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SEC Charges Issuers, Corporate Insiders, and Other Significant Investors for Violating Laws Requiring Reporting of Transactions in Company Stock

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On September 10, 2014, the U.S. Securities and Exchange Commission announced settlements with officers, directors, and significant shareholders for violating federal securities laws requiring information about their transactions in company stock. In addition, publicly-traded companies settled charges with the SEC for contributing to filing failures by insiders and failing to report their insiders' filing delinquencies. Notable for its departure from the SEC's previous practice of generally bringing such charges only in cases in which insiders were also being charged with other violations, these actions signal increased attention by the SEC on the compliance obligations of insiders and large shareholders of reporting companies. In addition, the actions send a strong message to insiders that any defenses they may rely upon regarding the untimely reporting of holdings or transactions in company stock may not be sufficient to prevent them from being subject to an action against them by the SEC and the imposition of a substantial monetary penalty.

SETTLEMENTS BY INSIDERS

The SEC charged public company insiders with violations of the federal securities laws, specifically violations of Sections 16(a), 13(d) and 13(g) of the Securities Exchange Act of 1934, as amended ("Exchange Act").

Legal Framework

In those actions, the SEC set forth the underlying legal framework for Section 16(a) of the Exchange Act:

- Every person who is the beneficial owner of more than 10 percent of any class of equity security registered under Section 12 of the Exchange Act (which we refer to herein as "equity securities"), and any officer or director of the issuer of any such security (collectively, "insiders"), must comply with the requirements of Section 16(a) of the Exchange Act.
- Section 16(a) and the rules promulgated thereunder require insiders to file initial statements of holdings on Form 3.
- Insiders must keep their holdings disclosures current by reporting transactions on Form 4 within two business days following the execution date of the transaction.
- Insiders are required to file an annual statement 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. Form 5 may also be filed as part of a deferred reporting process.

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Similar to Section 16(a), Sections 13(d) and 13(g) also require certain disclosures regarding securities holdings:

- Sections 13(d) and 13(g) of the Exchange Act address "beneficial ownership," which is defined broadly 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 an equity security.
- Beneficial ownership by an entity is often also attributable to a control person of an entity and any parent company in a control relationship with such entity.
- Any person or group who directly or indirectly acquires beneficial ownership of more than five percent of an equity security must comply with the requirements of Section 13(d) of the Exchange Act.
- Section 13(d) requires beneficial owners to file a statement on Schedule 13D with the Commission disclosing certain information relating to such beneficial ownership within 10 days after such acquisition.
- Amendments to Schedule 13D disclosing "material changes" to the disclosure previously made must occur promptly. An acquisition or disposition of one percent or more of a class of securities is deemed "material" for purposes of Section 13(d).
- Beneficial owners subject to Section 13(d) may use the short-form beneficial ownership statement on Schedule 13G under certain conditions.
- In lieu of filing a Schedule 13D, a person subject to Section 13(d) may file a short-form statement on Schedule 13G within 10 days after crossing the five percent ownership threshold if the person "has not 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," and is not directly or indirectly the beneficial owner of 20 percent or more of the class of securities. Such persons are referred to as "passive investors."
- A beneficial owner filing a Schedule 13G must file an annual amendment within 45 days after the year-end of each calendar year if there are any changes in the information reported in the previous filing on that Schedule, unless certain limited exceptions apply.
- In addition to annual amendments, a Schedule 13G filer must also amend the Schedule 13G promptly upon acquiring beneficial ownership of greater than 10 percent of a class of securities and must thereafter promptly amend the Schedule 13G upon increasing or decreasing its beneficial ownership by more than five percent of the class.
- Advisers and brokers who exercise investment discretion over accounts that hold equity securities may be required to file acquisition and ownership reports with the SEC.

Description of Settlements

The SEC's cases naming company insiders included cease-and-desist proceedings against officers, directors, and major shareholders. Such officers included CEOs, CFOs, Presidents, General Counsels, and Vice

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Presidents. Major shareholders charged were individuals, registered investment advisors, and entities providing investment management services to investment vehicles. The charges against these company insiders revealed significant delinquencies in terms of filing the required Forms 4, Forms 5, Schedules 13D, Schedules 13G, or applicable amendments.

The details of each case and the degree of non-compliance with the beneficial ownership reporting requirements varied significantly. For example, insiders were charged with the untimely filing of between nine and 70 Forms 4 and 5, with an average number of 30 untimely filings. Regarding the degree of untimeliness, Forms 4 were generally filed approximately six months late in the cases brought by the SEC, but some forms were filed up to four years late. Late-reported transactions had aggregate market values of between $1 million and $182 million. The SEC proceedings also addressed several instances in which beneficial owners failed to file required amendments to Schedules 13D and 13G disclosing changes in beneficial ownership.

For corporate insiders settling these violations with the SEC, monetary penalties ranged from $25,000 to $120,000, with the average penalty being just over $72,000 among the 28 insiders. Larger penalties—ranging from $60,000 and up—were associated with a greater number of missing reports (for example, 25 untimely beneficial ownership reports being filed) and/or extreme untimeliness in filing (for example, filing a required report three years late).

Unsuccessful Defenses

Officers and directors charged with violations of Sections 16(a), 13(d), and 13(g) of the Exchange Act by the SEC often claimed that the violations were the result of the failure of their publicly-traded issuer employer to file beneficial ownership reports and required amendments on their behalf. In turn, their publicly-traded issuer employer often blamed such violations on lack of internal staffing or the late receipt of necessary information from the corporate insider. The major shareholders charged by the SEC indicated that the violations were the result of the failure of outside counsel to correctly advise them on their reporting obligations.

When such defenses were brought by corporate insiders, the SEC noted in the cease-and-desist orders that reliance on an employer, outside personnel, or counsel to make the required beneficial ownership filings or provide correct advice does not excuse the charged violations, as an insider retains legal responsibility for compliance with the filing requirements.

Such defenses proved unpersuasive to the SEC and ultimately unsuccessful to the charged insiders because there is no state of mind requirement for violations of Sections 16(a) and 13(d) and the rules thereunder. The failure to timely file a required report, even if inadvertent, constitutes a violation.

SETTLEMENTS BY COMPANIES

Item 405 Disclosure Cases—Legal Framework

In addition to the actions brought against executives and investors, the SEC brought actions against six companies in connection with Section 16 matters. In those actions, the SEC set forth the underlying legal framework:

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- Reporting companies are subject to the disclosure requirements of Item 405 of Regulation S-K.
- Item 405 requires an issuer to disclose any known late filing or failure by an insider to file a Section 16(a) report in its Form 10-K.
- Item 405 requires an issuer to identify by name each insider who failed to file a Section 16(a) report on a timely basis during the most recent fiscal year or prior fiscal years and set forth the number of late reports, the number of late-reported transactions, and any known failure to file.
- The Item 405 disclosures are to be based on the issuer's review of insiders' Forms 3 and 4 filed during the most recent fiscal year, and Forms 5 filed with respect to the most recent fiscal year.
- A "known" failure to file includes, but is not limited to, a failure to file a Form 3 and a failure to file a Form 5 in the absence of a written representation that no Form 5 is required, unless the issuer otherwise knows that no Form 5 is required.
- An issuer does not have an obligation under Item 405 to research or make inquiries regarding delinquent Section 16(a) filings beyond the review specified in Item 405.
- Inaccurate or incomplete Item 405 disclosures may constitute a violation of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder, and no showing of scienter is necessary to establish a violation of Section 13(a).

Description of Item 405 Settlements

In a series of settlements, the SEC issued cease-and-desist orders against, and collected fines from, reporting companies for misstatements in, and failures to include, the required Item 405 disclosures. The misstatements and omissions were violations of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder. In each matter, the SEC noted that the reporting company "was required to review the forms filed and identify by name each such insider who failed to file on a timely basis and set forth the number of late reports and the number of transactions that were not reported on a timely basis." Further, the SEC listed the annual disclosures by each company and then stated the facts which showed the inaccuracy of those disclosures. For example, the settlements noted the following improper disclosures in response to Item 405:

- "Based solely upon a review of such reports and amendments thereto furnished to us and upon written representations of certain of such persons regarding their ownership of Common Stock, we believe that no person failed to file any such report on a timely basis during 2010, except that within the required two business day reporting requirement imposed by the SEC, the Company did not timely file one Form 4 report for [Section 16 Officer] with respect to the sale of 55 shares for which he has indirect beneficial ownership." The SEC noted that, during the fiscal years described in the disclosure, all of the company's officers and directors filed untimely Forms 4.
- "Based solely on a review of Forms 3, 4, and 5 and amendments thereto furnished to us, we know of no failure in Section 16(a) beneficial ownership reporting compliance except that through inadvertence certain

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directors or executives filed late." The SEC noted that, during each of the fiscal years described in the disclosure, there were multiple failures by insiders to file reports on a timely basis.

- "During the fiscal year ended December 31, 201[X], our Directors, executive officers and holders of more than ten percent of our common stock complied with all applicable Section 16(a) filing requirements." The SEC noted that, during each of the fiscal years described in the disclosure, there were multiple failures by insiders to file reports on a timely basis.
- "All Section 16(a) filing requirements applicable to its Directors, executive officers and greater than 10 percent beneficial owners were complied with for the most recent fiscal year." The SEC noted that, during each of the fiscal years described in the disclosure, the company's principal accounting officer failed to file required Section 16(a) reports. The company later disclosed that the principal accounting officer had not filed those reports, stating that "because the Company failed to timely advise [the principal accounting officer] that he was subject to the reporting requirements of Section 16 in his position as chief accounting officer.
- "All officers, directors and 10% beneficial owners, known to the Company, had timely filed required forms reporting beneficial ownership of Company securities, based solely on review of Filed Forms 3 and 4 furnished to the Company." The SEC noted that, during each of the fiscal years described in the disclosure, there were multiple failures by insiders to file reports on a timely basis.

Description of Section 16 Settlements

In bringing actions against public companies for causing violations of Section 16(a) by their insiders, the SEC noted that—while it encourages issuers to assist insiders in complying with Section 16(a) filing requirements—companies that voluntarily accept certain responsibilities and then act negligently in the performance of those tasks may be liable for causing Section 16(a) violations by insiders. In each matter, the SEC noted that the company had voluntarily agreed with its insiders to perform certain tasks in connection with the filing of Section 16(a) reports on their behalf, including the preparation and filing of all such reports. After noting that the companies had received the required information in a timely manner, the SEC stated that company personnel responsible for tasks relating to the preparation and filing of Section 16(a) reports repeatedly failed to perform on a timely basis the tasks the company had agreed to perform. The number of untimely filings ranged from 35 untimely filings over three years to 75 untimely filings in a single year. The amount of the fines in these matters ranged from $75,000 to $150,000.

FRAUD SETTLEMENTS

The SEC's charging of a publicly-traded issuer and corporate insiders for violations of Section 16(a) of the Exchange Act in separately announced settlements demonstrates the SEC's focus on these activities and the potential for fraud charges if these violations continue.

The SEC charged a biotech company and its former CEO with defrauding investors by failing to report his sales of company stock. Given the CEO's failure to file initial and annual beneficial ownership reports on Forms 3 and 5, respectively, the degree of untimeliness of the filing of several Forms 4 (up to 26 months late), and the significant value of the late-reported sales, the SEC order found that the CEO's "sales would have been viewed by a

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reasonable investor as significantly altering the total mix of available information given, among other things, his position as CEO, the frequency with which he was selling [company] stock, and the size of his sales." Due to his conduct, the CEO was charged with violating Section 16(a) of the Exchange Act, as well as various federal securities law provisions relating to committing fraud upon investors as a result of the CEO's certification of annual reports and signing of a proxy statement, which all included material misstatements regarding his compliance with Section 16(a) of the Exchange Act.

Related to the CEO's violations of Section 16(a), the issuer was charged with failing to provide the disclosures required by Item 405 of Regulation S-K in annual reports, in violation of Section 13(a) of the Exchange Act, and with various federal securities law provisions relating to committing fraud upon investors as a result of such action.

Both the publicly-traded issuer and its former CEO settled with the SEC, and agreed to the imposition of significant monetary penalties, in the amounts of $175,000 for the CEO and $375,000 for the issuer.

KEY OBSERVATIONS AND CONSIDERATIONS

The actions undertaken by the SEC as discussed above give rise to a number of important observations, as well as considerations for insiders, investors, and public companies.

- Public companies almost universally assist their officers and directors with the filing of Section 16 reports. Although the filing obligation ultimately rests with the individuals, the SEC actions make clear that public companies who undertake to assist their insiders with Section 16 obligations will also be held responsible for significant failures in Section 16 compliance. Accordingly, public companies must maintain a robust compliance system reasonably designed to avoid late or missed Section 16 filings.

- Likewise, the SEC actions make clear that insiders cannot rely solely on their public companies or counsel for compliance with Section 16; they must understand their reporting obligations. Periodic reminders and training are important to keep these compliance obligations front of mind. (We also recommend that companies provide a short summary of the SEC's actions to their directors and officers as enforcement actions often make good "teaching moments.")

- It is very common for public companies to include in their Item 405 disclosure language that the disclosures are "based solely on a review of Forms 3, 4, and 5, and amendments thereto furnished to us." It is clear from several of the actions that the companies actually did not review the forms, or that the individual reviewing the forms was unfamiliar with the legal requirements underlying them. As with other disclosures in a company's periodic reports, there should be a procedure that covers this review and an appropriately trained individual should undertake such review.

- One of the actions included a settlement with an insider and the related public company that included violations of Section 17(a) of the Securities Act of 1933, as amended. The SEC took the position that the insider and the company violated the anti-fraud provisions of the securities laws by failing to file Section 16(a) reports of securities transactions and holdings in a timely and accurate manner, rendering the company's annual reports and proxy statements false and misleading. This settlement demonstrates the SEC's belief

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that the failure to file timely reports, and a company's related materially inaccurate Item 405 disclosures, can serve as the basis of a fraud charge.

- The SEC noted the Enforcement Staff's use of "quantitative data sources and ranking algorithms" to identify late filers. The Staff has mentioned on numerous occasions its increasing use of electronic methods to identify potential issues. Expect to see more charges and settlements derived from these methods.

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