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SEC Targets Corporate Insiders for Failing to Promptly Disclose Stock Transactions

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The Commission has announced an unprecedented enforcement initiative against officers, directors, and major stockholders for violating beneficial ownership reporting requirements and against public companies for their roles in contributing to or failing to disclose such violations.

On September 10, the Securities and Exchange Commission (SEC) announced that it had charged 28 officers, directors, and major shareholders of public companies for repeated violations of requirements to promptly disclose their holdings and transactions in Section 16(a) reports and Schedule 13D and Schedule 13G filings.[1] The SEC also charged six public companies for contributing to the filing violations or for failing to report delinquent Section 16(a) reports in their proxy statements or annual reports. Thirty-three of the 34 individuals and companies agreed to settle the charges and paid civil penalties ranging from $25,000 to $150,000, for a total of $2.6 million.

The enforcement sweep focused on the following two types of reporting requirements under the Securities Exchange Act of 1934, as amended (Exchange Act):

- Section 16(a) of the Exchange Act, which requires executive officers, directors, and certain beneficial owners of more than 10% of a registered class of a company's stock to report on Form 4 transactions that result in a change in beneficial ownership within two business days following the date of the transaction, except for limited types of transactions eligible for deferred reporting on Form 5. Transactions that must be reported on Form 4 include purchases and sales of securities, exercises and conversions of derivative securities, and grants or awards of securities by a company under an equity compensation plan.
- Sections 13(d) and 13(g) of the Exchange Act, which require any person or group who directly or indirectly acquires or has beneficial ownership of more than 5% of any issuer's

outstanding equity securities to report such beneficial ownership on Schedule 13D or Schedule 13G. Depending on the circumstances, the person or group may file the short-form Schedule 13G rather than the long-form Schedule 13D.

Emphasizing that these charges do not require an element of intent or state of mind to prove the violation and that "inadvertence is no defense to filing violations," the SEC swept broadly, bringing cases against 13 corporate officers and directors, five individual beneficial owners of publicly traded securities, and 10 investment firms. In addition, while noting that Section 16(a) reports are technically the obligations of insiders, the SEC also brought charges against six public companies for violating Section 16(a) requirements based on two distinct legal theories.

First, the SEC observed that "[a]lthough the Commission encourages the practice of many issuers to assist insiders in complying with Section 16(a) requirements, issuers who voluntarily accept certain responsibilities and then act negligently in the performance of those tasks may be liable as a cause of Section 16(a) violations by insiders."[2] Thus, a company becomes secondarily liable for an insider's Section 16(a) violation unless the filing failure occurred because the insider failed to provide the relevant information to the company.

Second, a public company incurs primary liability if it fails to comply with the disclosure requirements applicable to it under the federal securities laws, including Item 405 of Regulation S-K, which requires companies to disclose, in their proxy statements or annual reports, any known delinquent Section 16(a) reports by insiders based on the company's review of Forms 3, 4, and 5. The SEC found that five of the six public companies named in its press release had violated the Item 405 disclosure requirement by failing to disclose or making misstatements about failures by insiders to comply with Section 16(a) reporting requirements.

In a separate case announced by the SEC on the same date, a company was charged with violations of the reporting requirements under the Exchange Act and the antifraud provisions in the proxy rules under the Exchange Act as well as those under the Securities Act of 1933, as amended (Securities Act).[3] The SEC charged the company, Advanced Cell Technology Inc., with making false and misleading statements regarding its CEO's noncompliance with Section 16(a) reporting requirements. In particular, the company reported four late Form 4 filings by the CEO and other late filings by certain of its directors but made no disclosure about the CEO's failure to report trading in the company's common stock on 14 other trading days. The SEC deemed the company's misstatements to be false and misleading, stating that "[t]here is a substantial likelihood that [the CEO's] trades would have significant importance to the reasonable Advanced Cell investor given, among other things, his position as CEO, the frequency with which he was selling Advanced Cell stock, and his failures to comply with reporting requirements."

The sweep signals a new level of scrutiny by the SEC of a filing requirement that, to date, has been largely immune from aggressive enforcement actions. In the past, the SEC typically instituted enforcement proceedings when violations of Section 16(a) reporting requirements were egregious and coupled with alleged fraudulent conduct, such as the Advanced Cell action noted above.[4]

The charges announced in the SEC's press release are consistent with a previously stated policy by SEC Chair Mary Jo White to focus on lesser infractions of federal securities law as a strategy to ensure that major violations are not overlooked or ignored—the so-called "broken windows" policy.[5] Under this policy, as demonstrated by juxtaposing the sweep cases with the Advanced Cell case, the SEC will take action on egregious reporting violations even if no fraudulent conduct is involved. In addition, it appears that the SEC may have brought these cases on such a large scale in part because it can: The SEC stated that it had used "quantitative data sources and ranking algorithms" to detect offenders who repeatedly failed to make filings on a timely basis. The existence of these quantitative tools alone suggests that more of these types of actions may be forthcoming from the SEC. Thus, the SEC's sweep should serve as a reminder to public companies, officers, directors, and major stockholders that filings of Section 16(a) reports and Schedules 13D and 13G are not mere formalities, but rather important reporting obligations that could lead to SEC action and penalties if not consistently complied with in a timely manner.

Practical Considerations

- Companies that assist insiders with Section 16(a) filings should make sure that processes and procedures are in place to ensure that all insider transactions (including under company equity compensation plans and Rule 10b5-1 plans) are promptly reported (e.g., within one business day). Indeed, companies should require preclearance of all transactions by insiders for both insider trading compliance and prompt reporting purposes.

- Companies generally should refrain from assisting beneficial owners with Schedules 13D and 13G filings, unless the company has real-time access to details and insight about the transactions effected by those beneficial owners.

- Companies that undertake to assist with or make Section 16(a) reports and Schedule 13D and 13G filings should consider whether such assistance (and any resulting cost) is permissible under the companies' codes of ethics, conflict of interest policies, related person transaction policies, or similar policies.

- Questionnaires for directors and officers of public companies should include questions and affirmations concerning stock transactions of respondents during the year to confirm whether all reportable transactions under Section 16(a) have been timely reported and to help ensure that the company's Regulation S-K Item 405 disclosure is correct. Any delinquent filings identified by the company should be promptly addressed.

- Companies should regularly monitor the identities and holdings of their 5% beneficial owners, including reviewing Schedule 13D and 13G filings, to help ensure that beneficial ownership information can be disclosed accurately in their proxy statements. During the annual proxy process, companies should consider distributing questionnaires to 5%+ beneficial owners to confirm beneficial ownership information.

- Investment managers, hedge funds, and other institutions should make sure that processes and procedures are in place to monitor their investments in public portfolio companies in order to ensure timely compliance with SEC filing requirements.

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[1]. Press Release, SEC, SEC Announces Charges Against Corporate Insiders for Violating Laws Requiring Prompt Reporting of Transactions and Holdings (Sept. 10, 2014).

[2]. In re KMG Chems., Inc., Exchange Act Release No. 73,051 at 6 (Sept. 10, 2014), available here. The KMG order also expressed the SEC's view that "getting close" does not count: "The fact that the majority of transactions were timely reported does not excuse Respondent's practices." Id.

[3]. In re Advanced Cell Tech., Inc., Exchange Act Release No. 73,066 (Sept. 10, 2014), available here. Advanced Cell—which already was subject to a 2012 injunction based on other conduct—was found to have violated Section 17(a)(2) of the Securities Act and Sections 13(a) and 14(a) of the Exchange

Act and Rules 12b-20, 13a-1, and 14a-9 thereunder. In the new case, the SEC fined Advanced Cell $375,000 and ordered it to retain an independent compliance consultant and provide Section 16(a) reporting training to its Section 16(a) reporting persons.

[4]. See e.g., SEC v. Wyly, No. 10-CV-5760 (S.D.N.Y. July 29, 2010) (alleging directors of companies engaged in a 13-year scheme to trade millions of securities without disclosing their ownership and their trading of those securities and charging violations of the antifraud provisions of the federal securities laws as well as Section 16(a) of the Exchange Act; on May 12, 2014, a jury returned a verdict in the SEC's favor); see also In re McCullough, Admin. Proc. File No. 3-14259 (Feb. 15, 2011) (finding that the CFO of CytoCore, Inc. failed to report 62 purchases of stock, totaling more than 300,000 shares, over a three-year period and another 96 transactions, totaling more than 946,000 shares, over a four-year period; CFO suspended from association with broker, dealer, or investment adviser for 12 months); SEC v. CytoCore, Inc., No. 1:11-cv-00246 (N.D. Ill. Jan. 26, 2011) (defendants

[5]. In her speech at the Securities Enforcement Forum on October 9, 2013, Chair White said "The theory is that when a window is broken and someone fixes it—it is a sign that disorder will not be tolerated. But, when a broken window is not fixed, it is a signal that no one cares, and so breaking more windows costs nothing." The full text of the speech is available here.

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