CLIENT UPDATE

BE TIMELY OR ELSE: SEC IMPOSES SANCTIONS AGAINST BOTH INSIDERS AND ISSUERS FOR BENEFICIAL OWNERSHIP REPORTING FAILURES

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Corporate insiders and issuers lulled into complacency regarding the requirements to file beneficial ownership reports be warned: These are not toothless guidelines to be treated lightly. The SEC recently stepped up enforcement against officers, directors and significant equity holders (including private fund management firms) who repeatedly failed to timely file their reports and against issuers for not properly disclosing the failures in their annual filings. In connection with this enforcement sweep, the SEC also sanctioned issuers who contributed to their insiders' reporting failures. The SEC warned that it will not accept excuses – even inadvertent failures due to electronic system errors or filing delays caused by the issuer or outside counsel could result in liability.

ENFORCEMENT ACTIONS

The SEC has implemented a sophisticated enforcement initiative, using computer-based systems with quantitative analytics and ranking algorithms to identify repeat offenders. To bring home the point, the SEC announced charges against 28 corporate insiders and significant shareholders (including both individuals and investment firms) for repeatedly failing to timely file Section 16 and Section 13(d) beneficial ownership reports. Each of the insiders was late on multiple occasions, and all but one of those charged settled with the SEC. The SEC also charged, and settled with, six issuers that either had taken on the filing responsibility for Section 16 reports for their insiders but did not submit timely reports (even though all necessary information had been provided to them) or failed to timely disclose violations of Section 16(a) in their Form 10-Ks or annual proxy statements. Monetary penalties ranged from $25,000 to $120,000 for insiders and $75,000 to $150,000 for issuers. A notable fact of the initiative is that it does not appear that any of the insiders were failing to file in order to hide non-exempt matching transactions. Thus, the initiative can be viewed as a warning to all Section 16 filers, not merely to the small subset of filers who engage in matching transactions that produce a disgorgement liability.

These actions reflect a change from historical practices, in which the SEC had previously generally brought Section 16(a) or Section 13(d) reporting actions in conjunction with another violation (e.g., insider trading, fraud or tax avoidance), often relying on tips from whistleblowers or third-party allegations. Nonetheless, the SEC's orders emphasize the legislative purpose behind Section 16(a) that the "most potent weapon against the abuse of insider information is full and prompt publicity," indicating that their focus may be attributable, in part, to the SEC's aggressive posture on insider trading.

REPORTING RULES

Under Section 16(a) of the Exchange Act, any director or executive officer of an issuer of SEC-registered securities and anyone else (including private equity funds and hedge funds and, in many instances, their general partners or other control persons) who directly or indirectly beneficially owns at least 10% of a class of such security must file an initial statement of ownership on Form 3 within 10 business days of becoming subject to the reporting requirements. That ownership record must be updated by Form 4 filings within two business days of most transactions in the securities, including purchases, sales, grants of equity compensation and other derivative transactions. In addition, if any of these forms are not timely filed, a Form 5 reporting previously unreported ownership or transactions must be filed within 45 days after the issuer's fiscal year-end. Issuers of SEC-registered securities are required to review annually all Section 16 filings of their insiders and disclose any known failures of insiders to timely file a Section 16 report during the most recent fiscal year, citing the name of the insider and number of missed reports and transactions. Under Section 13(d) of the Exchange Act, any person who acquires beneficial ownership of more than 5% of a class of securities registered with the SEC must file either a Schedule 13D or Schedule 13G, generally within 10 business days, and must update the report promptly following material changes. Also, following certain events, a report filed on a Schedule 13G must be switched to a Schedule 13D.

COMPLIANCE TIPS

The SEC's recent enforcement actions are part of an "enforcement initiative," and we expect that the SEC will continue to be on the lookout for reporting violations. Accordingly, it is worth pointing out some takeaways:

- The SEC does not appear to be targeting every foot fault, but repeat offenders with "especially high rates of filing deficiencies." Each of those charged had committed "multiple" infractions, typically over a period running a few months to several years, and in some cases on multiple issuers. Some of those who were charged had not filed Section 16 reports or amendments to a Schedule 13D for years, and then filed everything at once. It appears that the SEC targeted what it perceived to be a culture of noncompliance. Nonetheless, a reporting person who is late in filing a Section 16 report or an initial statement on Schedule 13D or Schedule 13G or amendment should assume that the SEC is aware of the failure.
- Corporate insiders and significant shareholders (including private investment firms) should diligently check that all of their Section 16 and Section 13(d) reports are timely and accurately filed. The recent actions make clear that reporting persons cannot discharge their filing responsibilities by tasking the issuer or outside counsel to handle the filings. A reporting person is ultimately responsible for timely filing and could be held liable (as was the case in some of the recent SEC charges), even though they had timely provided information to an employee of the issuer who failed to act with appropriate speed.
- If an issuer is assisting insiders with filing Section 16 reports, it must dedicate the appropriate resources to ensure that filings are made on time. An issuer that fails to do so could be held liable for negligently contributing to the insiders' reporting violations. Issuers who handle reports should have personnel available to assist with Form 4 filings on short notice and systems in place so that their insiders' brokers send them prompt notice of insiders' open market transactions.
- The SEC expects issuers to monitor the Section 16 reports of their insiders and to correctly disclose any missed filings in the Form 10-K or annual proxy statement (whether or not the issuer is directly involved in preparing the filings). An issuer that fails to do so could be sanctioned. Merely relying on a director or officer questionnaire is not enough.
- A number of those recently charged with reporting violations did not file the required reports until after being contacted by the SEC. It is possible that the SEC may have taken a lighter touch with those offenders had they filed the necessary reports on their

own initiative. When a reporting person identifies a missed report, it should be filed as soon as possible (e.g., reported on a late Form 4 or an annual Form 5). Bear in mind that the SEC has cautioned that an "inadvertent" omission is not an excuse.

- A reporting violation by itself can result in SEC prosecution and financial penalty, regardless of the excuses or intent or value involved, or whether the transaction involved open market sales and purchases, sales under pre-arranged 10b5-1 trading plans or stock option grants and exercises.
- An investor who files a Schedule 13G as a passive investor should keep a close eye on the investment in case it becomes necessary to switch to a Schedule 13D, either as a result of an increase in beneficial ownership to 20% or more or if for another reason its investment is no longer passive.

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Please do not hesitate to contact us with any questions.

October 2, 2014