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SECOND CIRCUIT REVIEW

Expert Analysis

Civil Penalties for Insider Trading

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Earlier this month, in *S.E.C. v. Rajaratnam*, the U.S. Court of Appeals for the Second Circuit reviewed whether the penalty available in a civil insider trading action pursuant to Section 21A of the Securities Exchange Act of 1934 (the Exchange Act) is limited to a defendant's personal profits. In a unanimous opinion, written by Judge Gerard Lynch, and joined by Judges Reena Raggi and Christopher Droney, the Second Circuit held that such a penalty is not so limited, and can be based on profits gained by other individuals or entities as a result of a defendant's insider trading violations. Against the backdrop of other recent developments in insider trading law, the Second Circuit's discussion of the contours of Section 21A's penalty provision represents an interesting extension of insider trading enforcement authority.

Section 21A of the Securities Exchange Act

Section 21A of the Exchange Act authorizes the Securities and Exchange Commission (SEC) to bring a civil action in a U.S. District Court to seek penalties against persons who violate the insider trading laws. 15 U.S.C. §78u-1. Subsection (a)(2) of Section 21A further states that the penalty in such an action "shall be determined by the court 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).

Although the statute defines "profit gained" and "loss avoided" as "the difference between the purchase or sale price of the security and the value of that security … after public dissemination of the nonpublic information," the statute does not expressly address whether the terms "profit" or "loss" refer to a defendant's *personal* profit or loss, or whether a court may consider the profits gained or losses avoided by other individuals or entities as a result of a defendant's insider trading violations.

'Salman v. United States'

In *Salman v. United States*, the Supreme Court settled a circuit split regarding the extent to which insider trading "tipper" liability requires proof of a tipper's actual or potential pecuniary gain. 137 S. Ct. 420 (2016). Ultimately, the court concluded that a tipper need not receive anything of pecuniary value in exchange for the tipper to be held criminally liable for providing material non-public information to a family member. The question in *Salman* originated with the Second Circuit's *United States v. Newman* decision, in which the

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court rejected the government's argument that a casual business relationship or family friendship between a tipper and tippee was sufficient to infer a tipper's personal benefit. 773 F.3d 438 (2d Cir. 2014), cert. denied 136 S. Ct. 242 (Oct. 5, 2015). Rejecting this argument, *Newman* held that criminal liability requires proof of a "meaningfully close personal relationship" between a tipper and tippee "that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." Id. at 452.

Salman, however, squarely abrogated *Newman*'s articulation of the personal benefit test "[t]o the extent the Second Circuit held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a [tip]." See *Salman*, 137 S. Ct. at 428. The court's opinion marked an expansion of tipper liability and an extension of insider trading enforcement authority. The ruling also struck another nail in *Newman*'s coffin, as did the Second Circuit's January 2019 decision in *Gupta v. United States*, 2019 WL 165930 (Jan. 11, 2019).

Prior Proceedings In 'Rajaratnam'

In 2011, the U.S. Attorney's Office for the Southern District of New York indicted Raj Rajaratnam on nine substantive counts of securities fraud, as well as five counts of conspiracy to commit insider trading. Concurrently, the SEC brought a parallel civil proceeding under Exchange Act Section 21A, seeking disgorgement, a civil penalty, and an injunction. These proceedings alleged that Rajaratnam engaged in a massive insider trading scheme using his position as head of Galleon Management Co., a multi-billion-dollar hedge fund, to trade on material, nonpublic information. See *S.E.C. v. Rajaratnam*, 822 F. Supp. 2d 432 (S.D.N.Y. 2011), aff'd sub nom. *S.E.C. v. Rajaratnam*, 2019 WL 1029257 (2d Cir. March 5, 2019).

Against the backdrop of other recent developments in insider trading law, the Second Circuit's discussion of the contours of Section 21A's penalty provision represents an interesting extension of insider trading enforcement authority.

After an eight-week criminal trial, Rajaratnam was found guilty on all counts, sentenced to 11 years in prison, and ordered to pay $10 million in criminal penalties. Rajaratnam also was ordered, pursuant to 18 U.S.C. §981, to forfeit $53.8 million, roughly $31 million of which encompassed profits derived from Rajaratnam's substantive insider trading violations. Although Rajaratnam's personal profits amounted to $4.7 million—derived from management fees and personal trades connected to his insider trading—the court also included in the forfeiture calculation the profits realized by Galleon and others "as a result of" Rajaratnam's offenses.

Because of his criminal conviction, Rajaratnam was collaterally estopped from contesting liability in the parallel Section 21A civil action. Accordingly, the SEC moved for summary judgment on the substantive insider trading counts, seeking a civil penalty in the amount of $92,805,705—the trebled $31 million forfeiture amount encompassing the substantive criminal violations. The only issue in dispute on summary judgment was the need for, and the amount of, the Section 21A civil penalty.

Rajaratnam argued that, because he personally profited by only $4.7 million, any civil penalty figure should not include the additional profits realized by Galleon and others. The district court (Judge Jed S. Rakoff) rejected this argument, reasoning that "nothing in the text of Section 21A" requires that a civil penalty be based only on the profits Rajaratnam "personally gained." *Rajaratnam*, 822 F. Supp. 2d at 435. The court further stated that such a reading would result in the "evasion … of [Rajaratnam's] responsibility for the wrongdoing he committed." Id. Accordingly, the district court imposed a civil penalty of $92,805,705, "entirely in addition to the forfeiture and other financial payments ordered" in the criminal proceedings. Id. at 436.

The Second Circuit Opinion

On appeal, Rajaratnam's primary argument was that the phrase "profit gained or loss avoided" in Section 21A's text refers only to a defendant's *own* profit or loss. The Second Circuit rejected this reading of the statute and affirmed the district court's penalty calculation.

In doing so, the court first stated that a "plain reading" of Section 21A "permits a civil penalty to be based on the *total* profits resulting from [a] violation." *S.E.C. v. Rajaratnam*, 2019 WL 1029257, *4 (2d Cir. Mar. 5, 2019) (emphasis added). The court emphasized that the terms profit and loss in the statute refer to the "profit gained or loss avoided *as a result of*" an insider trading violation. See id. (emphasis added). Thus, it is the profitability of a defendant's insider trading *violation*, and not the defendant's personal gain, that determines the maximum civil penalty. The court buttressed this reasoning by contrasting Section 21A's language with provisions of the federal code where "Congress expressly limited the 'amount of the penalty' for particular violations to the 'gross amount of pecuniary gain to *such defendant* as a result of the violation.'" Id. at *5 (citing Securities Act Section 20(d)(2), 15 U.S.C. §§77t(d)(2)(A), (B), (C); Exchange Act Section 21(d), 15 U.S.C. §§78u(d)(3)(B)(I), (ii), (iii); Investment Company Act of 1940 Section 42(e), 15 U.S.C. §§80a-41(e)(2)(A), (B), (C); Investment Advisers Act of 1940 Section 209(e), 15 U.S.C. §§80b-9(e)(2)(A), (B), (C)) (emphasis added).

The court next criticized Rajaratnam's reading of Section 21A as conflicting with the statute's treatment of insider trading tippers. The court noted that tippers, who often do not themselves profit from a violation, are still subject to Section 21A proceedings. This is because a Section 21A proceeding rests on an underlying violation of the insider trading laws, which can clearly encompass a tipper's unlawful communication of material nonpublic information to a trading tippee. After all, as the court noted, Section 21A's text explicitly permits a civil penalty to be based on "the profit gained or loss avoided as a result of such unlawful … *communication*." See id. at *5 (citing 15 U.S.C. §78u-1(a)(2)) (emphasis added). Accordingly, because "the only possible 'profit gained or loss avoided'" in certain tipper prosecutions "would result from the trading of the tipper's tippee(s)," the Second Circuit rejected the notion that Section 21A's penalty is limited to a defendant's personal profit or loss. Id. (citing 15 U.S.C. §78u-1(a)(2)).

The court also addressed the broader policy behind Section 21A proceedings. The court stated that "the purpose of Section 21A is to deter the whole of the conduct Rajaratnam engaged in by exacting a penalty for it." Id. Thus, an "appropriate penalty" under Section 21A "must be keyed to the total scope of [a defendant's] scheme." Id. On this basis, the Second Circuit affirmed the district court's $92,805,705 civil penalty and rejected Rajaratnam's interpretation of the Exchange Act.

Conclusion

The Second Circuit's decision in *S.E.C. v. Rajaratnam* broadens the scope of civil insider trading enforcement by authorizing civil penalties that extend beyond a defendant's personal gain. The Second Circuit's express reference to tipper liability invites future Section 21A cases against tippers that could result in broad civil penalties. Indeed, if the appropriate civil penalty is one "keyed to the total scope of [a defendant's] scheme," then Section 21A may in fact authorize more expansive civil penalties in the wake of large tipping cases. Id.