiture, disgorgement and penalties amounting to large multiples of the defendant's personal gain.

Finally, restitution has emerged as a minefield for defendants. Recent authority has articulated a broad standard for who is a "victim" entitled to restitution. See, e.g., *U.S. v. Archer*, 671 F.3d 149, 172 (2d Cir. 2011). One evolving area on the restitution front is the potential claim by a defendant's institutional employer for two categories of restitution: costs incurred during the course of the employer's response to the allegations, and compensation previously paid to the defendant during his employment.

One court recently awarded $10 million in restitution to a professional money manager's employer. See *U.S. v. Skowron*, 839 F. Supp. 2d 740 (S.D.N.Y. 2012) (appeal pending). And similarly, in *Gupta*, the tipper defendant's former employer is seeking restitution of more than $6 million, including attorney fees and 25 percent of all compensation paid to the defendant after the start of the insider-trading conspiracy. That request for restitution is pending.

To illustrate these profound financial consequences, imagine a hypothetical portfolio manager found to be guilty of insider trading resulting in a gain for his or her fund of $500,000. On the criminal side, the defendant will likely incur a $500,000 forfeiture order, a fine of up to $1 million and a restitution order requiring payment of his fund's legal fees in connection with the misconduct, likely totaling millions of dollars, as well as a portion of his compensation received during the time he was engaging in criminal conduct. On the regulatory front, the defendant would face a $500,000 disgorgement (which could be offset by the criminal forfeiture) and up to $1.5 million in penalties. Finally, the defendant may face millions of dollars in private actions. Defending all of these litigations would impose its own substantial legal costs. In total, the defendant's $500,000 "investment" could well result in millions of dollars in loss, a desultory return on investment to say the least. This all serves as a tag-along to the likely sentence of incarceration, the destruction of reputation and incalculable harm to family and loved ones.

In sum, insider trading may result in ruinous financial liability for professional money managers. The threat of these financial penalties should be part of counsel's compliance presentations to managers and should be considered in developing strategy in any criminal or civil defense of insider-trading allegations.

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