Court Finds Securities Rules Must Be Clear to Impose Liability

By**: Craig S. Warkol & John C. Lehman**

February 16, 2012

A federal district judge refused to impose liability on an investment adviser to a hedge fund and its CEO in an SEC enforcement action because the conduct was not clearly identified as being impermissible. The court also ruled that the Supreme Court's recent holding in *Janus Capital Group, Inc., et al, v. First Derivative Traders,*[1] which limited primary liability to "makers" of misstatements, only applies to private suits alleging material misstatements and not SEC enforcement actions.

On February 14, 2012, Judge Robert Sweet issued an opinion in *Securities and Exchange Commission v. Pentagon Capital Management PLC and Lewis Chester*, 08 Civ. 3324 (S.D.N.Y), one of the last remaining late trading and market timing cases. The court found that U.K.-based hedge fund investment adviser Pentagon, and its CEO Chester, violated the antifraud provisions of the federal securities laws by engaging in a scheme with one of their broker-dealers, Trautman Wasserman & Co., Inc., to deceive mutual funds by engaging in late trading.

Late trading is the practice of placing orders to buy or sell mutual fund shares after the mandated 4:00 pm cut-off order time while making it appear to the mutual funds as though the order was placed before the cut-off order time. The court ordered the defendants to disgorge $38.4 million and to pay an additional $38.4 million as a penalty. Significantly however, the court ruled that Pentagon and Chester did not violate the antifraud provisions by engaging in deceptive mutual fund market timing, a trading strategy premised on the rapid buying and selling of mutual fund shares to exploit short-term pricing inefficiencies, because market timing is not *per se* illegal.

The Regulations or Policies Must Be Clear

The court based its decision that Pentagon and Chester did not violate the antifraud provisions by engaging in market timing based on the SEC's failure to establish at trial that market timing regulations and policies were sufficiently clear prior to September 2003 when the defendants ceased trading in the U.S. The SEC has never enacted a regulation that explicitly prohibits the practice of market timing mutual funds.

Similarly, the court found that the SEC did not prove that at any given instant Pentagon and Chester knew or should have known that they engaged in a transaction that violated specific market timing policies that were clearly articulated in a mutual fund's prospectus or the manner in which these policies were enforced, only that the defendants generally sought to outwit the mutual funds. Absent an explicit regulation or clear policies or practices, the defendants did not violate the antifraud provisions by market timing, and to allow such would "further raise due process concerns, upsetting the basic notion that individuals have fair notice of the standards under which they may be held liable."

Clarifying the Scope of *Janus*

The Supreme Court recently ruled in *Janus* that only persons who "make" a misstatement by exerting ultimate authority over it can be held primarily liable under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 threunder. Judge Sweet rejected the defendants' argument that under *Janus* only the broker-dealer, not Pentagon and Chester, could be held primarily liable for the alleged late trading conduct, since it was the broker-dealer who made the misstatements to mutual funds when it placed the defendants' post 4:00 pm orders. Judge Sweet held that:

1. *Janus* does not apply to SEC enforcement actions, only to private suits, and
2. *Janus* only applies to cases brought under a misstatement theory, unlike the present case, which was premised on scheme liability.

The court also rejected the defendants' argument that *Janus* applies to actions brought under Section 17(a) of the Securities Act of 1933, as the word "make" which was the term the Supreme Court interpreted in *Janus* is absent from the operative language of the statute.

---

[1] 131 S. Ct. 2296 (2011).