SEC Continues Its "Strict Liability" Enforcement Campaigns, Focusing on Filing Failures and Rule 105 Violations

Written by Paul Bork

September 17, 2014

Nearly five years ago, the SEC launched an extensive "crackdown" on violations of Rule 105 of Regulation M, which prohibits short selling securities and then participating in secondary offerings of the same securities within certain periods (typically, five business days). Since then, the Enforcement Division has brought about 70 actions against firms and individuals who inadvertently violated Rule 105, and it has collected nearly $50MM in disgorgement, interest and penalties. The SEC has emphasized that Rule 105 is a "strict liability" regulation, meaning a person need not act with *scienter* to run afoul of the law. In late 2013, Chairman Mary Jo White highlighted the Rule 105 initiative as an important opportunity to advance the SEC's "broken windows" philosophy that no violations are too small to warrant attention and that minor violations, if ignored, encourage more serious frauds. Yesterday, the SEC announced the most recent wave of Rule 105 actions, involving 19 firms and individuals and netting $9MM. (**Click here** for previous alert on Rule 105.)

In addition, this past week, the SEC launched another, similar enforcement campaign, which also reflects the "broken windows" approach to investor protection. The new initiative is focused on two types of ownership reports; specifically, the SEC has turned its attention to Forms 3, 4 and 5 and Schedules 13D and 13G, which "give investors the opportunity to evaluate whether the holdings and transactions of company insiders could be indicative of the company's future prospects." In its press release, the SEC has explained that these reporting requirements "apply irrespective of profits or a person's reasons for acquiring holdings or engaging in transactions," and therefore, "[t]he failure to timely file a required beneficial ownership report, even if inadvertent, constitutes a violation of these rules." Put another way, like Rule 105, Section 16(a) and Sections 13(d) and (g) impose strict liability for violations. Enforcement Division Director Andrew Ceresney has cautioned that "[o]fficers, directors, major shareholders and issuers should all take note: inadvertence is no defense to filing violations" and that the SEC "will vigorously police these sorts of violations through streamlined actions."

According to the SEC, the requirement to file these reports was "motivated by a belief that the most potent weapon against the abuse of inside information is full and prompt publicity" of transactions by insiders, and the reports themselves "allow[] shareholders and potential investors to evaluate changes in substantial shareholdings."

- Forms 3, 4 and 5 report changes in beneficial ownership: Form 3 is the initial statement; Form 4 reports any change in ownership (e.g., purchases, sales or derivative transactions); and Form 5 is an annual report covering transactions not otherwise reported. They must be filed by an officer or director in a public company or a beneficial owner of 10% or more of any class of voting stock in the company. The forms must be filed electronically with the SEC, on the EDGAR system, within two business days of the relevant transactions.
- Schedules 13D and 13G, which report "beneficial ownership," are used to disclose information about the holdings and intentions of major shareholders in public companies. They must be filed when a person or group of persons acquires beneficial ownership of more than 5% of a voting class of stock in a company's equity securities registered under Section 12, and must be updated in connection with material changes to the disclosures, including changes of ownership of more than 1%. The initial filings on Schedules 13D and 13G must be made within 10 days of when the 5% ownership threshold was exceeded. In addition to basic information about the transactions, filers must also disclose the source of funds, the purpose of their purchases or sales, and any intentions to affect changes of control of the company or to influence management. Schedule 13G is viewed as a "short form," and its use is limited to typical "passive" investors like mutual funds.

This new enforcement initiative presents serious risks for officers, directors, major beneficial owners, issuers and advisors. By using advanced data analytics and combing its own records, the SEC is increasingly able to determine whether required reports were filed on time, filed late, or never filed at all. Further, if the SEC concludes that a violation has occurred and brings an enforcement action, the person or entity who broke the rules will not be able to excuse that oversight as a good faith mistake or harmless technical failure. In addition, these enforcement actions are brought as administrative proceedings before administrative law judges at the SEC. So certain protections available in the federal court, such as the opportunity to take broad discovery or the right to have a jury trial, are absent.

Notably, of the 34 enforcement actions that the SEC brought concerning violations of Section 16(a) and Sections 13(d) and (g), 33 respondents settled the charges and agreed to pay civil money penalties ranging from $25,000 to $150,000. Officers, directors and owners can be sanctioned for not filing reports about their transactions. *See, e.g., Stephen Gans*, AP File No. 3-16058. Issuers themselves can face penalties for contributing to filing failures and for failing to report delinquent filings by insiders in annual proxy statements. *See, e.g., KMG Chemicals*, AP File No. 3-16080. Finally, investment advisers may be caught up in this latest enforcement campaign if they fail to file reports on behalf of the funds for which they manage assets. *See, e.g., Brown Brothers Harriman & Co.*, AP File No. 3-16076.

The Rule 105 initiative has lasted almost five years, and the enforcement campaign to police filing violations of reporting requirements could have a similar lifecycle, with various waves of settlements based on a standard framework and comparable penalties. It is critical, therefore, that officers, directors, significant beneficial owners, issuers and advisers continue to ensure rigorous compliance to avoid even minor violations which may lead to enforcement actions.

RELATED PRACTICES

- Securities Litigation
- White Collar Crime & Government Investigations
- Capital Markets
- Business Counseling
- Litigation
