Client Alert

September 2014

SEC Concludes a Busy Week of Beneficial Ownership Enforcement

A series of recent enforcement cases initiated by the Securities and Exchange Commission (SEC) serve as stark reminders of the SEC's continued commitment to enforcing the beneficial ownership reporting rules under Section 13(d) and Section 16(a) of the Securities Exchange Act of 1934 (Exchange Act). The three sets of cases involved the SEC's first sweep investigation of beneficial ownership reporting and targeted dozens of public companies, officers, directors and significant shareholders (including both individuals and institutional investors) who failed to file beneficial ownership reports in a timely fashion. Several of the cases also involved antifraud charges, which are rare in the beneficial ownership reporting context. The cases are particularly notable because they:

- may signal increased enforcement focus on the SEC beneficial ownership rules;
- are the product of the SEC's new use of quantitative data analysis to identify suspicious behavior; and
- present an excellent opportunity for market participants to revisit their compliance procedures to prevent a repeat of the violations committed by the defendants here.

The cases are summarized below, and we conclude with some lessons learned from this unprecedented SEC enforcement initiative.

Overview of the SEC's Beneficial Ownership Reporting Rules

The rules governing beneficial ownership reporting are some of the most complex regulations promulgated by the SEC. These rules serve several purposes, including to provide greater transparency into ownership by significant stockholders and to prohibit certain behavior surrounding the ownership of public companies that Congress has deemed undesirable. The term "beneficial owner" is defined broadly under Exchange Act Rule 13d-3 to include "any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise" has or shares voting or investment power with respect to a registered equity security. More than one person may be a beneficial owner of the same securities. Beneficial ownership by an entity is ordinarily also attributable to any control person of that entity, including any parent company or principal.

Section 13(d) of the Exchange Act and the SEC's rules thereunder require any person or group who directly or indirectly acquires beneficial ownership of more than five percent of a class of equity securities registered under the Exchange Act to file with the SEC and provide to the issuer a statement disclosing certain information. [1] Typically, this information is disclosed on long-form Schedule 13D, which is due within 10 days after the first acquisition that crossed the five percent threshold. A reporting person must

[1] Under certain circumstances, a person may be deemed to beneficially own a security under the SEC's rules when that person has the right to acquire the security within 60 days, such as through ownership of an option or warrant exercisable within the 60-day period.

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amend a Schedule 13D "promptly" as material changes occur in disclosures previously made. An acquisition or disposition of 1 percent or more of a class of securities is deemed material by the SEC. The SEC has not formally defined what "promptly" means, but it has stated that any delay in filing beyond the date the filing reasonably can be made may not be prompt, and any delay beyond seven days is presumptively late.

Subject to certain exceptions, passive investors are typically permitted to file a short-form Schedule 13G in lieu of filing a Schedule 13D. Schedule 13G is also generally due within 10 days after the triggering acquisition. To be eligible to use the short form, a person must not have "acquired the securities with any purpose, or with the effect of, changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having that purpose or effect." Officers and directors of the subject company are not eligible to use Schedule 13G. A person filing a Schedule 13G generally must file an annual amendment within 45 days after the end of each calendar year if there are any changes in the information reported in the previous filing on that Schedule. A filer must also amend the Schedule 13G "promptly" upon acquiring beneficial ownership of more than 10 percent of a registered class of equity securities and must thereafter promptly amend the Schedule 13G upon increasing or decreasing its beneficial ownership by more than 5 percent of the class. A Schedule 13G filer must switch to Schedule 13D within 10 days after beneficial ownership first equals or exceeds 20 percent of the class and is prohibited from voting or acquiring additional securities of the class until 10 days after the Schedule 13D is filed.

Section 16(a) of the Exchange Act and the SEC's rules thereunder require officers and directors of a company with a registered class of equity securities, and any person or group that has beneficial ownership of more than 10 percent of such class, to file additional reports of securities holdings and transactions. The initial Form 3 is due within 10 days after becoming an insider and must disclose beneficial ownership of all securities of the issuer. Insiders must file Form 4 reports disclosing transactions resulting in a change in beneficial ownership within two business days following the execution date of the transaction, except for limited types of transactions eligible for deferred reporting on Form 5. In addition, insiders are required to file on Form 5 within 45 days after the issuer's fiscal year-end to report any transactions or holdings that should have been, but were not, reported on Form 3 or 4 during the issuer's most recent fiscal year and any transactions eligible for deferred reporting. Though not the subject of any of the recent enforcement cases, Section 16(b) of the Exchange Act requires insiders to disgorge "short swing" profits on certain purchases and sales made within six months of one another.

Notably, there is no state of mind requirement for violations of the reporting rules under Sections 13(d) and 16(a). Thus, the SEC is not required to prove knowledge, recklessness or even negligence on the part of the reporting person. The failure to file a required report on time, even if inadvertent or accidental, constitutes a violation of the SEC's rules.

Beneficial Ownership Sweep

In the first-ever sweep investigation of beneficial ownership reporting, on September 10, 2014, the SEC charged a total of 34 public companies, executive officers, directors and significant shareholders of public companies.[2] The defendants included 13 individual officers and directors, five individual 5 percent owners, six public companies, nine prominent asset managers and one money-center bank. The individual defendants and institutional investors were charged with making late filings under Section 13(d) and Section 16(a) or, in some cases, failing to make required filings at all. In some instances, the filings were only a few days late; others were late by months, weeks or even years. In bringing the charges, the SEC noted it had used sophisticated computer algorithms and quantitative data sources to identify the defendants.

[2] The SEC's charges are summarized in Press Release 2014-190 (Sept. 10, 2014), which hyperlinks to each of the underlying cases.

As to the six public companies, the SEC brought a mixture of charges. One of the companies was charged with making inaccurate disclosures under Item 405 of Regulation S-K in the company's annual report and proxy statement by misreporting the number of late insider Section 16(a) reports.[3] As to a second company, the SEC charged that because the company had undertaken the responsibility to file Section 16 reports on behalf of officers and directors, and because the company was negligent in meeting that obligation, the company was a "cause" of its insiders' Section 16(a) violations. [4] Four of the companies were charged both with Item 405 disclosure violations and causing Section 16(a) violations by their officers and directors as a result of their negligence in performing certain tasks they voluntarily agreed to undertake in connection with the filing of Section 16(a) reports on behalf of those insiders.

Of this group of 34 defendants, all but one settled to administrative charges and agreed to cease and desist from future violations. Each of the settling defendants also agreed to pay penalties ranging from $25,000 to $150,000 for a total of $2.6 million in penalties payable to the SEC.

Antifraud Case

On September 10, 2014, the SEC also brought charges against an individual who formerly served as the joint CEO, CFO and chairman of a biotech company. The SEC also charged the company itself.[5] Like the preceding cases, the former CEO was responsible for a number of late or missed Section 16(a) reports. Perhaps because of the widespread nature of the violations, the SEC also sought antifraud charges against both the CEO and the company.

According to the SEC, the CEO filed four Forms 4 that were each between 10 and 69 days late during 2011. In 2012, he filed two Forms 4, both six days late. Between February 2011 and January 2013, the CEO also failed to file the requisite Section 16(a) reports regarding sales on 27 separate trading days. During this period, he sold more than 66 percent of his holdings in company stock in undisclosed transactions. On April 15, 2013, the CEO finally reported those 27 transactions in a catch-up Form 4.

In its fiscal year 2011 Form 10-K filed on March 17, 2012, the company stated that "To the Company's knowledge, based solely on its review of the copies of such reports received or written representations from certain Reporting Persons that no other reports were required, the Company believes that during its fiscal year ended December 31, 2011, all Reporting Persons timely complied with all applicable filing requirements, except that Form 3s [sic] were not timely filed for [three new directors] and have since been filed." The company filed its 2012 Proxy Statement containing identical language in March 2012.

The SEC determined that the statement in the fiscal year 2011 Form 10-K and the 2012 Proxy Statement was false and misleading for at least two reasons. First, the CEO had filed four untimely Forms 4 during 2011, and he also sold company stock 12 times in 2011 without filing the reports required under Section 16(a). Second, contrary to the implication of the statement, the company neither sought nor obtained "written representations from certain Reporting Persons that no other reports were required." According to the SEC, the company thus did not comply with its disclosure obligations under Item 405 of Regulation S-K, which required it to disclose all of the CEO's late Forms 4 and his missing Form 5 (in the absence of a

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[3] Item 405 requires an issuer to disclose any known late filing or failure by an insider to file a report required by Section 16(a) based on the issuer's review of Forms 3 and 4 filed during the most recent fiscal year, and Forms 5 filed with respect to the most recent fiscal year, by the issuer's insiders.

[4] To establish "causing" liability in an administrative action, the SEC must generally demonstrate: (i) the existence of a primary violation of the securities laws; (ii) that the defendant to be held secondarily liable was, through an action or omission, a cause of the primary violation; and (iii) that the defendant knew or should have known that its conduct would contribute to the primary violation. Unlike aiding and abetting liability that requires a showing of recklessness or knowledge, causing liability can be based on a showing of mere negligence.

[5] See Release No. 33-9644 (Sept. 10, 2014) and Release No. 33-9645 (Sept. 10, 2014).

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written representation by the CEO that no Form 5 was required). The company filed the 2012 Proxy Statement containing identical language in March 2012, which suffered from similar deficiencies.

The company made similar misstatements in its fiscal year 2012 Form 10-K. On March 7, 2013, it filed its fiscal year 2012 Form 10-K, which stated that during the fiscal year ended December 31, 2012, the former CEO "filed Forms 4 late with respect to four transactions," but did not disclose that he had not reported trading in company stock on 14 other trading days in 2012.

The SEC's order found that the CEO's sales would have been viewed by a reasonable investor as significantly altering the total mix of available information about the company given his executive position as well as the size and frequency of his sales of the company's stock. The SEC found that the CEO and the company both violated the antifraud provisions of the securities laws by failing to file reports of these transactions and holdings in a timely and accurate manner. The former CEO agreed to settle the SEC's charges by paying a $175,000 penalty. The company agreed to pay a $375,000 penalty and retain an independent consultant to conduct a review of its Section 16(a) reporting and compliance procedures. They neither admitted nor denied the SEC's findings while consenting to orders that charge the company with violations of Sections 17(a)(2) of the Securities Act of 1933 (Securities Act) and Sections 13(a) and 14(a) of the Exchange Act as well as Rules 12b-20, 13a-1 and 14a-9, and charge the former CEO with violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act and Sections 14(a) and 16(a) of the Exchange Act as well as Rules 14a-9 and 16a-3. The former CEO also consented to an order charging him with causing the company's violations of Exchange Act Section 13(a) as well as Rules 12b-20 and 13a-1.

Offshore Holding Company

On September 9, 2014, the SEC filed suit against two individuals managing an offshore business that the SEC alleges was operated to help clients evade Section 13(d) reporting obligations concerning the ownership of certain microcap stocks as part of a larger money laundering scheme.[6] According to the SEC's complaint, two Belizean residents and their holding company are alleged to have facilitated arrangements through which their clients could conceal their ownership and spread their shares across numerous shell companies so that none of them contained more than 5 percent of the stock of any particular microcap issuer, each in an effort to evade Section 13(d) reporting.

The SEC alleges that the defendants stressed to their clients the importance of staying below the 5 percent reporting threshold for each associated entity. Because one of the principals and the holding company owned the shell companies used in this arrangement, the SEC asserts they assumed beneficial ownership of all the clients' shares of these microcap stocks. Therefore, the SEC alleges that the principal and his holding company were themselves required to report their beneficial ownership of more than 5 percent in each stock.

The SEC's complaint charges one of the principals and the holding company with repeated failures to make required filings of Schedules 13G and 13D, thus violating Section 13 of the Exchange Act and the SEC's rules. The other principal is charged with aiding and abetting those violations. The SEC's complaint seeks monetary relief and permanent injunctions against the holding company and both principals. Criminal authorities separately brought additional charges against the two principals. Though based on an entirely different set of facts, the SEC's long-running litigation against the billionaire Wyly brothers is also premised on the use of a complex network of offshore trusts and holding companies allegedly to evade beneficial ownership reporting.[7]

[6] See plaintiff's original complaint, *SEC v. Bandfield, et al.*, Case No. 1:14-cv-05271 (E.D.N.Y. Sept. 9, 2009).

[7] See Litigation Release No. 21607 (July 29, 2010).

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Some Lessons Learned

SEC enforcement actions for stand-alone violations of Section 13(d) or Section 16(a) are, for the most part, relatively rare. Though there is an active private plaintiff's bar that seeks to enforce Section 16(b) short-swing profits violations because case law permits plaintiff's counsel to recover attorneys' fees, the SEC has in the past generally focused its enforcement efforts involving beneficial ownership reporting on cases involving public offerings of securities, change-in-control transactions or where there are separate allegations of securities fraud. The recent cases are likely part of the "broken windows" enforcement strategy announced by SEC Chair Mary Jo White in which, in her words, "even the smallest infractions" will be pursued. These cases may also signal an increased enforcement focus on the SEC's beneficial ownership reporting rules even when other aggravating factors are not present.

The SEC's investigations were largely developed through the use of quantitative analytic devices. It is surprising to many observers that until recently the SEC lacked the analytical tools to conduct broad searches across large quantities of data in its own EDGAR database. Today, however, the SEC's enforcement division is becoming increasingly sophisticated in its use of quantitative analysis, and the agency as a whole has devoted greater resources to the development of algorithmic tools to cull through the substantial volume of EDGAR and other filings the SEC receives on a daily basis.

Companies, investors and executives should expect to see more enforcement cases predicated on quantitative analysis in the future. In particular, the XBRL-tagged financial data that public companies are now required to file with the SEC presents a treasure trove of information that easily lends itself to algorithmic analysis as the SEC pursues its publicly stated goal of bringing more enforcement cases based on aberrational financial performance and accounting irregularities. Perhaps coincidentally, on September 11, 2014, the SEC announced the creation of a new office within its Division of Economic and Risk Analysis that will coordinate efforts to provide data-driven risk assessment tools and modeling. According to the SEC, the new office will continue to develop and use predictive analytics to support supervisory, surveillance and investigative programs involving corporate issuers, broker-dealers, investment advisers, exchanges and trading platforms.

In several of the cases discussed above, public companies were charged for failing to make timely filings on behalf of insiders or failing to report an insider's filing deficiencies. In one of these cases, the SEC took the position that these deficiencies rendered the company's proxy statement materially misleading and subject to antifraud charges. Most public companies routinely file Section 16 reports on behalf of their officers and directors, and these cases highlight the importance for public companies of having disclosure controls and procedures that are tailored to capture and report appropriate beneficial ownership information in a timely fashion.

Although the two-business-day reporting rule for Forms 4 has been in place since 2002, some officers and directors of public companies still struggle to report trading information to reporting personnel on time. In many cases, the delay is due to the fact that trading information must flow from brokers through numerous intermediaries (such as financial advisers, personal accountants and personal lawyers) to the reporting person and then on to the public company. The increased use of Rule 10b5-1 trading plans may also present challenges to timely reporting if appropriate procedures are not in place. Further, some public companies only poll officers and directors on security ownership annually as part of the preparation of the Form 10-K and proxy statement. Now is a good time for public companies to revisit procedures for tracking beneficial ownership and explore where they may be streamlined or improved.

For asset managers and institutional investors, the cases underscore the importance of maintaining robust compliance systems that track public company investments and ensure that appropriate SEC reports describing those investments are made on a timely basis. The failure of asset managers to make timely Section 13 and Section 16 filings also presents certain risks that go beyond potential SEC enforcement of the Exchange Act's rules. For example, SEC-registered investment advisers are required to implement compliance policies and procedures that are reasonably designed to prevent violations of federal securities laws and such procedures typically address reporting of beneficial ownership to the

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SEC. Any failure to do so would result in a violation of their internal compliance program. Further, SEC-registered advisers are required to report on their Form ADV any violations of the federal securities laws, even minor violations that result in only monetary fines. Those documents are publicly available and are often reviewed by prospective investors in connection with deciding to invest with asset managers. Again, it is critical to ensure that systems and procedures are in place by which brokers, trading desks and other personnel with discretionary trading authority are required to report holdings to compliance personnel so that appropriate SEC reports may be prepared and filed on a timely basis. Likewise, trading personnel should be trained in the basic SEC reporting principles and the use of internal compliance systems to track reportable trades.

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