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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*

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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*

Abstract: On February 10, 2014, in *SEC v. Teo*, the U.S. Court of Appeals for the Third Circuit held that, in an action for disgorgement of profits under the Securities Exchange Act of 1934, the Securities Exchange Commission (SEC) does not have the burden of proving proximate cause. The court reasoned that the SEC must only prove but-for causation between alleged wrongdoing and ill-gotten profits. This Comment argues that, going forward, the Third Circuit should reject *Teo* and apply a proximate cause standard, especially regarding proceeds. Should the Supreme Court reach the issue in the future, it should similarly reject the Third Circuit's reasoning in *Teo*. Courts should require the SEC to show a proximate link between the alleged securities violation and the profits to be disgorged in order to avoid turning the remedy into an impermissible penalty.

INTRODUCTION

It is unlikely that investors enjoy filing paperwork with the Securities Exchange Commission (SEC), but, like it or not, the SEC requires numerous disclosures and reports.[1] Burdensome though it may be, those who violate the SEC's regulations face the prospect of civil and criminal penalties.[2] Under federal securities law, investors owning more than five percent of a certain class of stock are required to disclose to the SEC the number of shares owned and the amount paid for those shares.[3]

The U.S. Code does not provide a remedy for violations of this provision, but courts have widely accepted that the SEC has the equitable remedy of dis-

[1] *See, e.g.*, 17 C.F.R. § 240.13d-1(a) (2014) (requiring that any person who becomes the beneficial owner of more than five percent of any equity security must file with the SEC the information required by Schedule 13D within ten days); *id.* § 240.13e-4(b)-(d) (listing filings and disclosures required by issuer of a tender offer); *id.* § 240.13f-1(a) (requiring filing by investment managers holding securities with an aggregate fair market value of at least $100 million).

[2] *See* 15 U.S.C. § 78u(d) (2012) (conferring authority on federal courts to grant monetary penalties and equitable relief for securities violations);17 C.F.R. § 240.13d-101 (providing that "[f]ailure to disclose the information requested by this schedule may result in civil or criminal action").

[3] *See* 15 U.S.C. § 78m(d)(1). These mandatory disclosures are referred to as "Schedule 13D" disclosures, and violations of the disclosure rules as "section 13(d) violations." *See generally* Lora C. Siegler, Annotation, *Availability of Implied Private Action for Violation of § 13 of Securities Exchange Act of 1934 (15 U.S.C.A. § 78m)*, 110 A.L.R. FED. 758 (1992) (explaining the provisions of the Securities Exchange Act, SEC regulations under the Act, and subsequent violations of the Act).

gorgement in order to deprive wrongdoers from their unjust gains.[4] In order to calculate the amount a wrongdoer must disgorge, federal courts adjudicating SEC enforcement cases generally apply a burden-shifting framework.[5] The federal circuits, however, are divided on how to apply the requirement of causation within that framework.[6]

In 2014, in *SEC v. Teo*, the U.S. Court of Appeals for the Third Circuit held that the SEC does not have the burden of proving a proximate link between illegal activity and the profits sought to be disgorged.[7] In *Teo*, the court interpreted relevant case law as only requiring the SEC to prove but-for cause.[8]

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[4] *See, e.g.*, SEC v. Platforms Wireless Internet Corp., 617 F.3d 1072, 1096 (9th Cir. 2010) (stating that courts have broad equitable powers to order disgorgement in securities violations cases); SEC v. First City Fin. Corp., 890 F.2d 1215, 1230 (D.C. Cir. 1989) (stating that federal courts can order disgorgement for insider trading violations and do in fact routinely order disgorgement); SEC v. Tome, 833 F.2d 1086, 1096 (2d Cir. 1987) (stating that courts have the equitable power to order disgorgement). In an opinion joined by then Judge Ruth Bader Ginsburg, the D.C. Circuit held that disgorgement was available as an equitable remedy because the Securities Exchange Act vested jurisdiction in the federal courts. *See First City*, 890 F.2d at 1230.

[5] *See Platforms Wireless*, 617 F.3d at 1096; SEC v. Happ, 392 F.3d 12, 31 (1st Cir. 2004); *First City*, 890 F.2d at 1232. Under the framework, the SEC must put forth a reasonable approximation of profits causally connected to the securities violation. *See First City*, 890 F.2d at 1231–32. The burden then shifts to the defendant to demonstrate that the figure is not a reasonable approximation. *See id.* at 1232. The SEC bears the ultimate burden of persuasion that its disgorgement figure is a reasonable approximation of the defendant's unjust gain. *See id.* The D.C. Circuit's burden-shifting structure has been widely accepted across circuits. *See, e.g.*, SEC v. Razmilovic, 738 F.3d 14, 31–32 (2d Cir. 2013) (applying the D.C. Circuit's burden-shifting framework); *Platforms Wireless*, 617 F.3d at 1096 (same); *Happ*, 392 F.3d at 31 (same).

[6] *See infra* notes 39–55 and accompanying text (discussing the reasoning of the federal circuit courts of appeals). *Compare* SEC v. Teo, 746 F.3d 90, 107 (3d Cir.), *cert. denied* 135 S. Ct. 675 (2014) (concluding that the SEC's initial burden is only to prove but-for cause and an intervening cause raised by the defendant is not dispositive), *with Happ*, 392 F.3d at 32 (reasoning that the SEC's measure of disgorgement was reasonable because the SEC provided evidence of a proximate causal connection which the defendant failed to disprove), *First City*, 890 F.2d at 1232 (reasoning that disgorgement is a reasonable approximation of profits causally connected to wrongdoing which can be invalidated by evidence of causal attenuation), *and* SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1104 (2d Cir. 1972) (holding that proceeds of illegal profit could not be disgorged because it constituted a penalty).

[7] *See* 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 looks at 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 looks at 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).

[8] *See* 746 F.3d at 107. 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 a but-for cause of an event if that event would not have occurred absent the

This holding diverges from the case law of other circuits, which have all required the SEC to show some level of proximate cause.[9] Despite this emerging disagreement amongst the circuits, the U.S. Supreme Court denied certiorari when the defendants in *Teo* appealed.[10]

This Comment argues that, going forward, the Third Circuit should reject its reasoning in *Teo* and join its sister circuits by requiring the SEC to show proximate cause in securities enforcement actions, thereby ensuring the disgorgement remedy does not become a penalty.[11] Part I of this Comment discusses the factual and procedural history of the *Teo* case.[12] Part II analyzes the reasoning employed by the Third Circuit, and then contrasts the Third Circuit's rationale with that of the conflicting circuits.[13] Finally, Part III suggests that the Third Circuit misinterpreted the application of causation in SEC enforcement actions.[14] Accordingly, the reasoning in *Teo* should be rejected and the element of proximate cause more adequately applied to the remedy of disgorgement.[15]

I. WHERE *TEO* FIRST WENT WRONG

A. Factual History

Teo involved an enforcement action brought by the SEC against an investor, defendant Alfred Teo.[16] In 1992, the defendant established the MAAA

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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.

[9] *See, e.g.*, *Happ*, 392 F.3d at 32 (applying principals of proximate cause in determining the reasonableness of a proposed measure of disgorgement); *First City*, 890 F.2d at 1232 (explaining that a lack of proximate cause might invalidate a proposed measure of disgorgement); *Manor Nursing*, 458 F.2d at 1104–05 (holding that policy justifications did not warrant disgorging proceeds made on illegal income); *see also* SEC v. MacDonald, 699 F.2d 47, 53–54 (1st Cir. 1983) (en banc) (reasoning that insider trader's liability was limited by causation to ill-gotten gains). Proximate cause will often become most important when a defendant has earned consequential gains or proceeds on the illegally obtained income. *See Manor Nursing*, 458 F.2d at 1104; RESTATEMENT (THIRD) OF RESTITUTION §§ 51(5)(a), 53 cmt. d (2011) (noting that "[e]ven conscious wrongdoers are not liable for all identifiable consequential gains, however, because of the requirement that such gains be not unduly remote") (internal quotations omitted).

[10] Teo v. SEC, 135 S. Ct. 675 (2014) (denying certiorari).

[11] *See infra* notes 56–73 and accompanying text.

[12] *See infra* notes 16–38 and accompanying text.

[13] *See infra* notes 39–55 and accompanying text.

[14] *See infra* notes 56–73 and accompanying text.

[15] *See infra* notes 56–73 and accompanying text.

[16] *See* 746 F.3d at 93. The SEC filed its complaint against the defendant in 2004, alleging claims of insider trading and false filings. Complaint at 1, SEC v. Teo, No. 2:04-cv-01815(SDW)(MCA) (D.N.J. Sept. 12, 2011), 2004 WL 1374570, at *1.

Trust, of which he was the beneficial owner.[17] By 1997, the defendant and his trust held approximately 5.25 percent of the stock in Musicland, a Delaware corporation that sold music, books, and computer software.[18] Significantly, Musicland had a shareholder rights plan, otherwise known as a "poison pill" provision, which could be activated if any individual or group owned at least 17.5 percent of the company's stock.[19]

Up until 1998, the defendant properly disclosed his Musicland holdings as being below the "poison pill" threshold in accordance with the Securities Exchange Act.[20] By December of 2000, however, the defendant and his trust owned a combined 35.97 percent of Musicland's shares, and failed to report this to either the SEC or Musicland.[21] As a result of the defendant's failure to disclose the amount of his ownership, Musicland was unable to activate its "poison pill" provision.[22]

In December of 2000, Best Buy announced a tender offer of all Musicland shares, which caused a subsequent increase in the Musicland stock price.[23] In response, the defendant sold a portion of his shares both on the market and to

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[17] *Teo*, 746 F.3d at 93 (describing the defendant's holdings, which were the subject of the SEC enforcement action).

[18] *Id.*

[19] *Id.* "Poison pill" provisions have existed in corporate law since the 1980s. *See* Patrick J. Thompson, Note, *Shareholder Rights Plans: Shields or Gavels?*, 42 VAND. L. REV. 173, 173–75 (1982) (explaining the rise and validity of shareholder rights plans). The provisions were created in response to an increase in the number of hostile takeovers, and are typically enacted by a corporation's board of directors without shareholder approval. *See id.* at 173–76. If activated by a triggering event, such as a tender offer by an acquiring corporation, shareholders of the target corporation receive the right to purchase shares of stock at a specified price. *See id.* at 176. The purpose of the "poison pill" provision is to protect the company in the event of a hostile takeover by an outsider. *See Teo*, 746 F.3d at 93. Activating the provision would dilute the holdings of the hostile buyer, thereby making it more difficult to acquire a controlling share. *See id.*

[20] *See Teo*, 746 F.3d at 93; *see also* 15 U.S.C. § 78m(d) (2012) (requiring reporting to the SEC by any person owning more than a five percent beneficial share of any class of stock). In 1997, the defendant properly reported that he and his trust owned 5.25 percent of Musicland. *Teo*, 746 F.3d at 93. Beginning in July of 1998, the defendant's SEC filings misrepresented his ownership in Musicland. *Id.* at 93–94. He disclosed to the SEC that he "ceased to have investment powers with respect to the trust," but in reality continued to purchase Musicland stock on behalf of the trust. *Id.*

[21] *Teo*, 746 F.3d at 94.

[22] *See id.* (stating that the defendant's intent was to prevent the implementation of the poison pill). By falsely reporting that he owned less than 17.5 percent of Musicland, the defendant prevented the company from being able to implement the poison pill in response to a takeover attempt. *See id.* at 93–94.

[23] *See id.* at 94. Though the term "tender offer" includes numerous different transactions, it can be thought of as simply a bid to purchase stock from shareholders above the market price. *See generally* ARNOLD S. JACOBS, THE WILLIAMS ACT—TENDER OFFERS AND STOCK ACCUMULATIONS (2015) (describing the conventional definition of tender offer by analyzing legislative history and SEC regulations).

Best Buy, resulting in gross proceeds of $154,932,011.[24] Of this amount, the defendant profited $21,087,345 from the shares that he failed to report in his SEC filings.[25]

B. Procedural History

The SEC began investigating the defendant for securities fraud and, in April 2004, filed a civil enforcement action against him.[26] Amongst other violations, the SEC accused the defendant of violating sections 13(d) and 10(b) of the Securities Exchange Act.[27] In 2011, in the U.S. District Court for the District of New Jersey, a jury found the defendant guilty of having violated various rules and regulations of the Securities Exchange Act.[28] Thereafter, an issue of primary focus became the SEC's action to disgorge the defendant of the profits earned from his illegal activity.[29]

Following the jury verdict against the defendant and his trust, the SEC filed a motion to disgorge the profits earned as a result of the illegal activity.[30] The district court found that the defendant's profits were the result of his securities violations committed beginning in July, 1998, and held that the majority his profit could be disgorged.[31] The court based its reasoning on case law indi-

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[24] *Teo*, 746 F.3d at 94. Musicland's stock price increased shortly following the Best Buy tender offer. *See id.* After selling some shares on the open market, the defendant sold all of his remaining shares to Best Buy. *See id.*

[25] *Id.* The defendant's original cost to acquire the shares was $89,453,549. *Id.* He then sold them for $154,932,011. *Id.* The court's calculation of a roughly $21 million profit is the result of taking into account the date of the defendant's first SEC reporting violation. *See id.*

[26] *Id.* (noting that the defendant was charged with violating sections 13(d) and 10(b) of the Securities Exchange Act); Complaint, *supra* note 16, at 4–5 (alleging insider trading violations and seeking disgorgement and injunctions).

[27] *Teo*, 746 F.3d at 94. The Securities Exchange Act of 1934 requires disclosure to the SEC by any person holding more than a five percent share of company's stock. *See* 15 U.S.C. § 78m(d) (2012). For example, section 13(d) is a reference to the regulation requiring disclosure on a specific form by an investor. *See* 17 C.F.R. § 240.13d-1 (2014). Specifically, the regulation provides that "[a]ny person who, after acquiring . . . beneficial ownership of any equity security . . . , is directly or indirectly the beneficial owner of more than five percent of the class shall, within 10 days after the acquisition, file with the Commission, a statement containing the information required by Schedule 13D . . . ." *See id.*

[28] *Teo*, 746 F.3d at 94 (noting that the jury found the defendant guilty of violating sections 13(d), 10(b), and other sections of the Securities Exchange Act).

[29] *See id.* at 95. The SEC and defendant disagreed over the amount of profit that could be disgorged, and whether or not the Best Buy tender offer was an intervening event limiting the defendant's liability. *See* SEC v. Teo, No. 2:04-cv-01815(SDW)(MCA), 2011 WL 4074085, at *6 (D.N.J. Sept. 12, 2011).

[30] *See* Memorandum of Law in Support of Plaintiff's Motion for Disgorgement, Prejudgment Interest, Civil Monetary Penalties and Injunctive Relief Against Defendants Alfred S. Teo, Sr. and the MAAA Trust at 35–36, *Teo*, No. 2:04-cv-01815(SDW)(MCA) (arguing for the maximum penalty possible against the defendant for his securities violations).

[31] *Teo*, 2011 WL 407408, at *7 (concluding that the defendant's actual profit which could be disgorged amounted to $21,087,345).

cating that district courts have broad discretion to set a disgorgement order, but that defendants have the ability to show that there is no causal connection between their profits and the illegal activity.[32] The defendant asserted that his profits were not causally connected to his violations, but the court reasoned that, although there was uncertainty as to causation, any uncertainty should be resolved against the wrongdoer.[33]

Thereafter, the defendant appealed the district court's disgorgement ruling to the U.S. Court of Appeals for the Third Circuit.[34] The defendant argued that the SEC could only disgorge his profits upon a showing that his profits were proximately connected to his illegal activity, and that the profits were not attributable to an intervening cause.[35] The Third Circuit affirmed the district court's order, but based its decision on the SEC's burden of proof and the policy objectives of SEC enforcement cases.[36] The dissenting opinion agreed that the SEC met its initial burden by showing but-for cause, but argued that the majority had failed to adequately take into account the intervening cause raised by the defendant.[37] Following the Third Circuit's decision, the defendant appealed but the U.S. Supreme Court denied certiorari.[38]

II. A Causal Divide: How the Third Circuit's Decision Created a Split

In calculating the proper measure of profits to be disgorged, the U.S. Court of Appeals for the Third Circuit adopted the burden-shifting framework

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[32] *See id.* at *5 (citing *First City*, 890 F.2d at 1230–32) (explaining that disgorgement is an equitable remedy which deprives a wrongdoer of unjust gain but which cannot be used punitively); SEC v. Antar, 97 F. Supp. 2d 576, 578 (D.N.J. 2000) (observing that district courts have broad discretion to fix a measure of disgorgement); SEC v. Bilzerian, 814 F. Supp. 116, 121 (D.D.C. 1993) (noting that a defendant may show disruption of the causal chain).

[33] *See Teo*, 2011 WL 4074085, at *5–6 (citing *First City*, 890 F.2d at 1232) (determining that the defendant's argument that his violations had no effect on the Musicland stock price were too speculative and uncertain).

[34] *See Teo*, 746 F.3d at 93.

[35] *See id.* at 101.

[36] *See id.* at 108–09. The distinction between but-for cause and proximate cause was central to the court's decision. *See id.* at 107. The Third Circuit reasoned that the SEC only had to show but-for cause, a burden it presumptively met by showing the amount of profit the defendant earned on stock he had acquired while making false reports to the SEC. *See id.* The court determined that this was the extent of the SEC's burden based on its reading of *First City*. *See id.* at 105–07 (stating that the *First City* burden-shifting framework only established a but-for cause requirement). By contrast, any issue of proximate cause had to be raised by the defendant, but an assertion of an intervening cause would not be dispositive. *See id.* at 107. The Third Circuit reasoned that the policies of deterrence and preventing unjust enrichment had to weigh heavily in a court's determination of whether profits are legally attributable to a defendant's wrongdoing. *See id.*

[37] *See id.* at 112 (Jordan, J., dissenting) (arguing that the majority erred by treating disgorgement as an all-or-nothing proposition).

[38] *See Teo*, 135 S. Ct. at 675 (denying certiorari).

derived from the 1989 D.C. Circuit case *SEC v. First City Financial Corp*.[39] The Third Circuit's adoption of the framework is in-line with the jurisprudence of other federal circuit courts of appeals.[40] Breaking from other courts' decisions, however, the Third Circuit held that, under this framework, the SEC only has the burden of establishing but-for causation between profits gained and alleged illegal activity.[41] The Third Circuit based its rationale, in part, on the idea that tort principals of proximate cause are applicable in private enforcement actions, but not in public enforcement actions brought by the SEC.[42] The court reasoned that, unlike private suits, SEC enforcement actions had less need for an element of proximate because of the public policies those actions seek to enforce.[43]

The Third Circuit also based its reasoning on an analysis of the *Restatement (Third) of Restitution*.[44] In particular, the Third Circuit focused on the comments to the *Restatement* that suggest courts should not give inordinate

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[39] *See* SEC v. Teo, 746 F.3d 90, 105 (3d Cir.), *cert. denied* 135 S. Ct. 675 (2014) (citing SEC v. First City Fin. Corp., 890 F.2d 1215, 1231 (D.C. Cir. 1989)). Under the burden-shifting framework, the SEC has the initial burden of providing a reasonable approximation of profits causally connected to the securities violation. *See First City*, 890 F.2d at 1231–32. The burden then shifts to the defendant to demonstrate that the figure is not a reasonable approximation. *See id.* at 1232. The SEC bears the ultimate burden of persuasion that its disgorgement figure is a reasonable approximation of the defendant's unjust gain. *See id.*

[40] *See, e.g.*, SEC v. Razmilovic, 738 F.3d 14, 31–32 (2d Cir. 2013) (applying the D.C. Circuit's burden-shifting framework); SEC v. Platforms Wireless Internet Corp., 617 F.3d 1072, 1096 (9th Cir. 2010) (same); SEC v. Happ, 392 F.3d 12, 31 (1st Cir. 2004) (same)*; see also supra* note 5 and accompanying text (discussing the burden-shifting framework established by the D.C. Circuit).

[41] *See Teo*, 746 F.3d at 107. The Third Circuit stated that application of the burden-shifting framework required the SEC to produce evidence of a "reasonable approximation" of profits illegally gained. *Id.* at 105. The court reasoned that the reasonable approximation of profits was essentially, if not overtly, a but-for burden of causation. *See id.* Satisfying this burden creates a presumption that profits were illegally gained, after which the defendant has the burden of showing that the SEC's measure was not a "reasonable approximation." *See id.*

[42] *See id.* at 102. Because private suits seeking to redress individual harms have origins in common law torts, the plaintiff is required to prove that their monetary losses were proximately caused by the defendant's illegal activity. *See generally* Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005) (holding that plaintiff's complaint was legally insufficient because plaintiff failed to plead that losses were proximately caused by the defendant's misrepresentation).

[43] *See Teo*, 746 F.3d at 102. In defense of its proposition, the Third Circuit cited *SEC v. Apuzzo*. *Id.* at 103 (citing SEC v. Apuzzo, 689 F.3d 204, 212–13 (2d Cir. 2012)). In *Apuzzo*, the Second Circuit held that, in actions brought under 15 U.S.C. § 78t(e), the SEC does not have the burden of proving that an aider and abettor proximately caused a securities law violation. *See* 689 F.3d at 213.

[44] *See Teo*, 746 F.3d at 106. The Third Circuit reasoned that the *First City* burden-shifting framework was based on the *Restatement (Third) of Restitution*. *See id.* The *Restatement* states that a claimant may eliminate profit from wrongdoing through disgorgement, but that the remedy is not to be used as "the imposition of a penalty." *See* RESTATEMENT (THIRD) OF RESTITUTION § 51(4)–(5) (2011). More aptly, the *Restatement* states that courts may use tests of causation, and that a claimant seeking disgorgement has the burden of producing a reasonable approximation of the wrongful gain. *See id.* § 51(5).

weight to causation.[45] The court's reading of the *Restatement* led it to the conclusion that even if a defendant raises the issue of intervening causation, the issue is not dispositive.[46] Instead, the policies of deterrence and preventing unjust enrichment must be heavily weighed.[47]

In contrast, other circuits implicitly apply a proximate cause requirement, placing a greater burden on the SEC to show proximate causation.[48] For example, in 1972, in *SEC v. Manor Nursing Centers, Inc.*, the U.S. Court of Appeals for the Second Circuit held that the district court had erred in the measure of profits to be disgorged because there was an insufficient causal connection between the defendants' wrongdoing and the ill-gotten gains.[49] The Second Circuit reasoned that a portion of the district court's measure included income earned on proceeds—income not proximately caused by the illegal activity—and disgorging that income would have constituted a penalty.[50] Furthermore, in 1983, in *SEC v. MacDonald*, the U.S. Court of Appeals for the First Circuit, sitting en banc, applied a more rigorous causal standard than mere but-for cause to the remedy of disgorgement.[51] There, the court used proximate cause

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[45] *See Teo*, 746 F.3d at 106 (citing RESTATEMENT (THIRD) OF RESTITUTION § 51, cmt. f (2011) ("[I]t should be possible in almost every case to identify additional *causes* of the profit for which the defendant is liable.")).

[46] *See id.* at 107.

[47] *See id.*

[48] *See, e.g.*, *Happ*, 392 F.3d at 31 (applying principal that profits must be causally connected to wrongdoing); *First City*, 890 F.2d at 1231 (same); SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1104–05 (2d Cir. 1972) (holding that policy justifications did not warrant disgorging proceeds made on illegal income); *see also* SEC v. MacDonald, 699 F.2d 47, 53–54 (1st Cir. 1983) (en banc) (reasoning that insider trader's liability was limited by causation to ill-gotten gains).

[49] *See* 458 F.2d at 1105 (reversing district court order for a measure of disgorgement which included both profits and proceeds of profits). The defendants in *Manor Nursing* were found to have violated various securities laws in connection with the sale of stock. *See* SEC v. Manor Nursing Ctrs., Inc., 340 F. Supp. 913, 917–20 (S.D.N.Y. 1971), *rev'd*, 458 F.2d 1082. As a result, the district court ordered that the defendants disgorge any profit earned in connection with the sale. *See id.* at 936. The district court, however, also held that the defendants had to disgorge any proceeds earned from the investment of their profits. *See id.*

[50] *See Manor Nursing*, 458 F.2d at 1104–05. The Second Circuit was concerned that the policy of deterrence did not justify turning disgorgement into a penalty assessment. *See id.* at 1104. While it was necessary to disgorge illicit profits, the court's equitable powers were limited to profits connected to the wrongdoing. *See id.* Moreover, policy justifications, such as deterrence, were not enough to warrant disgorgement of the profits. *See id.* at 1104–05. More recently, in 2014, in *SEC v. Wyly,* the U.S. District Court for the Southern District of New York specifically declined to follow the causation analysis in *Teo*. *See* SEC v. Wyly, No. 10-cv-5760(SAS), 2014 WL 3739415, at *4 n.38 (S.D.N.Y. July 29, 2014) ("To the extent the Third Circuit has relieved the SEC of its initial burden to establish a causal connection between the profits and the violations when seeking disgorgement, this court disagrees and declines to follow *Teo*.").

[51] *See* 699 F.2d at 54–55 ("To call the additional profits made by the insider who held until the price went higher 'ill-gotten gains,' or 'unjust enrichment,' is merely to give a dog a bad name and hang him."). In *MacDonald*, the defendant had inside knowledge about a lucrative transaction about to be completed by a real estate company. *See id.* at 48–49. In advance of the deal closing, in 1975, he purchased 9,500 shares at $4.625/share. *Id.* After the deal was announced the stock price surged to

principles and temporally limited the defendant's liability to the period in which the full gain from the fraud was realized.[52] More recently, in 2004, in *SEC v. Happ*, the First Circuit emphasized the importance of proximate cause in estimating a reasonable measure of profits connected to wrongdoing.[53] The court reasoned that considerable attenuation of the causal connection—i.e. a lack of proximate cause—might invalidate the measure of disgorgement.[54] Similarly, the Ninth and Tenth Circuits have also applied notions of proximate cause to actions for disgorgement in SEC enforcement cases.[55]

III. The Case for Proximate Cause and How the Third Circuit Got It Wrong

In future SEC enforcement actions, the Third Circuit should reject its reasoning in *SEC v. Teo* and join the First, Second, Ninth, Tenth and D.C. Circuits in requiring a proximate connection between illegal activity and illicit profits.[56]

$5.50/share, and closed the year at $5.75/share. *See id.* The defendant eventually sold his shares in 1977 for $10/share. *Id.* The district court ordered the defendant to disgorge the entire profit realized from the sale, measured at $10/share. *See id.* at 52. On appeal, the First Circuit reversed. *Id.* at 55.

[52] *See id.* at 54. The First Circuit instructed that the defendant's profit be calculated using the price of the stock a reasonable time after the insider information was announced to the public. *See id.* at 55. The court's reasoning implies that disgorgement must be limited by proximate cause, even if a greater assessment would better serve the policy of deterrence. *See id.* at 54. Here, disregarding the amount of time between the dissemination of the information and when the defendant sold his shares impermissibly ignored an insufficient causal connection between the wrongdoing and the profits to be disgorged. *See id.*

[53] *See* 392 F.3d at 31–32. The defendant in *Happ* held shares in a company that was going through financial difficulty. *See id.* at 18. The company's Chief Financial Officer (CFO) contacted the defendant seeking advice, and mentioned that the company was having serious issues. *See id.* Shortly after being contacted by the CFO, the defendant sold all of his shares for $47,000. *See id.* Several weeks later the company's board issued a press release announcing the problems, which caused a sharp drop in the stock price. *See id.* Following a conviction for insider trading, the defendant was ordered to disgorge $34,758 in loss avoided. *See id.* at 19.

[54] *See id.* at 32. The court reasoned that there was a sufficient causal connection because the defendant's act of selling with knowledge of the financial problems directly enabled him to avoid the subsequent decline in stock price. *See id.* There was no evidence that anything other than the announcement of the financial problems caused the decline in stock price, which was exactly the information the defendant acted on. *See id.*

[55] *See Platforms Wireless*, 617 F.3d at 1096 (holding that SEC met its burden of reasonably approximating profits causally connected to wrongdoing and that there was no evidence that the SEC's approximation included anything which was not unjust profit); SEC v. Maxxon, Inc., 465 F.3d 1174, 1179 (10th Cir. 2006) (reasoning that a temporal limitation was necessary because disgorgement is not a punitive remedy). The Tenth Circuit's reasoning in *Maxxon* implies that a "reasonable approximation" takes into account temporal limitations associated with proximate cause principles. *See* 465 F.3d at 1179.

[56] *See* 746 F.3d 90, 107 (3d Cir.), *cert. denied* 135 S. Ct. 675 (2014) (holding that proximate cause is not an element of the SEC's burden and, if raised, is not dispositive); SEC v. Platforms Wireless Internet Corp., 617 F.3d 1072, 1096 (9th Cir. 2010) (adopting the causation analysis of the First, Second, and D.C. Circuits); SEC v. Maxxon Inc., 465 F.3d 1174, 1179 (10th Cir. 2006) (reasoning that limitations are necessary to avoid disgorging profits which are not proximately caused by a viola-

Disgorgement seeks to deprive a wrongdoer of their unjust gain.[57] Accordingly, the SEC must bear the burden to causally differentiate legally and illegally obtained profits.[58] A reasonable attempt must be made or else both just and unjust gains could be forfeited.[59]

First, the Third Circuit erred by glossing over the well-established principal that the SEC must set forth a *reasonable* approximation of profits causally connected to wrongdoing.[60] The court took this requirement to mean that the SEC must only show but-for cause, and that a lack of proximate cause is not dispositive.[61] This reasoning is problematic because it overlooks the possibility that an absence of proximate cause might make a proposed measure of profits inherently unreasonable.[62] It also increases the risk that disgorgement might become a penalty by including both illegal profits and subsequent proceeds.[63]

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tion); SEC v. Cavanagh, 445 F.3d 105, 116 n.25 (2d Cir. 2006) (stating that the amount of disgorgement cannot be more than the amount of money acquired by wrongdoing, because disgorgement is not a punitive remedy); SEC v. Happ, 392 F.3d 12, 31 (1st Cir. 2004) (holding that the amount of disgorgement is a reasonable approximation of profits causally connected to wrongdoing); SEC v. First City Fin. Corp., 890 F.2d 1215, 1231–32 (D.C. Cir. 1989) (noting that proceeds of illegally earned income may not be subject to disgorgement if there is a break in the causal chain); SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1104–05 (2d Cir. 1972) (holding that disgorgement of proceeds of illegal profit was not permissible and constituted a penalty assessment where portion of profits was not proximately caused by violation).

[57] *See Cavanagh*, 445 F.3d at 117; *First City*, 890 F.2d at 1230–31. The very act of depriving wrongdoers of their unjust gain deters future investors. *See Cavanagh*, 445 F.3d at 117.

[58] *See First City*, 890 F.2d at 1231. The D.C. Circuit's decision in *First City* (a case upon which many other circuits rely) implied that courts must weigh proximate cause when determining whether the SEC has satisfied its burden. *See id.*; *supra* note 5 and accompanying text (discussing the widespread acceptance of the D.C. Circuit's analysis). Failure to causally differentiate legal and illegal profits risks converting disgorgement into the impermissible imposition of a penalty. *See First City*, 890 F.2d at 1231 (reasoning that the SEC must make a causal differentiation because disgorgement may not be used punitively); *Manor Nursing*, 458 F.2d at 1104 (overturning disgorgement of proceeds because it constituted a penalty); *see also* SEC v. Contorinis, 743 F.3d 296, 306–07 (2d Cir. 2014) (distinguishing the equitable remedy of disgorgement from punitive criminal forfeiture).

[59] *See Maxxon*, 465 F.3d at 1179; *First City*, 890 F.2d at 1231. Though the causal analysis might result in ambiguity as to the *exact* measure of unjust gain, it is permissible to resolve that ambiguity against the wrongdoer. *See Happ*, 392 F.3d at 31; *First City*, 890 F.3d at 1232. However, the court is ultimately bound by the maximum amount of illicit gain, not simply its own discretion. *See Contorinis*, 743 F.3d at 306 (reasoning that disgorgement is constrained by the maximum amount of gain causally connected to wrongdoing, because the remedy seeks to deprive unjust gain but may not be used as a penalty).

[60] *Compare Teo*, 746 F.3d at 107 (stating that a reasonable approximation does not require a showing of proximate cause, in part because policy concerns weigh more heavily), *with Manor Nursing*, 458 F.2d at 1104 (reasoning that policy concerns do not justify ignoring a lack of proximate cause), *and* RESTATEMENT (THIRD) OF RESTITUTION § 51(5)(a) (2011) (requiring that profits to be disgorged not include unduly remote profits).

[61] *See Teo*, 746 F.3d at 107 (interpreting various authorities as indicating that a but-for cause standard satisfies the reasonable approximation requirement).

[62] *See Manor Nursing*, 458 F.2d at 1104 (reasoning that income earned on proceeds could not be disgorged because the income had no reasonable or justifiable connection to defendant's unjust gain); RESTATEMENT (THIRD) OF RESTITUTION § 51(5)(a) (2011) (stating that "[p]rofit includes any form of

Second, a close reading of the *Restatement (Third) of Restitution* suggests that the Third Circuit misinterpreted the *Restatement's* causation requirement.[64] The Third Circuit held that the "reasonable" requirement does not include proximate cause, in part based on its interpretation of the *Restatement*.[65] The *Restatement* makes clear that courts may apply tests of causation and remoteness as necessary to avoid converting disgorgement into a penalty.[66] The language suggests that proximate cause is a necessary tool to distinguish just and unjust gain.[67] The comments to the *Restatement* caution courts against relying too heavily on causation as a limiting factor for disgorgement, but this is only in recognition of the principal that not all causes are necessarily intervening.[68]

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use value, proceeds, or consequential gains . . . that is not . . . unduly remote"). The comments to the *Restatement (Third) of Restitution* illustrate the problem of disregarding proximate cause. *See* RESTATEMENT (THIRD) OF RESTITUTION § 53 cmt. d, illust. 8 (2011). Suppose an investor commits fraud that results in $1 million in profit. *See id.* The investor then uses the entirety of that money to purchase Blackacre. *See id.* Over the course of ten years the investor uses unrelated income to make improvements to Blackacre, such as building a home on the property, until ten years later the property is sold for $2 million. *See id.* Now suppose that of the $2 million, $1.5 million was for the value of the land and $500,000 for the value of the home. *See id.* It may be that the full $2 million cannot be disgorged because it stretches the outermost limits of but-for cause and includes profits that are unduly remote from the original wrongdoing. *See id.* § 53 cmt. d. Because only $1 million was proximately caused by the fraud, only that amount could be disgorged; any greater amount would be punitive. *See id.* (providing a similar example).

[63] *See Manor Nursing*, 458 F.2d at 1104 (reasoning that portion of defendants' proceeds were not causally connected to the wrongdoing and, if disgorged, would constitute an impermissible penalty). Even though the remedy is intended to prevent unjust gain, and even though the remedy is intended to deter future investors from violating securities laws, disgorgement becomes a penalty if the causal connection is too remote. *See First City*, 890 F.3d at 1231.

[64] *Compare Teo*, 746 F.3d at 106 (interpreting the *Restatement* to mean that proximate cause should be considered in light of policy and other considerations), *with* RESTATEMENT (THIRD) OF RESTITUTION § 51 (2011) (requiring that profit cannot be disgorged if it is unduly remote from wrongdoing or if it becomes a penalty assessment).

[65] *See Teo*, 746 F.3d at 106. The Third Circuit takes care to point out that the *Restatement* counsels applying tests of causation "as reason and fairness dictate," implying that policy considerations should be used to constrain the use of proximate cause. *See id.* at 106–07. However, the *Restatement* goes on to say that test of causation must be used in a manner consistent with the stated purpose of restitution. *See* RESTATEMENT (THIRD) OF RESTITUTION § 51(5) (2011). The stated purpose of restitution is to eliminate unjust gain, so far as possible, without imposing a penalty. *See id.* § 51(4).

[66] *See* RESTATEMENT (THIRD) OF RESTITUTION § 51(4)–(5) (2011). Moreover, "profit" as defined in the *Restatement* includes sources of gain that are measurable and not unduly remote. *See id.* § 51(5)(a).

[67] *See id.* § 51(4)–(5). Theoretically, if a wrongdoer's profit can include amounts which are unduly remote from the underlying wrong, and those amounts may not be disgorged, then the SEC has likely failed its burden under the *Restatement* of producing a reasonable approximation by including unduly remote profits in its calculation. *See id.* §§ 51(5), 53 cmt. d.

[68] *Compare First City*, 890 F.2d at 1232 (reasoning that intervening causes proposed by defendant did not sever the causal chain because they were too speculative), *with* RESTATEMENT (THIRD) OF RESTITUTION § 51 cmt. f (2011) (stating that in nearly every case it would be possible to identify additional causes for the defendant's unjust gain).

The SEC should be required to show proximate cause as a way of distinguishing just from unjust gains.[69] Even though proximate cause should be an element of the SEC's initial burden, it need not be an onerous burden.[70] The SEC must simply make a *reasonable* approximation.[71] So long as a court is weighing causal considerations, such as remoteness or attenuation, it would be doing enough to ensure that disgorgement is not being used punitively.[72] The Third Circuit simply failed to adequately weigh proximate cause and unnecessarily lowered the SEC's evidentiary burden.[73]

CONCLUSION

In enforcement actions by the SEC arising under the Securities Exchange Act, the SEC should bear the burden of showing proximate cause between illegal activity and unjust gain. To hold otherwise creates the undue risk that de-

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[69] *See First City*, 890 F.2d at 1231; RESTATEMENT (THIRD) OF RESTITUTION § 51(5) (2011). The SEC must make a causal distinction to avoid turning the remedy into a penalty. *See First City*, 890 F.2d at 1231.

[70] *See Happ*, 392 F.3d at 31–32 (reasoning that the SEC presumptively satisfied its burden by showing a change in stock price resulting from the public disclosure of insider information upon which the defendant had acted); *First City*, 890 F.2d at 1232 (reasoning that the SEC satisfied its burden by providing evidence of actual profits of the tainted transactions).

[71] *See Happ*, 392 F.3d at 31; *First City*, 890 F.2d at 1232. Suppose the SEC provided evidence, even if weak evidence, that a particular measure of profit was caused by the defendant's wrongdoing. *Cf. First City*, 890 F.2d at 1230–32 (suggesting that the SEC met its burden by placing a reasonable temporal limitation on its calculation on unjust gain); RESTATEMENT (THIRD) OF RESTITUTION § 51 cmt. f. (2011) (suggesting that a reasonable approximation of profits does not necessitate proving the definite and exclusive cause of the profit). For instance, the SEC could satisfy its evidentiary burden by establishing a timeframe during which illegal activity occurred. *Cf. Maxxon*, 465 F.3d at 1179 (reasoning that the evidentiary burden could be satisfied where "the end date chose results in a 'reasonable approximation' of profits"). If thereafter the defendant failed to produce additional evidence severing the causal chain, the court would be acting within its discretion to follow the SEC's estimation. *See Happ*, 392 F.3d 12, 32; *First City*, 890 F.2d at 1232.

[72] *See First City*, 890 F.2d at 1232 (considering the reasonableness of other possible causes compared to the SEC's approximation of profits); RESTATEMENT (THIRD) OF RESTITUTION § 51(4)–(5) (2011). Arguably, the reasoning applied by the district court in *Teo* actually achieves this result. *See* No. 2:04-cv-01815(SDW)(MCA), 2011 WL 4074085, at *7 (D.N.J. Sept. 12, 2011). The district court limited its measure of illegal profits to the period during which the illegal activity occurred. *See id.* Moreover, the court analyzed whether or not there were any intervening causes, but ultimately concluded that the suggested intervening causes were too speculative to destroy the causal connection. *See id.* at *6–7.

[73] *Compare Teo*, 746 F.3d at 107–08 (reasoning that a court must give greater weight to policy goals of disgorgement than the element of causation), *with* Brief for the Respondent in Opposition at 16–17, Teo v. SEC, 135 S. Ct. 675 (2014) (No. 14-00019), 2014 WL 5077238, at *16–17 (providing evidence that defendant's profits were the direct the result of the illegal activity). Arguably most telling, the SEC did not rely on the Third Circuit's reasoning in its argument in opposition to defendant's petition for a writ of certiorari. *See* Brief for the Respondent in Opposition, *supra*, at 16–17. The SEC argued, rather, that there was proximate cause between the defendant's illegal activity and the profits earned. *See id.* Specifically, the SEC contended that the purpose of the defendant's illegal scheme was the direct result that occurred— namely, obtaining illegal profits by selling stock at a profit. *See id.*

fendants will be overly punished for their actions by being forced to disgorge proceeds that are unduly remote. However, the SEC need not prove that the proposed cause is the exclusive cause, just that it is reasonable. The U.S. Court of Appeals for the Third Circuit's ruling in *SEC v. Teo* goes needlessly far in lowering the SEC's burden. Instead, courts should require a showing of proximate cause, while still retaining their equitable discretion to prevent unjust gain.

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