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## *Attempting to Fix the “Broken Windows”: Recent SEC Enforcement Action Targets Routine Disclosure Obligations of Public Corporations and Their Insiders*

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In its latest effort to pursue a “broken windows” strategy of enforcement, the Securities and Exchange Commission (“SEC”) announced, on September 10, 2014, charges against 34 individuals and companies for violating certain disclosure provisions of the federal securities laws.<sup>1</sup> The SEC’s September 10 charges resulted from an enforcement initiative focusing on, among other things, Section 16 of the Securities and Exchange Act of 1934 (“Exchange Act”), which requires corporate insiders to disclose their transactions in the corporation’s securities.

These disclosures—which are typically made on the familiar Form 4—are standard practice for public corporations. However, the SEC’s sharpened focus on enforcing the timeliness of such disclosures should sound a cautionary note for public companies and their officers and directors. In fact, in its press release announcing the enforcement action, the SEC explicitly issued a shot across the bow of public companies and their insiders. Andrew J. Ceresney, the Director of the SEC’s Enforcement Division, noted that “[o]fficers, directors, major shareholders, and issuers should all take note: inadvertence is no defense to filing violations, and we will vigorously police these sorts of violations through streamlined actions.”<sup>2</sup> Andrew M. Calamari, the Director of the SEC’s New York Regional Office, also emphasized that legal reporting requirements “are not mere suggestions, they are legal obligations that must be obeyed.”<sup>3</sup> These comments by high-ranking SEC enforcement officials echo Chair Mary Jo White’s 2013 statement that the SEC would follow a “broken windows” theory of enforcement—leaving no violation unpunished, regardless of its severity.<sup>4</sup>

To build the enforcement case it announced on September 10, SEC staff “used quantitative data sources and ranking algorithms” to ferret out purportedly dilatory filers.<sup>5</sup> This is indicative of the SEC’s willingness to use relatively sophisticated methodologies to police relatively minor securities law violations. Ultimately, 33 of the 34 charged individuals and companies agreed to settle the SEC’s claims, paying total financial penalties of \$2.6 million.<sup>6</sup>

By way of background, Section 16(a) of the Exchange Act requires directors and officers of an issuer, as well as those holding more than 10% of the issuer’s securities, to make certain public disclosures.<sup>7</sup> Depending on the circumstances, these disclosures must include the amount of the issuer’s securities held by the insider and any changes in that amount since the most recent preceding disclosure.<sup>8</sup>

Moreover, the insider must make such public disclosures at the time the issuer's securities first become registered on a national exchange, within ten days after he or she becomes an owner of those securities, or within two days after conducting any transactions in those securities.<sup>9</sup> The SEC rules dictate that corporate officers, directors, or holders of at least 10% of a corporation's shares initially report their ownership of the issuer's securities on a Form 3, and report any subsequent transactions in those securities on a Form 4.<sup>10</sup> Moreover, in some circumstances, a person subject to Section 16 must file an annual report on Form 5.<sup>11</sup> An individual can violate Section 16(a) by inadvertently making an untimely disclosure; no culpable state of mind is required.<sup>12</sup>

In many of the individual charges filed on September 10, the SEC was careful to detail those transactions that violated the aforementioned reporting provisions. In *In the Matter of Ligang Wang*, for example, the SEC alleged that an executive officer of a publicly-traded corporation failed to report eight transactions in the corporation's securities, and was tardy in reporting seven additional transactions.<sup>13</sup> Among the individuals charged, most agreed to pay a penalty. All told, the penalties ranged from \$25,000 (where, for example, an officer was late in reporting all of his 2011 and 2012 stock sales<sup>14</sup>) to \$100,000 (where, for example, a director failed to, among other things, timely report a sale of the corporation's stock "with an aggregate market value in excess of \$1 million, which constituted a disposition of a substantial portion of his holdings... ." <sup>15</sup>).

Notably, the SEC stated that an insider's reliance on the corporation to file appropriate disclosures on his or her behalf does not absolve a violation of the reporting rules. In *In the Matter of Bradley S. Forsyth*, for example, the corporate insider timely notified the corporation of his transactions in its securities.<sup>16</sup> This, however, did not excuse his Section 16(a) and Rule 16a-3 violations "because an insider retains legal responsibility for compliance with the filing requirements, including the obligation to assure that the filing is timely and accurately made."<sup>17</sup> In the same enforcement action, the SEC noted that the insider "took inadequate and ineffective steps to monitor whether timely and accurate filings were made on his behalf."<sup>18</sup>

Similarly, a corporation that voluntarily agrees to assist its insiders in filing their Section 16(a) disclosures must do so competently, and non-negligently. Otherwise, the corporation "may be liable as a cause of Section 16(a) violations," and, as demonstrated by the SEC's September 10 announcement, a subject of enforcement action.<sup>19</sup>

In addition to enforcing the rules mandating Form 3, 4, and 5 disclosures, the SEC also charged several individuals and investment management firms with violating Section 13(d) of the Exchange Act.<sup>20</sup> Section 13(d) imposes certain disclosure obligations on individuals who acquire beneficial ownership of greater than five percent of a publicly-traded security.

Ultimately, in policing mere disclosure violations, the SEC has taken yet another step to further its professed "broken windows" enforcement strategy. Although violations of federal securities reporting requirements might not seem as egregious as intentional, scienter-based fraud, public corporations and their officers, directors, and other insiders should take note of the SEC's renewed focus in this area, and pay particularly close attention to ensuring that their Section 16(a) reporting obligations are met.

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<sup>1</sup> Press Release, Securities and Exchange Commission, SEC Announces Charges against Corporate Insiders for Violating Laws Requiring Prompt Reporting of Transactions and Holdings (Sep. 10, 2014).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> Chair Mary Jo White, Remarks at the Securities Enforcement Forum (Oct. 9, 2013).

<sup>5</sup> Press Release, Securities and Exchange Commission, SEC Announces Charges against Corporate Insiders for Violating Laws Requiring Prompt Reporting of Transactions and Holdings (Sep. 10, 2014).

<sup>6</sup> *Id.*

<sup>7</sup> See 15 U.S.C. § 78p(a)(1).

<sup>8</sup> *Id.* § 78p(a)(3)(A)-(B).

<sup>9</sup> *Id.* § 78p(a)(2)(A)-(C).

<sup>10</sup> 17 C.F.R. § 240.16a-3.

<sup>11</sup> *Id.* § 240.16a-3(f)(1).

<sup>12</sup> Bradley S. Forsyth, Exchange Act Release No. 73059, at 3 (Sep. 10, 2014).

<sup>13</sup> Ligang Wang, Exchange Act Release No. 73065, at 2-3 (Sep. 10, 2014).

<sup>14</sup> Bradley S. Forsyth, Exchange Act Release No. 73059, at 4-5 (Sep. 10, 2014).

<sup>15</sup> Justin Tang, Exchange Act Release No. 73062, at 5 (Sep. 10, 2014).

<sup>16</sup> Bradley S. Forsyth, Exchange Act Release No. 73059, at 5 (Sep. 10, 2014).

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 5-6.

<sup>19</sup> KMG Chemicals, Inc., Exchange Act Release No. 73051, at 6 (Sep. 10, 2014). Note that, under Item 405 of Regulation S-K, public corporations must review the various Section 16(a) filings made by their insiders, and disclose, with some specificity, those that were untimely. *Id.* at 4.

<sup>20</sup> See, e.g., Stephen Adams, Exchange Act Release No. 73054, at 8 (Sep. 10, 2014) (charging an individual with violating Section 13(d)); Ridgeback Capital Management LP, Exchange Act Release No. 73032, at 8 (Sep. 10, 2014) (charging investment management firm with violating Section 13(d)).

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