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Reasonable Approximation and Proximate Cause: How the Disgorgement Elements Are Bound Together

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NOTE

REASONABLE APPROXIMATION AND PROXIMATE CAUSE: HOW THE DISGORGEMENT ELEMENTS ARE BOUND TOGETHER

Micah J. Long[†]

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ABSTRACT

The Securities Exchange Commission (SEC) has a host of tools to punish insider trading and other fraudulent investing activity. One of its most powerful weapons is the disgorgement of profits. In federal court, the SEC frequently seeks the disgorgement of ill-gotten profits by criminal defendants. However, disgorgement is an imprecise instrument. In the high-speed world of institutional investing, it can be incredibly difficult for the SEC to prove exactly which profits were ill-gotten and which were not.

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The difficulty arises because it is nearly impossible to prove with precision what gains were due to the ill-advised tip from an insider and what gains were due to the benign swings of the stock market.

Given the difficulty, courts have found that precision is too high a bar. In *SEC v. First City Financial Corp.*, a watershed 1989 case, the D.C. Circuit held that, given the inherent difficulty in proving causation with precision, the SEC only had to provide a “reasonable approximation” of ill-gotten gain. Essentially, once the SEC provided a ballpark estimate of the defendants’ gain, the onus was on the defendants to prove that approximation was wrong. This burden-shifting framework quickly spread to the other circuits, with varying applications.

The framework set out by the D.C. Circuit shifted the burden of proving precisely the amount to be disgorged, but it did not shift the burden of proving causation. This imbalance has created a contradiction in the law because the prosecution’s burden of proving proximate causation runs directly counter to the reasonable approximation rule of *First Financial Corp.* In proving damages, the burden-shifting framework only requires the SEC to prove a “reasonable approximation” of ill-gotten gains; however, in proving proximate cause, the SEC must prove with exactitude the profits that flowed from the wrong committed. The classic *First Financial Corp.* framework would allow the SEC to provide a reasonable approximation of profits for one element of the crime, but be forced to specifically prove damages in the other. Thus, if the SEC were required to prove that the profits received by defendants were proximately caused by their misdeeds, it would completely undermine the burden-shifting framework of *First Financial Corp.*

The Third Circuit solved this dilemma in *SEC v. Teo* by relaxing the SEC’s burden to prove causation. In *SEC v. Teo*, the Third Circuit held that the SEC does not have the burden of proving proximate cause. Rather, the SEC must only prove but-for causation between alleged wrongdoing and ill-gotten profits, which means that it must only prove that the defendant’s profits would not have occurred, but for his unlawful actions. Once that is proven, the burden shifts to the defendant to prove that the rest of his profits were not proximately connected to his unlawful gains.

The Third Circuit’s decision in *SEC v. Teo* was correctly decided. By relaxing the burden of proving causation, the Third Circuit has aligned the burden of proving causation with the burden of proving ill-gotten profits. The synergy between the rules requiring only but-for causation and “reasonable approximation” of ill-gotten profits is too great to be ignored by the other circuits. The other circuits should join the Third Circuit in

extending the reasoning of *First Financial Corp.* to the issue of proximate causation.

I. INTRODUCTION

On February 10, 2014, in *SEC v. Teo*, the Third Circuit held that, in an action for disgorgement of profits under the Securities Exchange Act of 1934, the SEC does not have the burden of proving that the illegal activity complained of proximately caused the profits sought to be disgorged.¹ Instead, the Third Circuit reasoned that the relevant case law only required the SEC to prove but-for causation between alleged wrongdoing and ill-gotten profits. In holding that the SEC needs only to prove but-for causation in disgorgement cases, the Third Circuit in *SEC v. Teo*² primarily rested on the authority of *SEC v. First City Financial Corp.*, which in turn relied on *SEC v. MacDonald*.³ The holding in *Teo* created a split with the other circuits, which have all required the SEC to show at least some level of proximate cause.⁴ Despite this circuit split, the Supreme Court denied certiorari when the defendants in *Teo* appealed.⁵

This Note argues that the Third Circuit's decision in *SEC v. Teo* was correctly decided.⁶ After discussing the development of the SEC's enforcement powers, Part III of this Note analyzes the formation of the current causation test created by the D.C. Circuit in *SEC v. First City Financial Corp.*, and its precedential development in *SEC v. Macdonald*. Part IV of this Note discusses the factual and procedural history of *SEC v.*

1. *SEC v. Teo*, 746 F.3d 90, 107 (3d. Cir. 2014).

2. *SEE TEO*, 746 F.3D AT 105-06.

3. *SEC v. MacDonald*, 699 F.2d 47 (1st Cir. 1983).

4. John P. Quinn, *A Cause for Concern: The Need for Proximate Cause in SEC Enforcement Actions and How the Third Circuit Got It Wrong in Sec v. Teo*, 56 B.C.L. REV. E-SUPPLEMENT 138, 140 (2015).

5. *Id.*

6. *See Teo*, 746 F.3d at 107 (holding that the investor was unjustly enriched as a result of his securities violations). Proximate cause can be thought of as a policy question asking how far liability for a particular action should extend. *See* Peter Tipps, Note, *Controlling the Lead Paint Debate: Why Control Is Not an Element of Public Nuisance*, 50 B.C.L. REV. 605, 628-29 (2009) (discussing the characteristics of proximate cause within the context of public nuisance liability). Proximate cause examines how far removed an individual's conduct is from a resulting harm, and seeks to determine if the harm was a foreseeable consequence of that harm. *See id.* As applied to the remedy of disgorgement, proximate cause examines whether or not the defendant's profit is directly attributable to the underlying wrong, taking into account causal attenuation. *See* RESTATEMENT (THIRD) OF RESTITUTION § 51 cmt. f (2011) (discussing causation and remoteness as applied to the elements of disgorgement).

Teo and analyzes the reasoning employed by the Third Circuit. Finally, Part V addresses the circuit split created by the decision in *Teo* and contrasts the Third Circuit's correct interpretation of the application of causation in SEC enforcement actions with that of the conflicting circuits.

II. BACKGROUND

"That most delicious of all privileges—spending other people's money."⁷ The SEC has a host of enforcement powers that it can bring to bear against a fraudster. In seeking a judicial remedy, the SEC can pursue civil monetary penalties, an officer or director bar, injunctions, disgorgement, or other equitable remedies.⁸ The SEC may also institute an action for civil or criminal contempt.⁹ However, one of the SEC's most powerful weapons is disgorgement. The SEC frequently seeks disgorgement of profits from illegal insider trading in federal court.¹⁰

A. *The SEC's Equitable Remedy of Disgorgement*

The equitable remedy of disgorgement is designed to deprive fraudsters of ill-gotten gains whereby they have been unjustly enriched.¹¹ The SEC defines disgorgement as "the repayment of illegally gained profits (or avoided losses) for distribution to harmed investors whenever feasible."¹² Disgorgement is not primarily intended to compensate victims, but instead

7. John Randolph of Roanoke, <http://izquotes.com/quote/349748> (last accessed Nov. 15, 2017).

8. Insider Trading, Third Edition § 7.01 (Matthew Bender, Rev. Ed.).

9. *Id.*

10. See, e.g., SEC v. Lipson, 278 F.3d 656, 662-63 (7th Cir. 2002); SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1103 (2d Cir. 1972); SEC v. Chester Holdings, Ltd., 41 F. Supp. 2d 505, 528 (D.N.J. 1999); SEC v. R. J. Allen & Assocs., 386 F. Supp. 866, 880 (S.D. Fla. 1974).

11. *Teo*, 746 F.3d at 105; see also SEC v. Contorinis, 743 F.3d 296, 301 (2d Cir. 2014) ("Disgorgement is an equitable remedy, imposed to 'forc[e] a defendant to give up the amount by which he was unjustly enriched.'") (alteration in original) (quoting FTC v. Bronson Partners, 654 F.3d 359, 372 (2d Cir. 2011)).

12. U.S. Sec. & Exch. Comm'n, Agency Financial Report: Fiscal Year 2014, at 66 n.9. (2014), <https://www.sec.gov/about/secpar/secfr2014.pdf> [<https://perma.cc/DD7S-FRLK>].

to deter future violations of securities law.¹³ As a deterrent, disgorgement is highly effective since awards are often punishingly large.¹⁴

Disgorgement is a highly effective weapon in the SEC's litigation arsenal. The Commission collects considerably more money from disgorgement remedies than it does in civil penalties. In 2014 (fiscal year) alone, the SEC recovered \$2.788 billion in disgorgement of illegal profit.¹⁵ Meanwhile, the Commission recovered only \$1.378 billion in civil penalties in the same period.¹⁶

B. *Historical Underpinnings of Disgorgement Power*

Courts have broad latitude in granting disgorgement because it is an equitable remedy, and fashioning equitable remedies is an inherent power of the court.¹⁷ Further, the various securities acts specifically provide the courts with broad equity powers to fashion remedies in securities fraud cases.¹⁸ However, neither The Dodd Frank, Wall Street Reform and Consumer Protection Act, nor the other securities acts, specifically give the SEC the statutory right to seek disgorgement in federal court.¹⁹

The Sarbanes-Oxley Act (SOX) does, however, specifically provide for equitable remedies. In Section 305(b), SOX provides that “[i]n any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the

13. SEC v. Cavanagh, 445 F.3d 105, 117 (2d Cir. 2006) (“In a securities enforcement action, as in other contexts, ‘disgorgement’ is not available primarily to compensate victims. Instead, disgorgement has been used by the SEC and courts to prevent wrongdoers from unjustly enriching themselves through violations, which has the effect of deterring subsequent fraud.”).

14. See, e.g., Russell G. Ryan, *The Equity Facade of SEC Disgorgement*, 4 HARV. BUS. L. REV. ONLINE 1, 2-3, n.12 (2013), http://www.hblr.org/wp-content/uploads/2013/11/Ryan_The-Equity-Fa%C3%A7ade-of-SEC-Disgorgement.pdf [<https://perma.cc/TG3D-6PD5>] (“In practice . . . the SEC rarely uses administrative proceedings to pursue contested disgorgement claims, preferring instead to file and litigate such claims in federal court.”).

15. These figures include both orders from SEC cease-and-desist proceedings, as well as enforcement actions in federal court. U.S. Sec. & Exch. Comm’n, *Select SEC and Market Data: Fiscal 2014*, at 2 tbl.1 (2014), <http://www.sec.gov/about/secstats2014.pdf> [<https://perma.cc/UQ6G-Z2Z4>].

16. *Id.*

17. *Cavanagh*, 445 F.3d at 118.

18. See *supra* notes 19-24 and the accompanying text.

19. See, e.g., SEC v. Lipson, 278 F.3d 656, 662-63 (7th Cir. 2002); SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1103 (2d Cir. 1972); SEC v. Chester Holdings, Ltd., 41 F. Supp. 2d 505, 528 (D.N.J. 1999); SEC v. R. J. Allen & Assocs., 386 F. Supp. 866, 880 (S.D. Fla. 1974).

benefit of investors.”²⁰ Furthermore, SOX recognizes (and may implicitly endorse) the SEC’s right to seek disgorgement in Section 308(a):

If in any judicial or administrative action brought by the Commission under the securities laws . . . the Commission obtains an order [or settlement] requiring disgorgement against any person and the Commission also obtains . . . a civil penalty against the same person, the amount of the penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.²¹

Similarly, Dodd Frank allows the SEC to “enter an order requiring accounting and disgorgement” in any proceeding in which the SEC can impose a civil penalty,²² but disgorgement is not defined anywhere in that statute.²³ Accordingly, courts have assumed that disgorgement is contiguous with the equitable remedies imposed by federal judges before Dodd Frank was passed.²⁴

The courts do not rely exclusively on Dodd Frank or the other securities acts for authority to grant disgorgement. Even before Dodd Frank was enacted, the SEC routinely obtained disgorgement of gains derived from illegal insider trading in federal courts.²⁵ The SEC persuaded courts to grant

20. Pub. L. 107–204, §305(b), adding Section 21(d)(5) of the Securities Exchange Act of 1934, codified at 15 U.S.C. §78u(d)(5).

21. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §308(a), 116 Stat. 745, 784-85 (codified at 15 U.S.C. §7246(a)).

22. 15 U.S.C. § 78u-2(e).

23. The SEC does not have statutory authority to seek disgorgement in federal court. Instead, it has asserted and courts have held that it has this authority as an equitable extension of its broader authority to enforce the securities laws. *See, e.g.*, SEC v. First City Fin. Corp., 890 F.2d 1215, 1231 (D.C. Cir. 1989) (describing disgorgement as an equitable power and noting it may not be used punitively).

24. *Id.*

25. *See, e.g.*, SEC v. Clark, 915 F.2d 439, 442 n.4 (9th Cir. 1990) (“It is well settled that §21(d) permits the SEC to obtain more than injunctive relief.”); *id.* at 453 (“The SEC’s power to obtain injunctive relief has been broadly read to include disgorgement of profits realized from violations of the securities laws.”); SEC v. First City Fin. Corp., 890 F.2d 1215, 1230 (D.C. Cir. 1989) (“Disgorgement, then, is available simply because the relevant provisions of the Securities Exchange Act of 1934, sections 21(d) and (e), 15 U.S.C. §§ 78u(d) and (e), vest jurisdiction in the federal courts.”); SEC v. Tome, 833 F.2d 1086, 1096 (2d Cir. 1987), *cert. denied*, 486 U.S. 1014 (1988); SEC v. Blatt, 583 F.2d 1325 (5th Cir. 1978). For a lengthy discussion of disgorgement and the SEC’s authority to seek it, see SEC v. Aragon Capital Mgmt., LLC, 672 F. Supp. 2d 421, 437–46 (S.D.N.Y. 2009) (insider trading case).

disgorgement pursuant to the court's equity jurisdiction in a great number of cases.²⁶ In fact, as early as 1971, the Second Circuit held in the landmark case *SEC v. Texas Gulf Sulphur Co.* that “[i]t would severely defeat the purposes of the [1934 Act] if a violator of Rule 10b-5 were allowed to retain the profits from his violation.”²⁷

According to the Second Circuit in *SEC v. Cavanagh*, federal courts have the power to award disgorgement pursuant to their equity jurisdiction independent of statutory grant of authority.²⁸ The Second Circuit showed that the test—originally set out by the Supreme Court in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*—for equitable jurisdiction is whether the remedy sought was available at chancery in 1789.²⁹ Given that the term “disgorgement” was unlikely used in 1789, the Second Circuit analyzed the question functionally. The Court investigated whether defendants in 1789 were allowed to keep ill-gotten gains from their misdeeds.³⁰ It found that eighteenth-century English chancellors ordered remedies that were functionally identical to the SEC's disgorgement remedy.³¹ Thus, disgorgement was available at chancery, and thereby within the equitable jurisdiction of the court.³²

C. Application of the Disgorgement Remedy

The SEC's disgorgement powers are far-reaching and incredibly effective. The Commission routinely employs disgorgement against insider traders. Not only has the SEC forced disgorgement from tippees, but it has also obtained disgorgement from tippers.³³ In some cases, the SEC has required

26. See, e.g., *SEC v. Lipson*, 278 F.3d 656, 662-63 (7th Cir. 2002); *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1103 (2d Cir. 1972); *SEC v. Chester Holdings, Ltd.*, 41 F. Supp. 2d 505, 528 (D.N.J. 1999); *SEC v. R. J. Allen & Assocs.*, 386 F. Supp. 866, 880 (S.D. Fla. 1974).

27. *SEC v. Tex. Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir. 1971).

28. *SEC v. Cavanagh*, 445 F.3d 105, 118 (2d Cir. 2006).

29. *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308, 318-19 (1999).

30. *Id.* (“[O]ur inquiry concerns not the name used by equity courts and commentators for historical remedies but rather their specific actions and the resulting practical consequences.”).

31. *Id.* at 118-20.

32. In finding disgorgement available at common law, the Court in *Cavanagh* relied on two cases from England and two from colonial America. *Id.* at 118-20.

33. See, e.g., *SEC v. Warde*, 151 F.3d 42, 48-50 (2d Cir. 1998); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990); *SEC v. Tex. Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971); *SEC v. Michel*, 521 F. Supp. 2d 795, 831 (N.D. Ill. 2007) (ordering stockbroker insider trading defendant to disgorge his own profits, the profits of his tippees, and the commissions earned on his client/tippees' trades).

tipper to disgorge profits earned by tippees—even if the tippees complied with federal securities law.³⁴ In *SEC v. Antar*, the court ordered innocent investors, who did not cooperate in the fraud, to disgorge their profits.³⁵ In that case, a defendant sold stock in an initial public offering (IPO) while in possession of material nonpublic adverse information.³⁶ Accordingly, he was convicted of insider trading. The SEC did not allege that the other innocent investors who participated in the offering were even aware of the fraud.³⁷ Despite their nonparticipation and lack of knowledge, the court found that the innocent investors were unjustly enriched.³⁸ Thus, the court ordered disgorgement of their profits.³⁹

Similar to the decision in *SEC v. Antar*, the federal district court for the Southern District of Florida in *SEC v. Chemical Trust*⁴⁰ found that innocent parties could be required to disgorge ill-gotten gains. The court in that case held that “[i]t is not necessary for the person holding the property to have done anything wrong in order for that person to be required to return the property to its rightful owner.”⁴¹ The court proceeded to order the defendant to disgorge the gross profits it received from the illegal scheme, even though the defendant was not the party that had defrauded the investors.⁴²

Not only can the SEC require innocent parties to disgorge profits, the SEC can also require more profits to be disgorged than the insider trader actually received. In *SEC v. Shapiro*, the Second Circuit found that the proper measure of disgorgement was not actual profits, but rather the “paper profits” resulting after dissemination and absorption of the information, even where such profits exceed actual profits.⁴³ The court reasoned accordingly:

A violator of the securities laws should disgorge profits earned by trading on non-public information. Once public disclosure is

34. *SEC v. Clark*, 915 F.2d 439, 454 (9th Cir. 1990) (reasoning that requiring a tipper to disgorge his tippee’s profits “is a necessary deterrent to evasion of Rule 10b-5 liability by either . . . enriching a friend or relative . . . or . . . tipping others with the expectation of reciprocity”).

35. *SEC v. Antar*, 15 F. Supp. 2d 477, 532–33 (D.N.J. 1998).

36. *Id.* at 533.

37. *Id.*

38. *Id.*

39. *Id.*

40. *SEC v. Chem. Trust*, No. 00-8015-CIV, 2000 WL 33231600 (S.D. Fla. Dec. 19, 2000).

41. *Id.* at *11.

42. *Id.* at *12-13.

43. *SEC v. Shapiro*, 494 F.2d 1301, 1309 (2d Cir. 1974).

made and all investors are trading on an equal footing, the violator should take the risks of the market himself. Moreover, a contrary holding would create a serious anomaly that might encourage insider trading. To require disgorgement only of actual profits in cases where the price of the stock subsequently fell would create a heads-I-win-tails-you-lose opportunity for the violator: he could keep subsequent profits but not suffer subsequent losses.⁴⁴

Given that the SEC can order a defendant to disgorge mere “paper profits,” it was only a short extension for federal courts to hold that the SEC need not prove with exactness the amount required to be disgorged. The D.C. Circuit held in *SEC v. First City Financial Corp.* that “disgorgement need only be a reasonable approximation of profits causally connected to the violation.”⁴⁵ In discussing *First City Financial Corp.*, the Second Circuit reasoned in *SEC v. Patel* that when the disgorgement measure cannot be exact, “any ‘risk of uncertainty . . . should fall on the wrongdoer whose illegal conduct created that uncertainty.’”⁴⁶

One court has gone so far as to hold that a brokerage firm must disgorge profits from illegal insider trading by its customers.⁴⁷ In *SEC v. Stephenson*, the customers asked their broker to reverse some illegal transactions.⁴⁸ Instead of informing the customers that such a reversal was impossible, the firm pocketed the funds.⁴⁹ The court held that the brokerage company must disgorge the profits because they were unjustly gained as a result of the fraud.⁵⁰ In another case, The Seventh Circuit suggested in dicta that a court might be able to order disgorgement of insider trading profits received as a nominee of the primary defendant, provided that the nominee had no ownership interest in the proceeds.⁵¹

As shown above, the court’s power to order disgorgement is founded on firm statutory and precedential authority. The SEC has forced an eclectic mix of defendants to disgorge profits in a variety of cases. Given this broad

44. *Id.* See *CFTC v. Am. Metals Exch. Corp.*, 991 F.2d 71 (3d Cir. 1993) (proper measure of disgorgement is amount of ill-gotten gains received by defendant, not amount of investor losses).

45. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989).

46. *SEC v. Patel*, 61 F.3d 137, 140 (2d Cir. 1995) (quoting *First City Fin. Corp.*, 890 F.2d at 1232).

47. *SEC v. Stephenson*, 720 F. Supp. 370, 327-78 (S.D.N.Y. 1989).

48. *Id.* at 371.

49. *Id.* at 371-73.

50. *Id.* at 373.

51. *SEC v. Cherif*, 933 F.2d 403, 414-15 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992).

equitable power, it is not unjust for federal courts to require the SEC to prove only but-for cause when seeking disgorgement of ill-gotten gains rather than requiring the SEC to prove both but-for cause and proximate cause.⁵² The federal courts have the power to require innocent individuals to disgorge ill-gotten profits; it is not a heavier burden to require culpable defendants to disgorge profits without the showing of proximate cause.

III. BURDEN-SHIFTING FRAMEWORK

The SEC employs a variety of remedies to punish insider traders and other violators of federal securities law. One of its most powerful remedies is the equitable remedy of disgorgement of profits. The SEC uses this remedy to prevent the unjust enrichment of defendants. Unfortunately, ill-gotten gains are extremely difficult to measure. For example, suppose that a stockholder purchases stock on insider information and then holds on to it for ten years. At the end of the decade, he sells the stock and uses the money to purchase a different stock in a completely legal manner. How much profit should he be required to disgorge? Should he be forced to disgorge the appreciation directly following the first purchase, or should he be required to return the full appreciation realized in the ten years he held the stock? What about the subsequent purchase? Should any profit from the second stock be disgorged simply because he bought it with money gained from insider trading? But for the insider trading, he would not have had the money to purchase the second stock; however, is his profit from the second stock proximately caused by his illegal insider trading activity?

The courts recognize that illegal gains are difficult to measure and even more difficult to trace to their source. Rather than allow this difficulty to favor defendants, the D.C. Circuit in *SEC v. First Financial Corp.*⁵³ shifted the burden of proving damages with certainty to the defendant. By universally adopting the D.C. Circuit's burden-shifting framework, the U.S. Circuit Courts of Appeals have already greatly lowered the prosecutor's burden of proof.

52. But-for cause is a hypothetical construct that asks whether or not a given event would have occurred in the same manner even if a particular factor were removed. See *Price Waterhouse v. Hopkins*, 490 U.S. 228, 240 (1989) (discussing the meaning of but-for cause). A particular factor is considered an actual cause of an event if that event would not have occurred absent the factor. See RESTATEMENT (THIRD) OF TORTS § 26 cmt. b (2005) (discussing but-for cause in tort law). The but-for test seeks to determine if a particular factor was a necessary condition for an outcome, but not necessarily that it was the exclusive cause. See *id.* § 26 cmts. b, c.

53. *SEC v. First City Fin. Corp.*, 890 F.2d 1215 (D.C. Cir. 1989).

A. SEC v. First City Financial Corp., 890 F.2d 1215 (D.C. Cir. 1989)

In *SEC v. First City Financial Corp.*, the D.C. Circuit first enacted a burden-shifting framework to prove causation in insider trading cases. In that case, the SEC charged Marc Belzberg and his company, First City Financial Corporation, Ltd. (“First City”), with the deliberate evasion of Section 13(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(d),⁵⁴ and its accompanying regulations. Section 13(d)⁵⁵ requires any person who has directly or indirectly obtained the beneficial ownership of more than five percent of any registered equity security to disclose the ownership (and other information) of such stock to the SEC within ten days.⁵⁶ In this case, the SEC alleged that the defendant deliberately filed his required disclosures after the mandated ten-day period in order to facilitate his attempted hostile takeover of Ashland Oil Company (“Ashland”).

The defendant corporation, First City, was a Canadian company, founded and controlled by the Belzberg family, that specialized in investing in publically traded American corporations.⁵⁷ Marc Belzberg managed the firm’s New York City subsidiary, which was tasked with evaluating investment opportunities for the parent company.⁵⁸ The sordid affair that sparked the litigation in *First City Financial Corp.* started with a letter on February 3, 1986 from a New York stockbroker to Belzberg’s father.⁵⁹ The letter described Ashland as a “sensational business opportunity” that First City should consider.⁶⁰

Belzberg conducted a preliminary analysis of Ashland with his team, which proved to be favorable.⁶¹ Consequently, First City purchased 61,000

54. *Id.* at 1217.

55. *Id.*

56. Section 13(d) of the Act provides in pertinent part:

Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security . . . is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition or within such shorter time as the Commission may establish by rule, file with the Commission, a statement containing . . . the following information, and such additional information, as the Commission may . . . prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78m(d)(1).

57. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1218 (D.C. Cir. 1989).

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

shares of Ashland on February 11, 1986.⁶² Throughout the next month, First City accumulated large blocks of Ashland shares. By February 26th, First City owned more than 1.3 million shares of Ashland.⁶³ This stock buildup left First City holding 4.8 percent of Ashland's total outstanding stock, not coincidentally riding just below the percentage that triggers mandatory reporting requirements.⁶⁴

On March 4th, Marc Belzberg called Alan Greenberg, who worked at a brokerage company known as Bear Stearns, about buying more Ashland stock.⁶⁵ The meaning of that call became the flashpoint of the litigation with the SEC.⁶⁶ Greenberg explained in his deposition that he thought the call was a command by Belzberg to buy Ashland stock on behalf of First City.⁶⁷ Contrarily, Belzberg later claimed that he only intended the statement to simply be a recommendation that Greenberg buy the stock himself on behalf of Bear Stearns.⁶⁸ Regardless, Greenberg immediately purchased 20,500 shares of Ashland stock.⁶⁹ If Greenberg purchased the shares on behalf of First City, (as he contended) it pushed First City over five percent ownership of Ashland, thus triggering mandatory disclosure of First City's ownership stake; however, if the shares were not purchased for First City, then First City had no duty to disclose its stock holdings to the SEC or the public.⁷⁰

Shortly thereafter, First City purchased the shares Greenberg had accumulated. Once accomplished, Belzberg's father informed Ashland of First City's stake in the company and proposed a friendly takeover.⁷¹ Ashland rejected the offer and issued a press release stating that First City

62. SEC v. First City Fin. Corp., 890 F.2d 1215, 1218 (D.C. Cir. 1989).

63. *Id.*

64. See 15 U.S.C. § 78m(d)(1).

65. SEC v. First City Fin. Corp., 890 F.2d 1215, 1218 (D.C. Cir. 1989).

66. *Id.*

67. *Id.* at 1218-19. Greenberg testified that:

[Marc Belzberg] called me and said something to the effect that – something like, “It wouldn’t be a bad idea if you bought Ashland Oil here,” or something like that. And I took that to mean that we were going to do another put and call arrangement that we had done in the past. . . . I was absolutely under the impression I was buying at their risk and I was going to do a put and call.

Id.

68. *Id.* at 1219.

69. *Id.*

70. *Id.*

71. *Id.* at 1220.

owned between eight and nine percent of its stock.⁷² On March 26th, First City finally filed the Schedule 13D disclosure.⁷³ On March 31st, Ashland agreed to buy back First City's shares for \$51 per share, resulting in a \$15.4 million profit for First City.⁷⁴

When the SEC found out about the sale, it initiated an informal investigation into the timeliness of the 13D disclosure.⁷⁵ After deposing Belzberg and Greenberg, the SEC filed suit against Belzberg and First City, alleging that they crossed the five percent threshold on March 4th, but did not file the required disclosure statement until March 26th, twelve days after the section 13(d) deadline.⁷⁶

The district court found that First City and Marc Belzberg entered into an informal put and call agreement on March 4th, and then deliberately violated the ten-day filing requirement of Section 13(d).⁷⁷ The district court permanently enjoined the defendants from future violations of Section 13(d) and ordered First City and Belzberg to disgorge the approximately \$2.7 million representing their profits on the 890,000 shares of Ashland stock acquired between March 14th and 25th.⁷⁸ The district court reasoned that the defendants were able to purchase the shares at artificially low prices because of the defendants' failure to make the Section 13(d) disclosure on March 14th.⁷⁹ The defendants appealed the injunction and disgorgement remedies as an abuse of discretion.⁸⁰

On appeal, the D.C. Circuit found that federal courts have the power to order disgorgement for insider trading violations.⁸¹ The D.C. Circuit reasoned that the court's authority to order disgorgement did not arise from the statute, which does not explicitly authorize a monetary remedy, but rather from the courts' inherent equity power.⁸² In fact, the D.C. Circuit noted that disgorgement is routinely ordered in insider trading cases, despite a lack of express authorization under securities law.⁸³

72. *Id.*

73. SEC v. First City Fin. Corp., 890 F.2d 1215, 1220 (D.C. Cir. 1989).

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. SEC v. First City Fin. Corp., 890 F.2d 1215, 1220-21 (D.C. Cir. 1989).

79. *Id.* at 1221.

80. *Id.*

81. *Id.* at 1230.

82. *Id.*

83. *Id.*

Turning to the question of measuring the profits to be disgorged, the D.C. Circuit found that the \$2.7 million figure delineated by the district court below was proper.⁸⁴ The district court had arrived at this number by simply calculating all of the profits First City realized on the sale of the 890,000 shares it purchased between March 14th (the date it was required to make a 13(d) disclosure) until March 28th (the date it actually did so).⁸⁵ In calculating this disgorgement number, the district court relied on the assumption that if First City had made the disclosure when it was required, then the stock purchased after that date would have been much more expensive.⁸⁶

In finding the district court's calculation to be proper, the D.C. Circuit held that "the court may exercise its equitable power only over property causally related to the wrongdoing."⁸⁷ Disgorgement may not be used punitively.⁸⁸ Thus, in order to obtain disgorgement of profits, the SEC must distinguish between legally and illegally obtained profits.⁸⁹

At trial, the defendants vigorously disputed the \$2.7 million figure, arguing that it was simplistic and did not take account of all the variables.⁹⁰ However, the D.C. Circuit reasoned that it would be impossible to precisely measure the amount of ill-gotten gain.⁹¹ Thus, the D.C. Circuit held that "disgorgement need only be a reasonable approximation of profits causally connected to the violation."⁹² The D.C. Circuit established a burden-shifting framework to prove causation wherein the SEC has the burden to prove (1) the defendants acted improperly, and (2) a reasonable approximation of the actual ill-gotten profits. Once the SEC establishes these two items, the burden shifts to the defendants to rebut the SEC's showing of actual profits.⁹³

At first blush, the rule from *First City Financial Corp.* seems like a very harsh rule. However, before one can judge the equity of the rule, one must

84. SEC v. First City Fin. Corp., 890 F.2d 1215, 1233 (D.C. Cir. 1989).

85. *Id.* at 1230.

86. *Id.* at 1230-31. The court reasoned that had First City properly disclosed the "market would have been affected by the disclosure that the Belzbergs had taken a greater than 5 percent stake in Ashland and would soon propose a tender offer." *Id.* at 1231.

87. *Id.*

88. *Id.*

89. SEC v. First City Fin. Corp., 890 F.2d 1215, 1231 (D.C. Cir. 1989).

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.* at 1232.

consider the prosecutorial backdrop to the rule. Insider trading⁹⁴ is a pervasive problem in our financial system. According to its website, the SEC prosecutes between 500 and 800 insider-trading cases per year.⁹⁵ Yet, this number represents merely a drop in the bucket of known insider-trading cases. Undetected insider trading is likely far more pervasive than the numbers show.

According to a study conducted by two professors at the Stern School of Business at New York University and one professor from McGill University, nearly a quarter of all public company deals likely involve some kind of insider trading.⁹⁶ The professors examined hundreds of transactions from 1996 through the end of 2012 in their study, conducting perhaps the most detailed and exhaustive study of its kind.⁹⁷ Despite the alarmingly large percentage of deals involving insider trading, the professors concluded that the Securities and Exchange Commission litigated only “about 4.7% of

94. Insider trading is the trading of securities by one who has material nonpublic information. See *Insider Trading*, Third Edition § 2.03 (Matthew Bender, Rev. Ed.). However, insider trading is not necessarily illegal. It may be perfectly legitimate, such as when corporate insiders, officers, directors, and employees buy and sell stock in their own company. See United States Securities and Exchange Commission, *Fast Answers*, Insider Trading <https://www.sec.gov/answers/insider.htm>. (Jan 15, 2013). However, the insider trading referred in this Note, (and most commonly referred to by the public) to is the illegal buying or selling of a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. See United States Securities and Exchange Commission, *Fast Answers*, Insider Trading <https://www.sec.gov/answers/insider.htm>. (Jan 15, 2013). Insider trading violations may also include “tipping” such information, securities trading by the person “tipped,” and securities trading by those who misappropriate such information. United States Securities and Exchange Commission, *Fast Answers*, Insider Trading <https://www.sec.gov/answers/insider.htm>. (Jan 15, 2013).

95. Year-by-Year SEC Enforcement Statistics, <https://www.sec.gov/news/newsroom/images/enfstats.pdf> (last accessed Nov. 15, 2017).

96. Patrick Augustin, Menachem Brenner, & Marti G. Subrahmanyam, *Informed Options Trading prior to M&A Announcements: Insider Trading?*, at 11, http://irrcinstitute.org/wp-content/uploads/2015/09/Informed-Options-Trading_June-12-20141.pdf (May, 2014).

97. See, e.g., SEC v. CMKM Diamonds, Inc., 729 F.3d 1248, 1260-62 (9th Cir. 2013) (\$409,638.11); SEC v. Pentagon Capital Mgmt. PLC, 725 F.3d 279, 280 (2d Cir. 2013) (\$38,416,500); SEC v. Boock, No. 09 Civ. 8261 (DLC), 2013 WL 4828571, at *2 (S.D.N.Y. Sept. 9, 2013) (\$1,050,000); SEC v. Simone, No. 07-cv-3928 (JG), 2013 WL 4495664, at *1 (E.D.N.Y. Aug. 19, 2013) (\$543,497); SEC v. Reynolds, No. 3:08--CV--0438--B, 2013 WL 3778830, at *7 (N.D. Tex. July 19, 2013) (\$10,531,225); SEC v. Graulich, No. 2:09-cv-04355 (WJM), 2013 WL 3146862, at *7 (D.N.J. June 19, 2013) (\$5,592,102); SEC v. Bass, No. 1:10-CV-00606 (LEK/DRH), 2012 WL 5334743, at *2-3 (N.D.N.Y. Oct. 26, 2012) (\$4,557,632).

the 1,859 M&A deals included in [the study's] sample."⁹⁸ It is against this overwhelming tide that the courts must struggle in their quest to protect the rights of the public and individual investors.⁹⁹

These statistics demonstrate the significant detrimental role that insider trading plays in the United States, and the importance of enforcement actions. Given this data, the burden-shifting decision of *First City Financial Corp.* was unsurprising and pressingly needed. However, the judges on the D.C. Circuit did not simply rely on their personal experience adjudicating fraud cases, nor did they simply research SEC statistics. Rather, the D.C. Circuit anchored its decision on the reasoning from *SEC v. MacDonald*, decided only six years prior.

B. *SEC v. MacDonald*, 699 F.2d 47 (1st Cir. 1983)

In *SEC v. MacDonald*,¹⁰⁰ the First Circuit affirmed the district court in finding that the defendant violated the antifraud provisions of the Securities Exchange Act and Rule 10b-5 by making purchases of trust stock without

98. Patrick Augustin, Menachem Brenner, & Marti G. Subrahmanyam, *Informed Options Trading prior to M&A Announcements: Insider Trading?*, http://irrcinstitute.org/wp-content/uploads/2015/09/Informed-Options-Trading_June-12-20141.pdf (May, 2014).

99. The primary rules used by the SEC to prosecute insider trading are 15 U.S.C. §78j(b) and SEC Rule 10b-5. Insider Trading, Third Edition § 1.01 (Matthew Bender, Rev. Ed.) (footnote 1.); 15 U.S.C. §78j (also known as Section 10(b) of the Securities Exchange Act of 1934) provides that [i]t shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. [Additionally,] SEC Rule 10b-5 . . . provides: It shall be unlawful for any person . . . (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

[To prove insider trading under these two rules, the SEC must establish six elements:] (1) Use of the requisite *jurisdictional means* in connection with the violative conduct. (2) Showing a material *misrepresentation or omission* or other deceptive or manipulative practice. (3) That such false or misleading statement was '*material*.' (4) Showing that the defendant acted with intent, to wit, '*scienter*.' (5) Showing that the defendant's deceptive conduct was '*in connection with*' the purchase or sale of the subject security.

See 1-4 Insider Trading: Liability and Compliance § 4.01.

100. *SEC v. MacDonald*, 699 F.2d 47 (1st Cir. 1983).

disclosing inside information.¹⁰¹ The First Circuit also affirmed the lower court's holding that required the defendant to disgorge profits he realized upon reselling the stock.¹⁰² However, the First Circuit reversed the amount of disgorgement required by the district court.¹⁰³ Instead of requiring full disgorgement of all profits realized upon the resale of the stock, the First Circuit required the defendant to disgorge only the profits "representing the increased value of the shares at a reasonable time after public dissemination of the information."¹⁰⁴ In other words, the First Circuit only required the defendant to disgorge profits proximately connected to his illegal insider trading.

The *MacDonald* case arose when the SEC brought a lawsuit against James E. MacDonald, Jr. for violating insider trading laws, specifically the Securities Exchange Act of 1934, Section 10(b), 15 U.S.C. § 78j(b), and SEC Rule 10b-5 promulgated thereunder in 17 C.F.R. § 240.10b-5.¹⁰⁵ The SEC alleged that MacDonald violated these laws "by making the purchases without disclosing certain material inside information learned in his capacity as chairman of RIT's board of trustees."¹⁰⁶ The district court ordered MacDonald "to disgorge profits of \$53,012 realized on the purchase and subsequent sale of 9,600 shares of Realty Income Trust (RIT) stock."¹⁰⁷

RIT was a publically traded real estate investment trust that owned land in Cincinnati, Ohio.¹⁰⁸ RIT owned the land under the Kroger Building, while the actual building was owned and managed by City Center Development Company (City Center).¹⁰⁹ Both the land and the building were subject to a first mortgage for the benefit of Prudential Insurance Company (Prudential).¹¹⁰ The lease specified that City Center would be obligated to pay ground rent to RIT and mortgage payments to Prudential.¹¹¹ This arrangement proceeded smoothly until 1975, when City Center defaulted on both payments.¹¹² To avoid foreclosure, RIT advanced

101. *Id.* at 48.

102. *Id.*

103. *Id.*

104. *Id.* at 52.

105. *MacDonald*, 699 F.2d at 48.

106. *Id.*

107. *Id.*

108. *Id.*

109. *Id.*

110. *MacDonald*, 699 F.2d at 48.

111. *Id.*

112. *Id.*

the mortgage payment to Prudential and then filed suit against City Center petitioning for reimbursement and appointment of a receiver.¹¹³ The suit was publically announced on December 4th and subsequently settled on December 12th.¹¹⁴ Though a local newspaper reported the settlement, it was not otherwise made known to the public.¹¹⁵ On the same day, RIT released its quarterly financial report, which contained substantially negative news.¹¹⁶

Almost immediately after the settlement, RIT began negotiations to rent the building to Kenner Products.¹¹⁷ On December 15th, a report on the proposed terms of the lease was provided to the trustees of RIT, including the defendant.¹¹⁸ On the very next day, the defendant instructed his wife to buy shares of RIT.¹¹⁹ She bought 100 shares on December 16th, and the defendant followed suit, buying 9,500 shares on December 23rd.¹²⁰

On December 24th, RIT issued a press release, stating “the Trust expects to sign a lease almost immediately . . . with a major new tenant. The lease will bring occupancy in the building up to 95%, which would indicate a market value of the building of approximately \$8,500,000 which is approximately \$2,000,000 more than the existing first mortgage and RIT’s investment in the property.”¹²¹ Following the press release, the price of RIT stock shot up from \$4 $\frac{5}{8}$ per share to \$5 $\frac{1}{2}$ per share in two days of trading—a rise of nineteen percent—and closed the year at \$5 $\frac{3}{4}$ per share.¹²² The defendant retained his stock until 1977 when he sold it at an average price of over \$10 per share.¹²³

After considering the facts of the case, the First Circuit acknowledged the general rule, established in *Janigan v. Taylor*,¹²⁴ that a defendant should generally be required to disgorge the entire profits realized from the sale of

113. *Id.*

114. *Id.*

115. *Id.*

116. *MacDonald*, 699 F.2d at 48.

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *MacDonald*, 699 F.2d at 48-49.

122. *Id.* at 49.

123. *Id.* at 49.

124. *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir. 1965), *cert. denied*, 382 U.S. 879 (1965), approved by the Court in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972).

ill-gotten securities—even if such securities were sold more than a year after illegitimate purchase—rather than be required to disgorge only an amount representing the increased value of the shares at a reasonable time after public dissemination of the information.¹²⁵ The First Circuit found that once it is determined that the defendant actually and fraudulently made a profit, then the profit is “the proximate cause of the fraud, whether foreseeable or not.”¹²⁶

The First Circuit quoted *Janigan*, stating that, “[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.”¹²⁷ Thus, the First Circuit acknowledged that under the general rule, MacDonald should be required to repay the full amount of the ill-gotten gain. The First Circuit conceded that there were no special circumstances in the case at bar that would affect the general rule.¹²⁸ However, in *MacDonald*, the First Circuit noted that there are limits to the general rule.

One such limit addressed by the First Circuit is that “where the fraudulently obtained securities are publicly traded, and hence readily available, the defrauded sellers can recover only those accretions occurring up to a reasonable time after they discovered the truth.”¹²⁹ The reason for such rule is that “when a seller of publicly traded securities has learned of previously undisclosed material facts, and decides nevertheless not to replace the sold securities, he cannot later claim that his failure to obtain subsequent stock appreciation was a proximate consequence of his prior ignorance.”¹³⁰

Accordingly, the First Circuit held that “[w]hen a fraudulent buyer has reached the point of his full gain from the fraud, viz., the market price a reasonable time after the undisclosed information has become public, any consequence of a subsequent decision, be it to sell or to retain the stock, is . . .

125. *MacDonald*, 699 F.2d at 52.

126. *Janigan*, 344 F.2d at 786.

127. *MacDonald*, 699 F.2d at 53 (quoting *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir. 1965)).

128. *Id.* at 52.

129. *MacDonald*, 699 F.2d at 53.

130. *Id.*

Consistent with this position, the ALI proposed Federal Securities Code (1978 Official Draft and 1981 Supp.), which is said to codify *Janigan*, initially limits an insider’s liability for profits in a case like the present one to his ill-got gains, defined as the excess over the insider’s purchase price of the “value of the security as of the end of the reasonable period . . . after . . . the time when all material facts . . . became generally available . . .”

Id. at 54 (Internal Citations Omitted).

not causally related to the fraud.”¹³¹ The First Circuit found that any disgorgement beyond the amount by which the defendant profited from his wrongdoing would constitute a penalty.¹³² Thus, there should be a cut-off date after which the defendant’s profits are no longer proximately tied to the wrongdoing. In accordance with this holding, the First Circuit remanded the case to determine what length of time was reasonable to cut off liability to the defendant.¹³³

By limiting disgorgement to profits earned a reasonable time after the fraud occurred, the First Circuit in *SEC v. MacDonald* essentially imposed a proximate cause restraint on an award of disgorgement. If the SEC wanted to require disgorgement, it must prove that the profits were proximately tied to the wrong committed. As the First Circuit noted, “the defendant could be compelled only to disgorge profits and interest wrongfully obtained.”¹³⁴

Despite the contrary holding, the D.C. Circuit in *First City Financial Corp.* built on the reasoning of *SEC v. MacDonald* when it cited *MacDonald* for the proposition that “the line between restitution and penalty is unfortunately blurred, and the risk of uncertainty should fall on the wrongdoer whose illegal conduct created that uncertainty.”¹³⁵ The Third Circuit would later appeal to both cases to justify its holding in *SEC v. Teo* that shifted the burden of proximate cause to the defendant. In *Teo*, the Third Circuit wrote the following:

In *First City* . . . [t]he court added that “the risk of uncertainty should fall on the wrongdoer whose illegal conduct created the uncertainty.” In this context, *First City* cites to a case from the Court of Appeals for the First Circuit to elaborate that the defendant could make its case by “pointing to intervening events from the time of the violation”

We draw two immediate points from *First City* and *MacDonald*. First, intervening causation is not an element of the SEC’s evidentiary burden in setting out an amount to be disgorged that reasonably approximates illegal profits. Second, if the issue of an

131. *MacDonald*, 699 F.2d at 54.

132. *Id.* at 54 (quoting *SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978)).

133. *Id.* at 55.

134. *Id.* at 54 (quoting *SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978)).

135. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1232 (D.C. Cir. 1989) (citing *SEC v. MacDonald*, 699 F.2d 47, 55 (1st Cir. 1983) (en banc)).

intervening cause is to be raised, it will normally be the defendant's burden to do so.¹³⁶

Even though the courts in *First City Financial Corp.* and *MacDonald* created rules that were more conservative than the rule from *Teo*, those courts still employed the same reasoning to fashion their respective remedies. All three courts found that the risk of uncertainty should fall on the defendant, and all three found that proving intervening causes is the burden of the defendant. Thus, the Third Circuit in *Teo* determined it was fully justified in requiring the SEC to prove only but-for cause.

IV. SEC v. TEO AND PROVING PROXIMATE CAUSE

“Understanding proximate cause is . . . like understanding your mother: it can take years and then, just when you think you have her figured out, she surprises you.”¹³⁷ In *SEC v. Teo*,¹³⁸ the Third Circuit extended the burden-shifting framework of *First City Financial Corp.* further than any of its sister courts by eliminating the SEC's burden to prove proximate cause. In that case, the Third Circuit affirmed the district court's holding that the defendants were liable for violating the Securities and Exchange Act of 1934, Sections 13(d) and 10(b).¹³⁹ The Third Circuit also affirmed the district court's order to disgorge \$17 million of ill-gotten profit, plus about \$14 million in prejudgment interest.¹⁴⁰

In *SEC v. Teo*, the defendant, Alfred Teo, failed to comply with the reporting requirements of Section 13(d) in order to secretly exceed the Shareholder's Rights Plan (commonly known as a poison pill) threshold of a Delaware corporation called Musicland.¹⁴¹ Musicland's poison pill allowed current shareholders to purchase stock at a significantly discounted price as soon as any group or individual reached 17.5 percent ownership in the company.¹⁴² This poison pill device was put in place to protect against hostile takeovers from people such as Alfred Teo.¹⁴³

136. *SEC v. Teo*, 746 F.3d 90, 105–06 (3d Cir. 2014) (internal citations omitted).

137. Peter F. Lake, <http://www.goodreads.com/quotes/tag/proximate-cause> (last accessed Nov. 15, 2017).

138. *SEC v. Teo*, 746 F.3d 90 (3d Cir. 2014).

139. *Id.* at 93.

140. *Id.*

141. *Id.* at 93–94.

142. *Teo*, 746 F.3d at 93.

143. *Id.*

Until July 1998, Teo properly disclosed his Musicland ownership interest in accordance with Section 13(d).¹⁴⁴ However, on July 30, 1998, Teo filed “Amendment 7” to his Schedule 13D that alleged: “Teo ceased to have investment powers with respect to the [MAAA] Trust.”¹⁴⁵ Thereafter, Teo reported his ownership in Musicland as less than 17.5 percent, but continued to buy shares of Musicland through MAAA Trust.¹⁴⁶ Throughout this period, Teo filed numerous false disclosures and failed to file many others.¹⁴⁷ The district court found that Teo and MAAA Trust collectively owned 17.79 percent of Musicland shares on August 2, 1998, and 35.97 percent on December 6, 2000.¹⁴⁸ Because Teo under-reported his Musicland holdings, he was able to keep Musicland in the dark about his ownership so that it could not activate its poison pill.¹⁴⁹

Nearly two years after Teo began his secret plan to build up ownership in Musicland, Best Buy announced an “all-cash tender offer of all Musicland shares.”¹⁵⁰ The deal was announced in December 2000, and was finalized in January 2001.¹⁵¹ During this time, Teo sold some of his shares on the open market and the rest to Best Buy as part of the tender offer.¹⁵² Teo’s profit from the sale of his personal Musicland stock as well as that of MAAA Trust amounted to \$21,087,345.¹⁵³

In 2004, the SEC filed suit against Teo asserting violations of Sections 13(d) and 10(b).¹⁵⁴ The district court granted summary judgment on several rule violations that Teo did not challenge or appeal.¹⁵⁵ At trial, the jury found that Teo violated both Section 10(b) and 13(d).¹⁵⁶ After trial, Teo and the trust moved for a new trial and judgment as a matter of law.¹⁵⁷ Both motions were denied.¹⁵⁸ The district court enjoined Teo and MAAA Trust

144. *Id.*

145. *Id.*

146. *Id.* at 93-94.

147. *Teo*, 746 F.3d at 94.

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.* at 94.

152. *Teo*, 746 F.3d at 94.

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.*

157. *Teo*, 746 F.3d at 95.

158. *Id.*

from future violations of securities law and held that Teo and the Trust were jointly and severally liable for paying the civil penalty and for disgorgement of the ill-gotten profits.¹⁵⁹

On appeal, the Third Circuit affirmed each of the district court's other findings before turning to the disgorgement issue.¹⁶⁰ The defendant did not appeal the calculation of the disgorgement, but rather that the SEC was granted disgorgement at all.¹⁶¹ He argued that the profits were a result of Best Buy's tender offer and were in no way connected to the violations of Section 13(d) and 10(b).¹⁶² Rather, he contended that the tender offer was the proximate cause of the profits.¹⁶³ Thus, the district court was in error when it ignored the tender offer.¹⁶⁴

The defendant further argued that "the District Court should have required the SEC to demonstrate that disgorged profits 'proceed directly and proximately from the violation claimed and [are] not . . . attributable to some supervening cause.'"¹⁶⁵ In making this argument, the defendant relied on *Wellman v. Dickinson*,¹⁶⁶ wherein the Second Circuit held that "[s]ince class plaintiffs have not demonstrated that their alleged injury was *directly caused* by the Section 13(d) violation, the district court properly denied their claims for damages against Dickinson."¹⁶⁷

The Third Circuit noted the elements for a private action included the element of proximate cause,¹⁶⁸ but distinguished *Wellman* by the nature of the action—private rather than public.¹⁶⁹ The Third Circuit explained the objectives of an SEC action are different from those of a private action.¹⁷⁰ The SEC's objectives are to "deprive a wrongdoer of his unjust enrichment

159. *Id.*

160. *Id.* at 95-98, 100-01.

161. *Teo*, 746 F.3d at 101.

162. *Id.*

163. *Id.*

164. *Id.*

165. *Teo*, 746 F.3d at 101 (internal quotations omitted).

166. *Wellman v. Dickinson*, 682 F.2d 355 (2d Cir.1982).

167. *Id.* at 368.

168. "In order to establish a claim under § 10(b) and Rule 10b-5, a plaintiff must prove that the defendant i) made misstatements or omissions; ii) of material fact; iii) with scienter; iv) in connection with the purchase or sale of securities; v) upon which the plaintiff relied; and vi) that reliance proximately caused the plaintiff's injury." *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1244 (3d Cir. 1989); see also *Mfr. Hanover Tr. Co. v. Drysdale Sec. Corp.*, 801 F.2d 13, 20 (2d Cir. 1986).

169. *SEC v. Teo*, 746 F.3d 90, 101 (3d Cir. 2014).

170. *Id.*

and to deter others from violating securities laws.”¹⁷¹ The goal of disgorgement is “not to compensate for losses but to deprive the wrongdoer of his ill-gotten gain.”¹⁷² The SEC initiates suits to “promote economic and social policies . . . independent of the claims of individual investors”¹⁷³ rather than initiating suits to act as “a collection agency for defrauded investors.”¹⁷⁴

The SEC is not an injured investor, so in Section 13(d) and 10(b) actions, it is not required to prove reliance or that any investor lost money as a result of the violation.¹⁷⁵ Instead, the Commission must only prove “(1) material misrepresentations or materially misleading omissions, (2) in the offer or sale of securities, (3) made with scienter.”¹⁷⁶

The Third Circuit further relied on the Restatement (Third) of Restitution to justify its relief of the SEC’s burden of proof.¹⁷⁷ Specifically, Restatement § 51(5) provides that “[i]n determining net profit [for purposes of disgorgement] the court may apply such tests of causation and remoteness . . . as reason and fairness dictate.”¹⁷⁸ The official comments to the Restatement counsel against giving inordinate weight to intervening causes:

To say that a profit is directly attributable to the underlying wrong, or (as sometimes expressed) that the profit is the “proximate consequence” of the wrong, does not mean that the defendant’s wrong is the exclusive or even the predominant source of the defendant’s profit. Indeed, because the disgorgement remedy is usually invoked when the defendant’s profits exceed the claimant’s provable loss, it should be possible in almost every case to identify additional causes of the profit for which the defendant is liable.¹⁷⁹

171. *Id.* at 105 (quoting *SEC v. Hughes Capital Corp.*, 124 F.3d 449, 455 (3d Cir. 1997)).

172. *Id.* at 105 (quoting *SEC v. Whittemore* 659 F.3d 1, 11 n.2 (D.C. Cir. 2011)).

173. *Id.* (quoting *SEC v. Rind*, 991 F.2d 1486, 1490 (9th Cir. 1993)).

174. *Teo*, 746 F.3d at 102 (citing George W. Dent Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865, 930 (1983)).

175. *Id.* (citing *SEC v. Morgan & Co.*, 678 F.3d 1233, 1244 (11th Cir. 2012)).

176. *SEC v. Teo*, 746 F.3d 90, 103 (3d Cir. 2014) (citing *SEC v. Merchant Capital, LLC*, 483 F.3d 747, 766 (11th Cir. 2007)).

177. *Id.* at 106.

178. *Id.* (quoting RESTATEMENT (THIRD) OF RESTITUTION § 51(5)) (AM. LAW INST. 2011) (alterations in original)).

179. *Id.* (citing RESTATEMENT (THIRD) OF RESTITUTION § 51(5) comment f (AM. LAW INST. 2011) (emphasis omitted)).

This point is elaborated upon in an example.

[I]f the defendant embezzles \$100 and invests the money in shares that he later sells for \$500, the \$500 that the claimant recovers is largely the result of causes independent of the wrong: favorable market conditions and the defendant's investment acumen or simply luck. The determination in this easy case that the embezzler's profit is properly attributable to the underlying wrong rests on a number of related judgments. The first, evidently a matter of causation, is a finding (or a presumption) that the defendant would not have made the investment (and realized the profit) but for the wrong. But causation in this sense gives only part of the answer. The conclusion that the defendant's profit is properly attributable to the defendant's wrong depends equally on an implicit judgment that the claimant, rather than the wrongdoer, should in these circumstances obtain the benefit of the favorable market conditions, acumen, or luck, as the case may be. The conclusion draws further support from another implicit judgment, that there would be an incentive to embezzlement if the defendant were permitted to retain the profits realized in such a transaction.¹⁸⁰

With these justifications from policy, precedent, statute, and the Restatement in mind, the Third Circuit found that the analytical framework for determining a remedy in an SEC enforcement suit is different than private suits.¹⁸¹ Consequently, the Third Circuit found that tort-based proximate cause analysis is misplaced in the context of an SEC-initiated action.¹⁸² Rather, according to the Third Circuit, the burden-shifting approach of *First City Financial Corp.* is essentially only a but-for causation test that creates a presumption of illegal profits.¹⁸³ The SEC must only prove but-for causation to assert a reasonable approximation of illegal profits.¹⁸⁴

The Third Circuit next looked to *SEC v. McDonald* in order to hold that it is the responsibility of the defendant to raise an intervening cause that cuts off liability, rather than the burden of the SEC to disprove any

180. *SEC v. Teo*, 746 F.3d 90, 106-07 (3d Cir. 2014) (citing RESTATEMENT (THIRD) OF RESTITUTION § 51(5) comment f (AM. LAW INST. 2011)).

181. *See id.* at 107.

182. *Id.* at 103.

183. *Id.* at 105.

184. *Id.*

supervening intervening cause.¹⁸⁵ Having established such a high bar, the Third Circuit easily found that the defendants had not rebutted the presumption of illegality, nor sufficiently proven a supervening intervening cause that cut off their liability.¹⁸⁶

A. *The Dissent*

Judge Jordan dissented in part due to the majority's loose interpretation of causation.¹⁸⁷ According to Jordan, the direct causal link between the amount of ill-gotten gain and the amount disgorged is precisely what makes the remedy a remedial measure rather than a punitive one.¹⁸⁸ Jordan did not dispute the majority's reasoning that once the SEC could prove the transaction was "tainted," it would create a presumption of illegal profits under the burden-shifting approach of *First City Financial Corp.*¹⁸⁹ Jordan acknowledged that in this case, the SEC met its initial burden; however, Jordan argued that the defendants successfully bore the burden of proof once it had shifted to them and successfully rebutted the presumption of illegality by showing a supervening cause—namely the buyout by Best Buy.¹⁹⁰

According to Jordan, the majority improperly ignored the defendant's evidence that some of the profits were directly caused by the buyout, not proximately caused by the fraud. Thus, the dissent recognized that under *First City Financial Corp.*, the SEC correctly showed a reasonable approximation of the amount to be disgorged,¹⁹¹ but that was only a presumption, not proof positive. The defendant ought to have the ability to rebut the presumption and carry his burden. Jordan reasoned that the defendant was able to correctly show that the Best Buy sale was an intervening supervening cause that cut off liability to the defendant.¹⁹² The majority, on the other hand, held that the mere allusion to the Best Buy sale was not enough to carry the defendant's burden.¹⁹³

185. SEC v. Teo, 746 F.3d 90, 105-06 (3d Cir. 2014).

186. See *id.* at 109.

187. *Id.* at 110 (Jordan, J. dissenting).

188. *Id.* at 110.

189. *Id.* at 111.

190. SEC v. Teo, 746 F.3d 90, 112 (3d Cir. 2014) (Jordan, J. dissenting).

191. *Id.*

192. *Id.* at 113.

193. *Id.*

V. CIRCUIT SPLIT

A. *The First Circuit*

In contrast to the Third Circuit, other circuits have implicitly required the SEC to prove proximate cause rather than merely proving but-for cause. The First Circuit followed its precedent set by *MacDonald* in a recent 2004 decision, *SEC v. Happ*,¹⁹⁴ which emphasized the importance of proving proximate cause in order to estimate a reasonable measure of profits connected to wrongdoing. The defendant in *Happ* argued that the amount of disgorgement required by the district court was not causally connected to his violation because he did not know the exact contents of the insider information he traded on.¹⁹⁵ However, the First Circuit found that the defendant's knowledge that the inside information was generally bad news was enough for the SEC to meet its burden to prove a causal connection.¹⁹⁶

Once the burden shifted to the defendant, "he failed to show that the amount of 'loss avoided' was not a reasonable approximation."¹⁹⁷ *Happ* failed to demonstrate, for example, any 'clear break in or considerable attenuation of the causal connection between the illegality and the ultimate profits."¹⁹⁸ By reasoning that the defendant could only meet his burden if he demonstrated an intervening cause that cut off his liability (such as a considerable degree of attenuation between the profits and the wrongful action), the First Circuit implicitly recognized the need for the SEC to prove not only actual cause, but also proximate cause.

B. *The Second Circuit*

Even the classic limitation of disgorgement to an equitable remedy rather than a punitive one has been a justification in requiring proof of proximate cause. The Second Circuit noted such relationship between cause and equity in *SEC v. Cavanagh*.¹⁹⁹ In that case, the Second Circuit found that the amount of disgorgement cannot be more than the amount of money acquired by wrongdoing, because disgorgement is not a punitive remedy.²⁰⁰ If the remedy were punitive, causation analysis would be immaterial. Equity

194. *SEC v. Happ*, 392 F.3d 12 (1st Cir. 2004).

195. *See id.* at 19-20.

196. *See id.* at 21-22.

197. *Id.* at 32.

198. *Id.*

199. *SEC v. Cavanagh*, 445 F.3d 105 (2d Cir. 2006).

200. *Id.* at 116-17.

demands that the defendant only pay back the amount that he stole. If the goal of disgorgement were to punish, the defendant would also be forced to pay fines or punitive damages on top of the amount of ill-gotten gains.²⁰¹

In the 1972 case, *SEC v. Manor Nursing Centers, Inc.*,²⁰² the Second Circuit applied a much more rigorous causation standard than the Third Circuit did in *SEC v. Teo*. In finding that the district court had erred by over-valuing the amount of ill-gotten profits, the Second Circuit held that there was an insufficient casual connection between the defendants' gain and their misdeeds.²⁰³ Essentially, the Second Circuit reasoned that the defendants could be ordered to return the money they stole, but not the interest they subsequently earned using such ill-gotten gains.²⁰⁴ The Second Circuit opined that to require disgorgement of the subsequent profits would be to punish some defendants more than others simply for being better investors.²⁰⁵

For example, if two thieves stole ten dollars and one spent the money on lunch, but the other used his ten to make another ten, it would be inequitable to require the wise investor to pay back twenty, but the foolish investor to pay back only ten. Thus, the Second Circuit reasoned that part of the amount of profits ordered to be disgorged by the district court was more properly allocated to income earned on valid proceeds that were not proximately caused by illegal actions.²⁰⁶ Therefore, disgorging such valid profits would constitute a penalty rather than an equitable remedy.²⁰⁷

C. *The Ninth Circuit*

In the same way that the Second Circuit found defendants could not be liable for money made after the fraud ran its course, the Ninth Circuit found that defendants could not escape liability for divesting themselves of the funds after the fraud. According to the Ninth Circuit in the 2010 case, *SEC v. Platforms Wireless Internet Corp.*,²⁰⁸ “[t]he manner in which [the defendant] chose to spend the illegally obtained funds has no relevance to

201. Since *SEC v. Cavanagh* was decided, the Supreme Court has found that disgorgement is indeed a punitive remedy. See *Kokesh v. SEC*, 137 S. Ct. 1635, 1639 (2017) (“Disgorgement in the securities-enforcement context is a ‘penalty.’”).

202. *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082 (2d. Cir. 1972).

203. See *id.* at 1104.

204. See *id.* at 1104-05.

205. See *id.*

206. *Id.* at 1105.

207. *Id.* at 1104.

208. *SEC v. Platforms Wireless Int’l Corp.*, 617 F.3d 1072 (9th Cir. 2010).

the disgorgement calculation.”²⁰⁹ Such reasoning relies on the same proximate cause analysis used in *SEC v. Manor Nursing Centers, Inc.*²¹⁰ If extra profits created long after the fraud were not proximately caused by the fraud, then necessarily any money lost in the same time period was also not proximately caused by the fraudulent activity.

In *Platforms*, the Ninth Circuit required a stricter finding of causation than the bare but-for causation allowed by the Third Circuit. The Ninth Circuit held that the SEC had successfully met its burden to prove a reasonable approximation of profits causally connected to the defendants’ misdeeds, but that the defendants were unable to meet their burden to prove that the SEC’s approximation included anything but unjustly gained profits.²¹¹ Thus, the Ninth Circuit still found proximate cause to be a vital link in the SEC’s case against fraudsters, thereby adopting the causation reasoning of the First, Second, and D.C. Circuits.

D. The Tenth Circuit

In *SEC v. Maxxon, Inc.*,²¹² the Tenth Circuit found that temporal limitations must be imposed in order to cut off liability for defendants after a reasonable period.²¹³ Reasoning from the purpose of disgorgement as an equitable remedy, the Tenth Circuit found that “some end-date determination is certainly necessary so that the defendant is not required to disgorge profits not ‘causally connected to the violation.’”²¹⁴ The court noted that, in *SEC v. MacDonald*, “disgorgement was appropriate only as to the profits made prior to the time insider information was made public.”²¹⁵ Once the information became public, the profits were not caused by the insider information, but rather by the natural movement of the market.

The Tenth Circuit held that “so long as the end date chosen results in a ‘reasonable approximation’ of illegal profits, there is nothing wrong with the court itself determining that date.”²¹⁶ The Tenth Circuit’s reliance on *MacDonald*’s causation analysis as well as its own holding in *Maxxon*—which implied that a “reasonable approximation” takes into account

209. *Id.* at 1097-98 (quoting *SEC v. JT Wallenbrock & Assoc.* 440 F.3d 1109, 1116 (9th Cir. 2006)).

210. *See supra* notes 203-06 and accompanying text.

211. *Platform Wireless Int’l Corp.*, 617 F.3d at 1096-97.

212. *SEC v. Maxxon, Inc.*, 465 F.3d 1174 (10th Cir. 2006).

213. *Id.* at 1179.

214. *Id.*

215. *Id.*

216. *Id.* at 1179.

temporal limitations associated with proximate cause principles—showed that the Tenth Circuit is far from abandoning the requirement that the SEC prove proximate cause.

E. The Third Circuit

According to the Third Circuit in *SEC v. Teo*, the SEC must only prove that the defendant's profits were actually caused by his unlawful actions. Once that is proven, the burden shifts to the defendant to prove that the rest of his profits were not proximately connected to his unlawful gains. Shifting the burden of proximate cause to the defendant seems to be a strict rule. Yet, it is a rule that is extremely necessary.

Insider trading undermines investor confidence in the fairness and integrity of the securities markets. Investors are unlikely to participate in markets where they know others have the inside track because of special knowledge. Even the Supreme Court has noted the danger inherent in illegal insider trading. The Court noted in *United States v. O'Hagan*,

The [misappropriation] theory is also well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence . . . Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-à-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.²¹⁷

According to the SEC, “[f]ew practices, short of manipulation, have as deleterious an effect on the investing public’s confidence in corporate institutions and the securities markets as the selective disclosure of and misuse of so called inside information, i.e., material non-public information.”²¹⁸ Due to its stance on insider trading, “the SEC has treated

217. *U.S. v. O'Hagan*, 521 U.S. 642, 658–59 (1997) (citation omitted).

218. Nicholas Pellicani, *No Pain, No Gain: The Criminal Absence of the Efficient Capital Markets Theory from Insider Trader Sentencing*, 84 ST. JOHN'S L. REV. 3, 1057, 1086 n.224 (2011) (quoting *In re Faberge, Inc.*, Exchange Act Release No. 10174 (May 25, 1973)).

the detection and prosecution of insider trading violations as one of its enforcement priorities.”²¹⁹

Disgorgement of profits only works as a remedy if it serves as a deterrent. However, if the defendant is to keep his illicit profits, then he is incentivized to break the law. Such a rule would create a “no lose” situation for the defendant. Even if the defendant is caught and must give up the money that he gained illegitimately, he can still keep the money he made by putting the illegitimate money to further use. As any first-year finance student knows, the use of money even for a short time has value. Such a rule would provide a de facto free loan from the victims to the defendant.

The rule from *SEC v. Teo* is necessary because the disgorgement remedies employed by other circuits are not sufficient deterrents to insider trading and other financial crimes. Under the proximate cause standard of the other circuits, the defendant would be able to wriggle out of the “reasonable approximation” standard by arguing that the SEC has the burden of proving proximate cause.

For instance, suppose several defendants were to start an investment company that received a variety of illegal inside information, but also made plenty of legitimate investments. Suppose further that the defendants made millions of dollars over the course of several years before they were caught. In the damages phase of the trial, the SEC would be able to simply prove that the defendants harvested somewhere in the range of \$10 to \$13 million dollars of profit from their illegal transactions. In any of the circuits, the burden would then shift to the defendants to prove that such an approximation was unreasonable. The defendants would have the opportunity to argue that they received only \$9 or \$10 million from illegal tips, but that the rest were profits legitimately made from investing decisions.

Unfortunately, this framework is severely jeopardized by the causation requirements of most of the circuits. If the SEC sued in the First Circuit instead of the Third, causation and damages rules would directly collide. Instead of having to disprove the SEC’s approximation of profits in the damages phase of trial, the defendants could show that the SEC failed to meet its burden in proving proximate cause. In the above example, the defendants could argue that the SEC only successfully showed that \$10 million of the defendants’ profits were causally connected to the insider trading. The onus would be on the SEC to prove that the extra money was proximately connected to the fraud. Thus, the defendants would be able to

219. United States Securities and Exchange Commission, *Fast Answers, Insider Trading* <https://www.sec.gov/answers/insider.html> (Jan 15, 2013).

make an end run around the burden-shifting rule of *First City Financial Corp.*

However, if the SEC were to litigate the case in the Third Circuit, causation and damages would align. In proving damages, the SEC would only need to show a reasonable approximation of illegal gain. Similarly, in proving causation, the SEC would only need to show a but-for causal connection between profits and bad behavior.

Thus, in the above example, the SEC would only need to show that the defendants engaged in illegal behavior, and, but for that illegal behavior, the defendants would not have made the profits of \$13 million. The burden would then shift to the defendants to show that the extra \$3 million dollars was too remotely connected to the fraud to be disgorged, perhaps by proving that the defendants engaged in several legitimate transactions with the money after the initial illegal tip and it was these legitimate transactions that resulted in the extra profit. The causation rule from *Teo* is superior to the rule from the other circuits for two reasons: (1) it comports with the burdens placed on defendants in proving damages and (2) the defendants are in a much better position to prove causation than the SEC because the defendants have greater access to their financial history than the SEC. As the D.C. Circuit aptly stated in *SEC v. First City Financial Corp.*,

If exact information were obtainable at negligible cost, we would not hesitate to impose upon the government a strict burden to produce that data to measure the precise amount of the ill-gotten gains. Unfortunately, we encounter imprecision and imperfect information. Despite sophisticated econometric modelling, predicting stock market responses to alternative variables is, as the district court found, at best speculative. Rules for calculating disgorgement must recognize that separating legal from illegal profits exactly may at times be a near-impossible task.

....

Placing the burden on the defendants of rebutting the SEC's showing of actual profits, we recognize, may result, as it has in the insider trader context, in actual profits becoming the typical disgorgement measure. But the line between restitution and penalty is unfortunately blurred, and the risk of uncertainty should fall on the wrongdoer whose illegal conduct created that uncertainty.²²⁰

220. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1231-32 (D.C. Cir. 1989) (citations omitted).

VI. CONCLUSION

The Third Circuit may stand alone in requiring only proof of but-for causation from the SEC, but it does not stand in error. Disgorgement presents a unique proof problem because profits resulting from fraud are so difficult to measure. The financial markets are incredibly complex and increasingly fast-paced. Securities are bought and sold in large markets over the phone, online, or even by computer programs. Buyers and sellers generally do not meet in person to trade. Instead, they are separated by geographic distances as well as a web of third parties, including issuers, underwriters, brokers, and investors. This complex trading system often creates a complicated web of transactions that can be nearly impossible to untangle. Many fraudsters are masters of deception, able to launder illegal gains with legitimate ones, hide revenue off books, or simply take the money offshore. Determining which profits were caused by fraud and which were not is a daunting task for prosecutors.

However, causation difficulties have traditionally been resolved in favor of the victim rather than the defendant. For instance, in personal injury claims courts developed the substantial factor test²²¹ to address situations where the traditional but-for cause test fails. Rather than allow a defendant to escape liability because proof of causation was difficult, the courts fashioned a new rule that placed a greater burden on the defendant. Likewise, where proving causation in fraud cases is difficult, the onus should fall on the defendants, rather than the victims. The Third Circuit's causation test accomplishes this policy by shifting the burden of proving an intervening cause to the defendants, rather than forcing the SEC to prove proximate cause.

Critics of *Teo* also argue that reducing the proximate cause burden gives plaintiffs too much power. Relaxing the burden of proof gives plaintiffs an extra incentive to abuse the remedy to enlarge the award for their own personal gain, or so the argument goes. However, SEC enforcement actions are intended to promote economic and social policies, not redress the claims of individual shareholders. The SEC's task is to uphold the integrity

221. The substantial factor test is used when multiple defendants act independently of one another in such a way that the victim would have been hurt even if only one defendant had acted. For instance, if two people start fires independently of each other that combine and burn down a neighborhood, determining fault is impossible under but-for causation. Under but-for causation, neither individual could be found liable because, but for his actions the neighborhood would still have burned down. The same test would be used if two people both shot a victim wherein the victim would have been killed by either bullet. In such situations, the court will determine if the acts of each defendant were a "substantial factor" in causing the victim's injury. If so, both defendants will be liable. *See e.g.*, Judicial Council of California Civil Jury Instruction 430.

of the financial markets. Thus, it is far less likely that the SEC's disgorgement power will be abused, since no one will be enriched by such action.

The SEC already has greater latitude than individual litigants because of the lack of a financial motive. One such rule that recognizes the unique role of the SEC is the relaxed requirement of standing. When the Commission prosecutes fraudsters, it does not have to prove reliance, or demonstrate that any investor lost money as a result of the violation.²²² The courts instituted such a rule because they recognize that the SEC has a unique role in policing the financial markets.²²³ The Commission should have the power to deter fraudsters from violating the law and cheating investors. Accordingly, the Third Circuit was correct in holding that the SEC need only establish a reasonable approximation of the illegal profits that flow on a but-for basis from the violations. The defendant must raise any question about an intervening cause.

The Third Circuit's rule fully comports with the underlying purpose of disgorgement—restoration of all ill-gotten gains. While it may seem to some observers that the Third Circuit has developed an onerous rule to burden defendants, on further examination the rule proves to be only a modest extension of the traditional burden-shifting framework. The Third Circuit did not egregiously violate the rights of defendants, but rather fashioned a rule that fully comports with the policy of the burden-shifting framework.

Furthermore, the step is even more modest in practice. Generally, the traditional burden-shifting approach already usually results in full disgorgement of all the defendants' profits.²²⁴ By relaxing the burden of proving proximate cause, the Third Circuit did more to protect the burden-shifting framework than it did to increase the size of the SEC's disgorgement remedy. Finally, the rule's harsh effect has been most recently mitigated by the Supreme Court's holding in *Kokesh v. SEC*.²²⁵ In that case, the Court held that disgorgement constitutes a penalty, and is thus subject to a five-year statute of limitations enacted in 28 U.S.C. § 2462.²²⁶ Accordingly, as of 2017, the SEC no longer has the power to force

222. See *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1363 & n.4 (9th Cir. 1993); *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985). See also *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963) (similar holding under the Investment Advisers Act).

223. See *supra* note 224.

224. See *SEC v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072 (9th Cir. 2010).

225. *Kokesh v. SEC*, 137 S. Ct. 1635 (2017).

226. *Id.* at 1639.

disgorgement of profits that were illegally gained more than five years ago. Given restriction, as well as the other limiting factors, the holding of *SEC v. Teo* is not the egregious extension of government power that it seems to be at first blush, but rather a practical extension of a long-standing practice.

