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Welcome to our latest issue of the Insider Trading & Disclosure Update, Debevoise's periodic update focusing on recent legal, compliance and enforcement developments in the areas of insider trading, the management of material non-public information, and disclosure-based matters.

Figuring prominently in this Update is the continuing fallout from the *Newman* decision (and failure of subsequent government appeals), including proposed legislative responses, increasing scrutiny of individuals in enforcement actions and the Securities and Exchange Commission's (SEC) continued use of administrative law courts (notwithstanding the unresolved controversy related to those proceedings). In this Update we also highlight the Supreme Court's decision in *Omnicare,* recent efforts by the SEC and plaintiffs to hold issuers to a higher standard for disclosure of MD&A trends and uncertainties and the potential convergence of insider trading and criminal cyber theft.

We hope that you find this Update useful and informative, and we look forward to bringing you further news and analyses in future issues.

Sincerely,
The Editorial Board

Case Law & Market Updates

Newman Revisited: Following the Denial of Cert., Courts Continue to Grapple with the Second Circuit's Articulation of the Personal Benefit Requirement

On October 5, 2015, the Supreme Court of the United States denied certiorari in *United States v. Newman*,[1] leaving the Second Circuit's decision undisturbed. In *Newman*, the Second Circuit held that to establish insider trading tippee liability, the government must prove that the tippee knew both that the tipper breached a fiduciary duty by disclosing material, nonpublic information *and* that the tipper

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received a personal benefit by disclosing the information.[2] In reversing the convictions of hedge fund managers Todd Newman and Anthony Chiasson, the Court found that the government's evidence was insufficient to prove that the corporate insiders in *Newman* had obtained any personal benefit in exchange for their tips, stating that although the standard is "permissive," proof of a personal benefit cannot be inferred from "the mere fact of a friendship, particularly of a casual or social nature" between the tipper and tippee, but rather the government must present some proof "of a meaningful[] close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[3]

The sweeping nature of *Newman* has led many to opine that the decision represents a seismic change in insider trading liability as it would be difficult for the government to demonstrate knowledge of personal benefit by tippees,

particularly in a case premised on the tipping of information to "friends" where there is no suggestion of a potential or concrete pecuniary benefit for the insider. A review of *Newman's* progeny, however, suggests that, although significant, the prediction that *Newman* will severely limit insider trading investigations and prosecutions going forward might be overstated because what qualifies as a "personal benefit" continues to rely on a court's assessment of the underlying facts and circumstances.

Recent Second Circuit Case Law Applying *Newman*

Following *Newman*, several defendants facing insider trading allegations moved to withdraw guilty pleas or vacate convictions of insider trading based on the standard established by *Newman*. In *United States v. Conradt*,[4] four of five defendants had pled guilty to trading on inside information concerning IBM Corp.'s $1.2 billion purchase of SPSS Inc. The government alleged that one of the defendants had received a tip from a friend who was an associate at a prominent law firm who had been working on the IBM deal. After receiving the tip, the analyst allegedly passed it along to his roommate, a trader, who traded on the information as well as tipped the information to three other traders, all of whom traded on the information in their personal accounts. The government's indictment contained no obvious allegations that the law firm associate who provided the inside information received a benefit for that disclosure.

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After additional briefing from the parties regarding the applicability of *Newman* to *Conradt* given that the latter was brought under the misappropriation theory of insider-trading liability, the district court (Carter, J.) vacated the guilty pleas, finding them to be insufficient "in light of *Newman*'s clarification of the personal benefit and tippee knowledge requirements of tipping liability for insider trading."[5] Importantly, the court echoed the Second Circuit's pronouncement in *Newman* that "the elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory,"[6] finding that even *assuming arguendo* that the cited language in *Newman* is dicta, it is "emphatic dicta which must be given the utmost consideration."[7] Shortly after the ruling, the government requested permission to drop the charges against all five defendants, conceding that it did not have the requisite evidence to establish personal benefit or knowledge thereof. The district court subsequently granted the government's request for dismissal without prejudice.

In *United States v. Riley*,[8] a jury convicted Riley for tipping material nonpublic information after the court instructed the jury that it could convict if the insider provided the information for the purpose of "maintaining or furthering a friendship."[9] Riley argued that the Court's "personal benefit" jury instruction was plain error.[10]

The district court (Caproni, J.) acknowledged that according to *Newman*, "the mere fact of a friendship, particularly of a casual or social nature," between the tipper and tippee is not sufficient to establish a personal benefit.[11] The district court, however, denied the motion for a new trial in part because, according to the court, the instruction may have been erroneous, but it was not plain error. The district court noted that the jury instruction did not permit the jury to convict Riley just because the tippee and Riley were friends. Instead, the jury instruction "required that the tip be given to maintain or further a friendship."[12] The court concluded that if a tip maintains or furthers a friendship, then that is circumstantial evidence that the friendship is a *quid pro quo* relationship.[13] The court further opined that "[w]hile a court could rule that merely maintaining or furthering a friendship is not a sufficient personal benefit, it is not "plain" that the Second Circuit has done so already."[14] The district court went on to find that Riley received three other concrete benefits that were "objective, consequential, and represent[ed] at least a potential gain of a pecuniary or similarly valuable nature"[15] further satisfying *Newman*'s standard—receiving help for his business, investment advice that resulted in profitable trades, and

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assistance in trying to secure a new job.[16] Riley's appeal remains pending.[17] The Second Circuit, however, granted his request for a stay of his surrender date, granted bail, and has expedited the appeal, at least suggesting that the Court might find the lower court's interpretation of *Newman* problematic.[18]

In *United States v. Gupta*,[19] the district court (Rakoff, J.) rebuffed Gupta's attempts to "take advantage" of *Newman* in moving to vacate his sentence under 28 U.S.C. § 2255 on the basis of the court's jury instruction concerning personal benefit.[20] Describing the motion as "too late and too little" the court found that Gupta had forfeited the claim by failing to raise it on direct review.[21] Moreover, the district court rejected Gupta's argument that Newman requires that a tipper such as Gupta receive from his tippee a "*quid pro quo*" in the form of "a potential gain of a pecuniary or similarly valuable nature."[22] The district court observed that Newman was fundamentally concerned with what evidence of a personal benefit could reasonably support an inference of knowledge on the part of a remote tippee, not to suggest that in all circumstances a potential pecuniary benefit must be obtained by the tipper. In this case, the court observed, Gupta was the tipper and consequently what the tippee Rajaratnam knew was irrelevant to Gupta's own liability.

The district court further found that even if the personal benefit element did apply to tippers, the burden of proof was satisfied in Gupta's case. At trial, the evidence had established that Gupta and Rajaratnam were close business associates with a "considerable history" of exchanging financial favors.[23] The district court found that the tips, which conveyed non-public information about a $5 billion investment in Goldman as well as an unprecedented quarterly loss, were "objective, consequential, and represent[ed] at least a potential gain of a pecuniary or similarly valuable nature."[24] Further, because Gupta was an investor in the fund managed by Rajaratnam, any tips on which Rajaratnam traded had the potential to increase the value of Gupta's shares. Although Gupta's request for a certificate of appealability pursuant to 28 U.S.C. § 2253(c) from the district court was denied,[25] he has appealed to the Second Circuit.[26]

Interestingly, Rajaratnam, who was convicted of fourteen counts of securities fraud and conspiracy to commit securities fraud and is currently serving an eleven-year prison term, has also moved to vacate five of those securities fraud counts under *Newman* and requested a new trial on two more counts for unrelated reasons. His motion is still pending,[27] as are similar motions in *United States v. Martoma*[28] and *United States v. Goffer*[29] suggesting that courts will continue to grapple with how to apply *Newman* retroactively.

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The government has also effected a strategic retreat in cases with seemingly unfavorable facts. After the Supreme Court denied certiorari in *Newman*, U.S. Attorney Preet Bharara indicated that charges would be dropped against Michael Steinberg, the former SAC Capital Advisors LP portfolio manager convicted of insider trading, as well as six cooperating witnesses (former Whittier Trust Co. fund manager Danny Kuo; former Sigma Capital Management analyst Jon Horvath; former Neuberger Berman analyst Sandy Goyal; Spyridon Adondakis, a former analyst at Chiasson's firm Level Global Investors LP; Jesse Tortora, a former analyst at Newman's firm Diamondback Capital Management LLC; and Hyung Lim, former executive at tech company Aletera Corp.) who pled guilty in connection with the government's cases against Steinberg, Newman and Chiasson.

Courts are also grappling with the impact of *Newman* in civil proceedings. In the companion SEC enforcement action to *United States v. Conradt*, *SEC v. Payton*,[30] the district court (Rakoff, J.) denied a motion to dismiss by two of the alleged remote tippees accused of trading on inside information concerning IBM's 2009 acquisition of SPSS Inc. Defendants argued that under *Newman*, the SEC failed to adequately allege either that the original tipper received a personal benefit in exchange for disclosing the inside information, or that defendants knew of any such benefit.

The district court opined that, as an initial matter, it was far from obvious that Newman's suggestion that a meaningfully close personal relationship must generate "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature"[31] is required under *Dirks v. S.E.C.*, 463 U.S. 646 (1983), noting that while *Dirks* presented *quid pro quo* and friendship as distinct examples of relationships that may give rise to an inference of personal benefit, a casual reading of *Newman* might suggest that personal benefit can only be inferred from mere friendship "where there is evidence that it is generally akin to *quid pro quo*."[32] Nonetheless, the district court held that even under the "more onerous standard of benefit" set forth in *Newman*, the SEC had adequately alleged personal benefit, in alleging that the direct tippee and tipper "shared a close mutually-dependent financial relationship, and had a history of personal favors" and that their expenses were intertwined.[33] Moreover, the Court found that even though the alleged remote tippees arguably had no specific knowledge of a personal benefit, the SEC had plausibly pled that they knew, *inter alia*, that (1) the tipper was the source of the inside information, (2) the tipper and tippee were friends and roommates, and (3) the tipper had legal troubles. The district court found that this circumstantial knowledge was sufficient, at least under the burden of proof in a civil action, "to raise the

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reasonable inference that the defendants know that [tipper's] relationship with [tippee] involved reciprocal benefits."[35]

Payton at least raises the suggestion that, in spite of *Newman*, district courts may be reluctant to dismiss cases where the SEC has articulated a colorable claim of personal benefit. Trial is currently scheduled to begin in *Payton* on February 16, 2016.

Other Jurisdictions Apply *Newman*

Newman has been cited by, among others, defendants in proceedings across the country, including in New Jersey (*SEC v. Holley*)[35], California (*United States v. Decinces*[36], *SEC v. Sabrdaran*[37]), Kentucky (*SEC v. Somers*[38]), North Carolina (*SEC v. Musante*[39]), and Georgia (*In the Matter of Thomas D. Melvin*[40], *SEC v. Megalli*[41]).

Notably, in *United States v. Salman*,[42] Salman argued that his conviction for insider trading should be overturned because under *Newman*, the existence of friendship or familial friendship alone is insufficient to demonstrate that the tipper received a benefit, so there must be a "tangible benefit" to the insider in exchange for the inside information and that Salman did not know of any tangible benefit received by the insider, his future brother-in-law.[43]

Noting that *Newman* was not binding on it, the Ninth Circuit, through Judge Rakoff (who had already expressed doubts about whether *Newman* was consistent with *Dirks* in *Payton*) sitting by designation, acknowledged it could not "lightly ignore" the Second Circuit's opinion "in an area of law that [the Second Circuit] has frequently encountered."[44] However, the Ninth Circuit nonetheless rejected Salman's interpretation of *Newman*, holding that, under *Dirks,* an element of breach of fiduciary duty is met where an "insider makes a gift of confidential information to a trading relative or friend," which *Newman* recognized by stating that "personal benefit is broadly defined to include not only pecuniary gain, but also the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend."[45] The Ninth Circuit explained that if Salman's theory was correct, then "a corporate insider or other person in possession of confidential and proprietary information would be free to disclose that information to her relatives, and they would be free to trade on it, provided only that she asked for no tangible compensation in return."[46] The Ninth Circuit's articulation of its holding relative to *Newman* seemed largely designed to avoid creating a circuit split in favor of narrowing the way in which *Newman* should be read.

In *United States v. McPhail, et al.*,[47] a Massachusetts district court (Casper, J.) denied defendant Parigian's motion to dismiss the indictment based on *Newman*. According to the government's superseding indictment, an insider disclosed material, nonpublic information about the corporation to McPhail who

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misappropriated the insider information ultimately passing along the information to Parigan and his other golfing buddies. The district court found that the *Newman* test did not apply because the government's case is premised on the misappropriation theory and opined that "under this theory, a personal benefit need not be alleged to inure to the benefit of the unknowing participant, the source of the inside information."[48] The court further found that "[t]o the extent that the [d]efendants are alternatively arguing that the indictment must allege that the tipster (McPhail) must receive a personal benefit and/or that the tippee (Parigian) knew that McPhail would receive, or expected to receive, such benefit, the indictment here alleges both," pointing to the communications cited in the indictment that suggested McPhail expected to be paid back for the inside information in the form of Pinot Noir and a steak dinner.[49]

While it is difficult to predict where the First Circuit might land on this case, it seems clear that the decision raises at least the potential of a future circuit split with the Second Circuit on the question of whether the government must allege and prove a "personal benefit" to a tipper when alleging liability under the misappropriation theory of insider trading.[50]

Finally, in a significant loss on its own home turf, on September 14, 2015, SEC ALJ Jason S. Patil dismissed a case brought by the SEC Division of Enforcement in *In the Matter of Gregory T. Bolan, Jr., and Joseph C. Ruggieri ("Bolan")*.[51] In that case, the SEC alleged that Ruggieri, a former trader at Wells Fargo Securities LLC, received material, nonpublic tips from Gregory Bolan, a Wells Fargo research analyst, regarding ratings changes for stocks before that information was publicly disclosed. Judge Patil dismissed the case on the grounds that the SEC had failed to prove that Bolan tipped Ruggieri for a "personal benefit."

Legislative Developments

One of the more interesting developments to follow *Newman* was the introduction of several pieces of proposed legislation intended to define prohibited insider trading. Each of these bills, as currently proposed, would reverse the precedent set by *Newman* and potentially call into question certain other aspects of decades of Supreme Court and lower court decisions, while also raising a new set of interpretive challenges necessitating extensive guidance through jurisprudential developments. See "Legislative Focus on Insider Trading Following *United States v. Newman*" elsewhere in this Update for a more detailed summary of the legislative response to *Newman*.

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Supreme Court's *Omnicare* Decision Clarifies when Statements of Opinion Are Actionable Under Section 11 of the Securities Act

On March 24, 2015, the U.S. Supreme Court resolved a circuit split holding that a statement of opinion in a registration statement does not constitute an untrue statement of fact that gives rise to liability under Section 11 of the Securities Act of 1933 simply because it ultimately proves to be incorrect.[52] Instead, a statement of opinion may give rise to liability only if the issuer either (i) does not genuinely believe the opinion or (ii) omits a material fact regarding the issuer's basis for the opinion that renders it misleading to a reasonable person. The *Omnicare* decision clarified a key issue in securities litigation and has already had an observable effect on fraud-based securities litigation.

The Omnicare Decision

In *Omnicare*, the Supreme Court considered a Section 11 claim based on statements by Omnicare that it believed certain contractual arrangements were in compliance with applicable laws. Section 11 provides that issuers of securities and other associated persons may be held liable if a registration statement contains "an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[53] Following the text of Section 11, the Court considered separately the questions of (i) when a statement of opinion constitutes an untrue statement of fact and (ii) when the omission of a fact can render a statement of opinion misleading.

Regarding the first question, the Court rejected the Sixth Circuit's holding in *Indiana State Dist. Council of Laborers & HOD Carriers Pension & Welfare Fund v. Omnicare, Inc.*, 719 F.3d 498, 505 (6th Cir. 2013) that a statement of opinion that is genuinely believed when made may constitute an "untrue statement of a material fact" simply because it ultimately proves to be incorrect.[54] That holding, the Court explained, "wrongly conflates facts and opinions" and ignores congressional intent in crafting the first part of Section 11 to expose issuers to liability for untrue statements of *fact*.[55] Instead, the Court reasoned that a statement of opinion explicitly affirms only the fact that "the speaker actually holds the stated belief." A statement of opinion is an untrue statement of fact, therefore, only if the speaker does not genuinely believe it.[56] Section 11 "does not allow investors to second-guess inherently subjective and uncertain assessments."[57] Of course, if supporting facts are supplied along with a statement of opinion and those facts turn out to be false, liability under Section 11's untrue statement provision may follow.

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As to the second question, the Court stated that "a reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about how the speaker has formed the opinion — or, otherwise put, about the speaker's basis for holding that view."[58] For example, a statement that the issuer believes its conduct complies with the law may be misleading if the issuer makes the statement without having consulted a lawyer.[59] Accordingly, the Court held that an issuer may be liable under Section 11 "if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion [even if such statement is literally true], and if those facts conflict with what a reasonable investor would take from the statement itself."[60]

The Court emphasized that whether an omission renders a statement of opinion misleading must be determined taking into account factors that a reasonable investor would consider (such as the customs and practices of the relevant industry) and in the context of the registration statement as a whole, including "hedges, disclaimers, and apparently conflicting information."[61] ("[t]he reasonable investor understands a statement of opinion in its full context, and § 11 creates liability only for the omission of material facts that cannot be squared with such a fair reading").[62]

Thus, to plead a Section 11 claim with respect to a statement of opinion based on omitted facts, a plaintiff "must identify particular (and material) facts going to the basis for the issuer's opinion — facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have — whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context."[63] The Court also provided helpful guidance to issuers on how to avoid liability under this standard: "[T]o avoid exposure for omissions under § 11, an issuer need only divulge an opinion's basis, or else make clear the real tentativeness of its belief."[64]

The Court remanded the case for a determination of whether the plaintiff had adequately alleged that Omnicare omitted a material fact regarding its statements of opinion, and, if so, whether "the excluded fact shows that Omnicare lacked the basis for making those statements that a reasonable investor would expect."[65] As of the date of this Update, the case remains undecided on remand.

Recent Developments

Since the Court's decision, federal courts have cited the *Omnicare* decision in over 30 court-related orders and decisions in securities fraud cases. In those cases, both plaintiffs and defendants have

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sought to put the *Omnicare* decision to favorable use;[66] lower courts have permitted plaintiffs to amend their complaints and invited litigants to submit supplemental briefings focused on plaintiff's pleadings in light of *Omnicare*;[67] and several previously dismissed securities class action claims have been revived upon application for reconsideration in light of *Omnicare*, including two by the Supreme Court.[68]

Notably, while *Omnicare* addressed only Section 11 many lower courts have since chosen to apply the Court's reasoning to securities fraud claims brought under Section 12(a)(2) of the Securities Act and Section 10(b) of the Securities Exchange Act of 1934 (or simply assumed without deciding that *Omnicare* applies to such causes of action) given the similarity of language and reasoning as between Section 11 on the one hand and Section 12(a)(2) and Rule 10b-5 on the other.[69]

The opinion imposes significant pleading requirements on a plaintiff seeking to base a securities lawsuit on a statement of opinion, which the Court stated will be "no small task for an investor" to satisfy.[70]

Final Thoughts

It seems clear from the *Omnicare* opinion that issuers face a diminished risk of incurring securities fraud liability for stating an untrue fact when disclosing statements of opinion formed with a reasonable basis. Further, even assuming that an opinion statement is *actually* believed by the issuer, however, if an issuer's disclosure omits facts that go to the reasonableness of the basis for the statement of opinion, the issuer may not succeed on a motion to dismiss the claim and could ultimately face potential fraud-based liability based on the omission of those facts (if proven material).

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Second Circuit Decision Opens Door for Section 10(b) Liability Based Specifically on Item 303 "Omissions"

Earlier this year, the Second Circuit issued a significant decision regarding liability for disclosures under Item 303 of Regulation S-K. In *Stratte-McClure v. Morgan Stanley*,[71] the Second Circuit held that a failure to comply with Item 303, which creates a specific and affirmative duty to disclose a known trend or uncertainty, can give rise to liability under Section 10(b) of the Securities Exchange Act of 1934. The Second Circuit's holding in *Stratte-McClure* created a circuit split with the Court of Appeals for the Ninth Circuit, which in its October 2014 ruling in *In re NVIDIA Corp. Securities Litigation*,[72] held that Item 303 does not create a specific and affirmative duty to disclose for purposes of Section 10(b).

Item 303 of Regulation S-K

Item 303 requires disclosure, among other things, of "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[73] In order to determine whether a trend or uncertainty requires disclosure under Item 303, an issuer must assess (i) if the known trend is likely to come to fruition and (ii) if management is unable to make that determination, it must evaluate the consequences of the known trend assuming that it will come to fruition. After assessing the potential consequences, disclosure is required unless management concludes that a material effect on the company's financial condition or results of operations is not reasonably likely.[74]

The Second Circuit had already held that Item 303's requirement to disclose known trends or uncertainties is actionable under Sections 11 and 12(a)(2) of the Securities Act of 1933, which pertain to registration statements and prospectuses.[75] However, in 2014, the Ninth Circuit declined to extend those holdings to apply to Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. In *Stratte-McClure*, the Second Circuit handed down an opposite decision.

Background and Procedural History

The *Stratte-McClure* decision involves disclosures surrounding Morgan Stanley's investment strategy that allegedly exposed the company to large liabilities with subprime residential mortgage backed securities ("RMBSs"). According to the second amended complaint, in December 2006, Morgan Stanley's proprietary trading group purchased $2 billion of credit default swaps ("CDSs") on collateralized debt obligations ("CDOs"), which were

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backed by mezzanine tranches of subprime RMBSs. On these CDSs, Morgan Stanley paid annual premiums that ensured if the RMBSs backing the CDOs defaulted or declined, Morgan Stanley would receive payments. At the same time, Morgan Stanley sold $13.5 billion of CDSs on CDOs backed by super-senior tranches of subprime RMBSs and received annual premiums in exchange for the guarantee that it would pay purchasers in the event the CDO tranches defaulted or declined in value. The tranches of RMBSs that backed the CDOs that Morgan Stanley sold were higher rated and lower risk than the tranches of RMBSs that backed the CDOs that Morgan Stanley purchased. Underlying Morgan Stanley's strategy was a view that the subprime market was due for a correction that was big enough to impair the value of the CDOs backed by mezzanine level RMBSs, but not big enough to impair the value of the CDOs backed by the super-senior tranches of RMBSs. Thus, Morgan Stanley would receive payment on the CDSs it purchased (the "Short Position"), but would not have to make payment on the CDSs it sold (the "Long Position"). Contrary to Morgan Stanley's expectations, however, the subprime mortgage market experienced a much more substantial correction, and by the end of 2007, Morgan Stanley had suffered significant losses, including on its Long Position that was backed by the higher quality RMBSs.

Plaintiffs initially filed suit in the United States District Court for the Central District of California after Morgan Stanley's stock price declined in value, alleging actionable misstatements and omissions that concealed Morgan Stanley's risk exposure and fraudulently inflated the stock price. After plaintiffs amended their complaint, the case was transferred to the District Court for the Southern District of New York. The district court found that the plaintiffs failed to allege why the statements were false.[76]

On June 9, 2011, plaintiffs filed their second amended complaint alleging that Morgan Stanley violated Sections 10(b) and 20(a) of the Exchange Act.[77] The plaintiffs argued, in relevant part, that Item 303 created an affirmative duty for Morgan Stanley to disclose the Long Position in the company's Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") section of its Form 10-Q filings for the second and third quarters of 2007 and that failure to make such disclosures constituted violations of Rule 10b-5. The plaintiffs claimed that by no later than July 4, 2007, Morgan Stanley knew that the Long Position was reasonably expected to have a material negative impact on revenue, but made no such disclosures in its 2007 10-Q filings.

The district court agreed with the plaintiffs and held that a failure to comply with Item 303 created an

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actionable cause under Rule 10b-5.[78] The district court, in forming its opinion, relied on prior Second Circuit rulings which held that Item 303 may provide a basis for disclosure obligations under Sections 11 and 12(a)(2).[79] However, the case was dismissed because plaintiffs were unable to plead "a strong inference of scienter" with respect to defendant's lack of disclosure.[80]

The Second Circuit Decision

On appeal, the Second Circuit considered as a matter of first impression whether a failure to comply with Item 303 creates potential 10(b) liability. Section 10(b) is supplemented by Rule 10b-5(b), which states that it is unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading."[81] It is generally understood that "silence, absent a duty to disclose, is not misleading under Rule 10b-5."[82] Rather "[a]n omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts."[83] The Second Circuit ruling in *Stratte-McClure* holds that the Item 303 requirement to disclose known trends and uncertainties imposes such a duty and thus can serve as the basis for a claim under Section 10(b).

The Second Circuit provided two lines of reasoning. First, as mentioned, the Second Circuit had previously held that failing to comply with Item 303 can give rise to liability under Sections 11 and 12(a)(2)[84] (citing the decision in *Panther Partners Inc. v. Ikanos Communications, Inc.*[85], among others). The Second Circuit noted that Rule 10b-5 and Section 12(a)(2) have the same language.[86] Therefore, the court reasoned that if a lack of Item 303 disclosures provides an actionable case under Section 12(a)(2), it must also provide an actionable case under Rule 10b-5.

Second, the *Stratte-McClure* decision held that the Second Circuit and "sister circuits have long recognized that a duty to disclose under 10(b) can derive from statutes or regulations that obligate a party to speak …[therefore,] omitting an item required to be disclosed on a 10-Q can render that financial statement misleading."[87] Applying these holdings to the case, the Second Circuit found that Item 303 creates an affirmative obligation to disclose information and "[d]ue to the obligatory nature of these regulations, a reasonable investor would interpret the absence of an Item 303 disclosure to imply the nonexistence of 'known trends or uncertainties.'"[88] Therefore, the absence of this required disclosure could make the public filing misleading and thus actionable under Section 10(b).

However, even if Morgan Stanley failed to make a required disclosure,

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to maintain an actionable 10(b) claim, the omission must also have been material. In determining the materiality of a forward looking statement, the Second Circuit applied the 10(b) standard laid out in the seminal case *Basic v. Levinson*.[89] Under the *Basic* framework, materiality for a "forward looking disclosure is determined by 'a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in the light of the totality of the company activities.'"[90]

The *Basic* standard is different than the Item 303 standard used to assess whether a known trend or uncertainty needs to be disclosed. Under Item 303, management must first determine whether the known trend or uncertainty is "likely to come to fruition."[91] "If management cannot make that determination, it must evaluate objectively the consequences of the known trend … on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operation is not reasonably likely to occur."[92] In 1989, the SEC issued guidance that the disclosure standard for Item 303 is inapposite to *Basic* and a Third Circuit court has held that Item 303 disclosure obligations "extend considerably beyond those required by Rule 10b-5."[931] Therefore, just because a factor or trend should be disclosed under Item 303, it does not necessarily follow that an absence of such disclosure is material under 10(b) to maintain a cause of action.

Applying the facts, the Second Circuit held that plaintiffs sufficiently alleged that Morgan Stanley knew of "a significant downward trend in the subprime residential mortgage market that could negatively affect [its] overall financial position" and that this downward trend created "significant [financial] exposure."[94] Therefore, plaintiff adequately alleged that Morgan Stanley's knowledge of the downward trend gave rise to a duty to report under Item 303 because the exposure created through the long position was a 'known trend[] … that [was] reasonably expected to have material effects' on the company's financial position.[95]

The Second Circuit also noted that generic disclosures about market trends do not satisfy Item 303. Rather, Item 303 "'requires not only a 'discussion' but also an 'analysis' of known material trends' and that disclosure is 'necessary to an understanding of a company's performance, and to the extent to which reported financial information is indicative of future results."[96] In other words, the disclosure must make clear that there is a known trend and how it may be expected to impact the company's overall financial position. The Second Circuit did not act so far as to require Morgan Stanley to specifically

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disclose its internal business strategy, but it did require it to quantify the expected impact on the company's overall financial position.

The Second Circuit agreed with the district court that the plaintiff's had failed to establish a strong inference of scienter and affirmed the lower court's dismissal without deciding whether the omissions regarding the Long Position were material under either of Item 303 and Rule 10b-5.[97]

The Second Circuit's Handling of the *NVIDIA* Decision

As mentioned, the *Stratte-McClure* decision is at odds with the Ninth Circuit's holding in *NVIDIA*. In *In re NVIDIA Corp. Sec. Litig.*, the Ninth Circuit held that "Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5."[98] In reaching that decision, the Ninth Circuit dismissed the idea that since a failure to comply with Item 303 has been held to create potential liability under Sections 11 and 12(a)(2), such a failure should also create potential 10(b) liability. Section 11 specifically provides liability for "omitt[ing] to state a material fact required to be stated" as opposed to Rule 10b-5, which only provides liability for omissions if the omissions could cause other information disclosed to be rendered misleading.[99] However, the Ninth Circuit failed to differentiate between the language in Sections 11 and 12(a)(2), as the language in 12(a)(2) is virtually identical to that of Rule 10b-5.

Further, both the Second Circuit and the Ninth Circuit pointed to the Third Circuit case *Oran*, to support their positions. In *NVIDIA*, the Ninth Circuit decision quotes *Oran* as follows, "[b]ecause the materiality standards for Rule 10b-5 and [Item 303] differ significantly, the 'demonstration of a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b–5. Such a duty to disclose must be separately shown.'[100] The Ninth Circuit focused on this last sentence which seems to imply that Item 303 does not impose its own separate reporting requirement. In dismissing the Ninth Circuit's reasoning, the Second Circuit focused instead on the *Oran* rationale noting that because the materiality standards are different, Item 303 does not "*automatically* give rise to a material omission under Rule 10b-5."[101] Therefore, according to the Second Circuit, Item 303 *could* be applied to Rule 10b-5 if the underlying known trends or uncertainties omitted are both "material under Basic, and the other elements of Rule 10b-5 have been established."[102]

Final Thoughts

In our last Update, we highlighted Bank of America's August 2014 settlement with the Department of Justice (DOJ)

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Second Circuit Decision Opens Door for Section 10(b) Liability Based Specifically on Item 303 "Omissions"

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that included a $20 million settlement with the SEC for failing to include disclosure regarding known trends or uncertainties as required by Item 303. As with the omission at issue in Stratte-McClure, the Bank of America settlement related to a failure to provide disclosures around the accelerating decline of its residential mortgage investments during the financial crisis and subsequent economic downturn.

Although the Second Circuit dismissed the claim against Morgan Stanley, the Stratte-McClure decision opens the door, however slightly, for future private securities fraud claims to be brought based on a failure to disclose known trends and uncertainties required by Item 303.

In the Bank of America settlement, however, the SEC's action was brought under Section 13(a) of the Exchange Act, which does not require a finding of scienter or otherwise knowingly culpable conduct. Importantly, an inability to satisfy the scienter requirement was what precluded the plaintiffs from moving forward with their claim against Morgan Stanley.

Further, despite the current circuit split, the Supreme Court denied the petition for a writ of certiorari in *NVIDIA*, without comment, making it unlikely that the question will be settled any time soon. Nevertheless, the *Stratte-McClure* ruling underscores the importance of both (i) careful drafting and review of MD&A disclosures and (ii) maintaining effective disclosure policies and practices. In particular, companies should prepare their MD&A mindful of the fact that material forward-looking information regarding known material trends and uncertainties is required to be disclosed, including an analysis of their impact on results of operations, and that a failure to comply could serve as the basis for future securities fraud claims.

Developments to Watch

SEC Proposes Amendments to "Rules of Practice" Concerning Use of Administrative Proceedings for Alleged Securities Violations

Increasingly, the SEC is using administrative proceedings to pursue insider trading and other complex securities actions,[103] which, prior to the Dodd-Frank Act ("Dodd-Frank") could only have been brought in federal district court.[104] This practice has come under scrutiny, because administrative proceedings — held in front of an administrative law judge ("ALJ") appointed by the Commission — lack the due process and the discovery opportunities afforded to defendants in federal court. The Second Circuit and the Eleventh Circuit are currently considering the constitutionality of this practice in the context of securities fraud and insider trading cases respectively.[105]

On September 24th, the SEC released a proposal to amend the Commission's Rules of Practice.[106] Rather than signaling a shift in policy away from bringing administrative proceedings in insider trading cases, the proposed amendments reaffirm the SEC's commitment to this course. Perhaps the strongest indicator of this allegiance is the SEC's proposal to create an electronic filing system for these proceedings and to make electronic filing mandatory.[107]

Beyond the new filing system, the proposed amendments seek to address some of the fairness concerns that have been raised since this practice became more commonplace. *First*, the SEC has proposed extending the time prior to each hearing in order to allow for discovery.[108] Under amended Rule 360, the hearing "must be scheduled to begin approximately four months after service of the order instituting proceedings, but not later than eight months after service of the order."[109] This proposed change doubles the maximum amount of time between initiation of the proceedings and the hearing and "is intended to provide additional flexibility during the prehearing phase of a proceeding and afford parties sufficient time to conduct deposition discovery pursuant to the proposed new rules."[110]

Second, proposed amendments to Rule 233 would allow parties in more complex administrative proceedings to take limited oral depositions of witnesses: three witnesses for a single defendant and five for multiple defendants.[111] Under the current Rules, parties may only take depositions by oral examination if a witness is unable to attend or testify at a hearing. This change is "intended to provide parties

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SEC Proposes Amendments to "Rules of Practice" Concerning Use of Administrative Proceedings for Alleged Securities Violations
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with an opportunity to develop arguments and defenses … which may narrow the facts and issues to be explored during the hearing."[112]

Third, the SEC proposed amendments to Rule 410, which effectively adopt a notice pleading standard for appeals of ALJ decisions. Under this more lenient standard, a petitioner need not set forth all of the specific findings and conclusions it believes to be erroneous. Instead, a petitioner would provide "a summary statement of the issues presented for review," without fear of waiving specific claims.[113]

The view that the administrative proceedings provide a "home court advantage" for the SEC remains unchanged following the proposed amendments. However, the proposal does provide greater opportunity for defendants to develop their understanding of the facts and arguments as part of the administrative process.[114] While the SEC's desire to cabin the length and costs of the proceedings is understandable, concerns remain regarding the admissibility of hearsay evidence and the lack of flexibility afforded to administrative judges to make allowances based on case-specific needs; for example, to allow for additional depositions if parties can show good cause.[115]

Each of the proposed amendments, though, highlights the reality that the SEC's administrative proceedings lack the procedural certainty of actions brought in federal court, which, in turn, raises prudential and constitutional concerns.

In the words of SEC Chair Mary Jo White, the amendments "seek to modernize" the SEC Rules by providing "additional time and prescribed discovery" to defendants in administrative proceedings brought by the Commission.[116]

Finally, while the proposed amendments seek to address some of the complaints about the procedural fairness of the administrative proceedings, they ignore completely the constitutional challenges that have been raised in recent cases. As such, many of the same alleged concerns remain unaddressed: (i) the absence of a jury; (ii) the Commission's role as both prosecutor and adjudicator; (iii) the lack of independence of ALJs, who are appointed by the SEC; and (iv) the potential Appointments Clause violation.[117] See "Constitutional Challenges to the SEC's Appointment of Administrative Law Judges" elsewhere in the Update.

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Legislative Focus on Insider Trading Following *United States v. Newman*

In February and early March of 2015, Democratic members of the House of Representatives and the Senate introduced bills that would amend Section 10(b) of the Exchange Act to prohibit both trading on the basis of, or while in possession of, certain categories of nonpublic information and certain disclosures of such information by insiders. The third bill, introduced on March 25, 2015 by a bipartisan group of members of the House of Representatives, would add a new Section 16A of the Exchange Act prohibiting similar conduct. The principal common element in the first two proposed bills is the elimination, in most cases, of the traditionally required nexus between insider trading as a cause of action with Section 10(b)'s prohibition of deceptive conduct. The third proposed bill, reflecting an approach that more closely follows the current state of insider trading law, retains a requirement of "wrongful" conduct in connection with trading in securities.

Prohibited Trading Activity

The proposed Senate bill (the "Reed/Menendez Bill")[118] would make it illegal to "purchase, sell, or cause the purchase or sale of any security on the basis of material information that the person knows or has reason to know is not publicly available," however, the bill does not define "material information," likely leaving intact the standards developed by case law.[119] The bill does attempt to delineate what constitutes nonpublic information by specifying that "information that the person has independently developed from publicly available sources"[120] is categorically *not* nonpublic.[121] The first bill proposed in the House of Representatives (the "Lynch Bill")[122] would similarly prohibit the purchase or sale of any security "based on information that the person knows or … should know is material information and inside information." The second bill introduced in the House of Representatives (the "Himes Bill")[123] would prohibit trading in securities "while in possession of material,

Each bill raises interpretive questions that could undermine the intent of the proposals to clarify the current state of the law.

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nonpublic information relating to such security … or relating to the market for such security … if such person knows, or recklessly disregards, that such information has been obtained wrongfully, or that [the trade] would constitute a wrongful use of such information."

The Lynch bill, by contrast to the Reed/Menendez Bill, retains a partial link between "insiders" and traders by requiring as an element of a violation of new Section 10(d), the use, and not just the possession of, "inside information" (*i.e.* information that is both "nonpublic" and either obtained "directly or indirectly from an issuer with an expectation of confidentiality or that such information will only be used for a legitimate business purpose" or obtained "in violation of a fiduciary duty").[124] Interestingly, the bill defines "material information" as information that relates "directly or indirectly … to an issuer or a security, and that, if it were made public, would be likely to have a significant effect on the price of a security," diverging from the traditional definition of "materiality" and potentially widens the scope of prohibited conduct by bifurcating the "issuer," as the source of the information, from the generic "security" that is the subject of the trade.

The Lynch Bill also expressly contemplates a sliding scale concept to be used to test the sophistication of a tippee such that sophisticated market participants would be deemed more culpable when trading on the basis of certain information than a hypothetical average retail investor trading after receiving the same information.

Tipper/Tippee Liability

In addition to prohibiting trades on the basis of prohibited categories of information, each proposed bill expressly provides for tipper liability. Neither the Lynch Bill nor the Reed/Menendez Bill would require that a recipient of the subject information actually trade on it in order for tipper liability to attach. The Reed/Menendez Bill eliminates the *quid pro quo* element of the test for tipper liability. It would ban the knowing or reckless communication of "material information that the person knows or has reason to know is not publicly available to any other person under circumstances in which it is reasonably foreseeable" that the tippee will trade on the information, without elaboration on or clarification of what the phrase "reasonably foreseeable" means in this context. Similarly, the Lynch Bill would make it a violation of a new Section 10(d) to intentionally disclose "without a legitimate business purpose to another person information that the discloser knows or… should know is material information and inside information," with a sophisticated person being held to a higher standard of conduct.

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Under the Himes Bill, a tipper would be potentially liable if the tippee actually trades — or passes the tip on to someone else who trades—and the resulting trade while in possession of the tip is "reasonably foreseeable."[125] While the Himes Bill, like the Lynch Bill, expressly states that neither tipper nor tippee is required to know the specific means by which the tip was communicated or whether any personal benefit was paid or promised to "any person in the chain of communication," a tippee subject to prosecution under the Himes Bill must be aware, or must have recklessly disregarded, that the information was wrongfully obtained or communicated.[126] Thus, the Himes Bill creates a potential third standard of conduct by which tippees would be judged with (i) the Lynch Bill's "knows or… should know" standard of conduct and (ii) the Reed/Menendez Bill's "knows or has reason to know" standard of conduct for tippee liability.

Perhaps with the passage of time we will know whether legislative inertia or a desire for greater clarity and certainty (particularly post-*Newman*) proves to be the more powerful force. ■

Are the Boundaries Between Insider Trading and Criminal Cyber-Theft Converging?

On August 11, 2015, the SEC announced fraud charges against a criminal group that used high tech capabilities to accomplish a decidedly low tech goal: trading on stolen corporate earnings information.[127] The group accomplished this feat by hacking the computer systems of wire services, including by SQL[128] injection, credential theft and other hacking techniques, in order to gain access to corporate earnings reports before they were released publicly.

Authorities estimated that this scheme netted the group more than $100 million in profits over a period of approximately five years. Assuming the alleged facts are true, the defendants clearly engaged in criminal behavior. However, extending the charges against them to securities fraud requires a judicial leap with respect to traditional insider trading law theories, a leap that may have been made possible by the 2009 decision by the United States Court of Appeals for the Second Circuit in *SEC v. Dorozhko*.[129]

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Are the Boundaries Between Insider Trading and Criminal Cyber-Theft Converging?
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In *Dorozhko*, the Second Circuit determined that a "deceptive device" under Rule 10b-5 does not require a breach of a fiduciary duty[130] (as the district court had ruled) but can instead turn on the "ordinary meaning of 'deceptive.'"[131] Following this "ordinary meaning" theory, the Second Circuit determined that "misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive'"[132] and thus could serve as the basis for an insider trading action under Section 10(b). However, the Second Circuit went on to state that it was unclear whether this would extend to all forms of computer hacking, such as those that exploit weaknesses in electronic code rather than identity misrepresentation.

With the charges announced in August, the SEC seems to be attempting to take the next step in characterizing computer hacking as an affirmative deception, thus requiring no breach of a fiduciary duty. The SEC complaint was clearly drafted with a nod to the Second Circuit decision in *Dorozhko*, characterizing the hacker's activities as "using deceptive means to gain unauthorized access."[133] Notwithstanding the SEC's characterization of such actions as deceptive, "deploying malicious computer code"[134] and "using back-door access modules" may not fit squarely within the "ordinary meaning" of deceptive as outlined in the *Dorozhko* ruling. Further, the fact that, unlike Dorozhko, the hackers in this case did not trade on the information — they sold the information to others who then traded on the stolen information they purchased — renders the satisfaction of the "in connection with the purchase or sale of any security"[135] requirement of the SEC's Section 10(b) tenuous.

With the incidence of securities trading-related cyber-theft on the rise, pressure may increase on civil and criminal law enforcement agencies to bring securities fraud charges in these cases. Further, given the importance of the outcome of these cases to various aspects of our economy, it may be that the SEC will find a sympathetic ear among jurists when seeking to charge these computer hackers with violating Section 10(b) and blurring the line between criminal theft and insider trading.

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Constitutional Challenges to the SEC's Appointment of Administrative Law Judges

The SEC, in its discretion, may bring actions alleging securities violations in federal court or as administrative proceedings. The Dodd-Frank Act expanded the universe of actions the SEC is permitted to bring as administrative proceedings to include both those against unregistered and registered persons.[136] Since the passage of Dodd-Frank, the SEC has greatly increased its use of administrative proceedings to pursue alleged securities violations[137] and there are clear indications that it intends to continue in this vein.[138]

Administrative proceedings take place in front of an administrative law judge ("ALJ") and not juries. ALJs are non-Article III judges and are appointed by the SEC. Concerns about the general fairness of these proceedings, in which the SEC acts as both prosecutor and adjudicator, are common.[139] Recently a specific — and somewhat esoteric — constitutional challenge has gained some traction: whether the process by which the SEC appoints its ALJs comports with the requirements of the Appointments Clause in Article II of the Constitution. The Seventh Circuit recently side-stepped the Appointments Clause issue in *Bebo v. SEC* when it concluded that it lacked jurisdiction over the action.[140] However, cases currently pending before the Second and Eleventh Circuits squarely present this issue.[141]

The dispositive question in these cases is whether the ALJs are "inferior officers," which, under Article II, may only be "appointed" by the President, by the heads of departments, or by the Judiciary.[142] It is undisputed that the SEC does not follow the process laid out in Article II when appointing its ALJs. Rather, the ALJs are "hired by the SEC's Office of Administrative Law Judges, with input from the Chief Law Administrative Judge, human resources functions, and the Office of Personnel Management."[143] As such, if the courts determine that the ALJs are "inferior officers," the ALJ appointments are necessarily unconstitutional.

The SEC argues that ALJs are not inferior officers and instead are "mere employees" based on: Congress's treatment of them, the fact that they cannot issue final orders, and the ALJs' inability to compel compliance with their orders.[144] One might wonder why the SEC does not simply amend its appointments procedure going forward, in order to avoid this particular constitutional challenge. However, such a move by the Commission would create an avenue for all defendants currently facing — and those who have previously faced — SEC administrative proceedings to challenge the constitutionality and the results of those proceedings.[145]

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Constitutional Challenges to the SEC's Appointment of Administrative Law Judges

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Two judges in the Southern District of New York recently reached different conclusions when confronted with Appointment Clause challenges. In *Duka*, the SEC brought an administrative proceeding against a managing director at Standard & Poor's Ratings Services, alleging failure to disclose properly the methodology for calculating Debt Services Ratios. The SEC argued that this failure misled market participants "into believing that the ratings at issue were more conservative than they actually were."[146] Duka filed a complaint in the Southern District of New York seeking to enjoin the administrative proceeding based on an alleged Appointments Clause violation. Judge Berman concluded that ALJs are "inferior officers" because they exercise "significant authority pursuant to the laws of the United States"[147] and enjoined the SEC from pursuing administrative proceedings against the Duka.[148] *In Tilton v. SEC*, also filed in the Southern District of New York, plaintiffs sought to enjoin SEC administrative proceedings by putting forth the same arguments that were made in *Duka*.[149] However, Judge Abrams denied Tilton's motion for a preliminary injunction holding that the court lacked jurisdiction over the matter.[150]

Each of these decisions was appealed to the Second Circuit and on September 17, 2015, that court ordered that the SEC stay its administrative proceeding against Tilton pending further order.[151] While the Second Circuit has not yet ruled on the merits of Duka's or Tilton's Appointments Clause challenge, its order staying the SEC administrative proceedings pending the court's decision may suggest that it is seriously considering the argument that the SEC ALJs are inferior officers.

The same question is also pending before the Eleventh Circuit. In two separate cases brought in the Northern District of Georgia,[152] Judge May concluded that the plaintiffs had established a likelihood of success on the merits that the appointments of the SEC ALJs is unconstitutional and enjoined the SEC administrative proceedings in each.[153] She held that "SEC ALJs exercise "significant authority" and are thus inferior officers" because "they take testimony, conduct trial, rule on admissibility of evidence, and can issue sanctions . . . ."[154] The SEC appealed both of these decisions. The Eleventh Circuit has yet to weigh in on the merits of these actions, but "refused to lift the injunction against administrative proceedings" pending the appeal in *Hill*.[155]

It remains to be seen what the Second and Eleventh Circuits will conclude, but it seems likely that respondents to SEC administrative proceedings will continue to mount Appointments Clause challenges in federal court until there is more clarity from the Circuits or the Supreme Court ultimately speaks on the issue.

Notable Cases & Enforcement Actions

Recent SEC Actions Highlight Scrutiny of Individuals

A series of recent enforcement actions by the SEC underscore the agency's willingness to hold executives and directors, as well as outside professionals, accountable for securities fraud and disclosure violations. These SEC enforcement actions highlight the need for directors and senior management to maintain a sharp focus on their company's controls and disclosure practices, given the potential heightened scrutiny of their conduct by the SEC. Senior managers and directors should also be cognizant that the DOJ in its recently announced "Yates Memorandum" articulated a renewed focus on holding individuals accountable for criminal wrongdoing by directing prosecutors to focus on individual conduct when pursuing cases.

Enforcement Actions

MusclePharm Corporation. On September 8, the SEC settled charges against MusclePharm Corporation (MusclePharm)[156] and MusclePharm's chief executive officer, two former chief financial officers and former audit committee chair for various disclosure and accounting failures, including: a failure to disclose perquisite compensation to executive officers and related party transactions involving a major customer; and improper accounting of costs and expenses by the company. Moreover, MusclePharm continued to file materially inaccurate disclosure regarding perks even after an internal review had been commenced and the audit committee chair became directly involved in the review process.

Bankrate, Inc. On September 8, Bankrate, Inc. (Bankrate) and its former vice president of finance agreed to settle accounting fraud charges focused on the manipulation of financial results in order to meet analyst consensus estimates.[157] The SEC charged Bankrate and its former chief financial officer, director of accounting and vice president of finance with various accounting fraud schemes, including: the fraudulent booking of fictitious revenue by three divisions of the company; the improper reduction of a marketing expense accrual in a "cushion" account that had been previously used to manipulate financial results; and the failure to book accountant fees. The case against the other two individuals is continuing.

KIT Digital, Inc. On September 8, the SEC charged the former chief executive officer and chief financial officer of KIT Digital, Inc. (KIT) with falsifying financial statements and misleading investors and outside auditors.[158] The officers are alleged to

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have, among other violations: hidden a loss of approximately $2 million with an offshore money manager by characterizing the investment as cash or cash equivalent in KIT's financial statements; failed to disclose an arrangement with a hedge fund manager to trade KIT stock in order to manipulate the trading volume and price of the stock; improperly recognized revenue on the sale of a software product that was in fact never delivered to the customer and for which the customer never made any payments; and falsely disclosed that $7.85 million in cash would be paid as consideration in an acquisition, but instead used the cash to falsely reduce KIT's customer accounts receivables and other expenses.

BDO USA LLC. On September 9, the SEC settled charges with BDO USA LLC (BDO) and five of its partners in connection with accounting fraud by General Employment Enterprises, Inc. (GEE).[159] Two former GEE chief executive officers separately settled charges that they provided misleading statements to BDO. During the audit of GEE's 2009 financial statements, BDO received conflicting accounts regarding the existence of a $2.3 million certificate of deposit (the CD). BDO demanded that the audit committee commission an independent investigation of the matter. Notwithstanding unresolved questions and red flags regarding the CD, BDO withdrew its demand several days later and issued its audit report with an unqualified opinion. Further, after learning of a criminal complaint involving the CD, BDO did not perform appropriate audit procedures to determine if the new information would impact BDO's unqualified opinion on the 2009 financial statements and failed to consider this information in its subsequent audit of GEE's 2010 financial statements. Among the failures cited by the SEC: BDO failed to exercise due professional care and professional skepticism when it recognized red flags regarding the CD and potential illegal acts by management; failed to obtain sufficient evidential matter to support the assertion in the 2009 and 2010 GEE financial statements that the CD existed and was a cash equivalent; placed undue reliance on management representations from individuals they did not trust; and failed to appropriately consider new facts when it learned of the criminal complaint. The SEC also charged GEE's former chairman and controlling shareholder with securities fraud and that case is ongoing.

SMF Energy Corp. On September 25, the SEC charged the former chief executive officer, chief financial officer, chief accounting officer and senior vice president of sales and investor relations of SMF Energy Corp. (SMF) with inflating SMF's financial results by overbilling certain of its mobile fueling customers, including the United States Postal Service (USPS).[160] The officers are alleged to have, among other

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violations, charged a surcharge on fuel that had not been delivered through an incremental allowance billing scheme and imposed hidden charges on fuel deliveries that were not permitted under the governing contracts. As a result of the fraudulent billing scheme, SMF materially overstated its revenue, margins, shareholders' equity and net income while understating liabilities in 2010, 2011 and the first half of 2012. In March 2012, SMF's board of directors was advised that the USPS had been improperly overbilled by SMF. Thereafter, the fraudulent billing practices ceased resulting in a decrease in revenue and deterioration in the company's financial condition. SMF filed for bankruptcy in April 2012 and self-reported potential securities law violations in May 2012.

Trinity Capital Corporation. On September 28, Trinity Capital Corporation (Trinity), its wholly-owned subsidiary, Los Alamos National Bank, and its former chief executive officer, chief financial officer and vice president of internal audit agreed to settle accounting fraud charges in connection with material misstatements in Trinity's quarterly and annual reports with the SEC in 2010, 2011 and the first half of 2012.[161] In addition, the SEC charged Trinity's former chief credit officer and senior lender officer with financial fraud and these cases are ongoing. The SEC charged Trinity and its officers with, among other violations, failing to properly account for loan losses and impairments related to Trinity's loan portfolio and other real estate owned by Trinity. As a result of these failures, Trinity reported a net income of $4.9 million instead of a loss of $25.6 million in 2011.

Focus Media Holding Limited. On September 30, the SEC settled charges against Focus Media Holdings Limited (Focus Media) and its chief executive officer in connection with inaccurate and misleading disclosure relating to the March 2010 partial management buyout (MBO) of Focus Media's internet advertising subsidiary, Allyes Online Media Holdings Ltd. (Allyes).[162] A private equity firm purchased Allyes for $200 million in July 2010. The SEC charged that Focus Media made materially false disclosures in its filings regarding the MBO and valuation of Allyes. Focus Media and its chief executive officer ignored a number of red flags, including: the CEO of the parent company being the largest purchaser in the MBO and non-manager consultants participating in MBO notwithstanding the fact that the MBO was described in SEC filings as an incentive initiative for managers of Allyes; there was a vast valuation difference between the MBO price and the acquisition price; evidence that negotiations with the private equity firm regarding a sale of Allyes at a $200 million price had commenced prior to the closing of the MBO; and a lack of appropriate corporate formalities

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surrounding the MBO and sale of Allyes to the private equity firm.

ContinuityX Solutions Inc. On September 30, the SEC charged the former chief executive officer and former chief financial officer of ContinuityX Solutions Inc. (ContinuityX) with perpetuating various fraudulent schemes to fabricate ContinuityX's revenue from April 2011 to September 2012.[163] The officers are alleged to have, among other violations, used straw buyers for purchases and improperly book commissions from such sales as revenue; and book revenue from sales transactions that were wholly fabricated. Over 99% of the revenues reported in ContinuityX's SEC filings were derived from the fraudulent schemes.

OCZ Technology Group Inc. On October 6, the SEC charged the former chief executive officer and former chief financial officer of OCZ Technology Group Inc. (OCZ) with accounting fraud in connection with inflating OCZ's revenues and gross margin.[164] The chief executive officer was alleged to have, among other violations, mischaracterized sales discounts as marketing expenses, channel-stuffed OCZ's largest customer to improperly book revenue and concealed customer product returns to avoid having the returns recorded in the financial statements. The SEC settled with the chief financial officer who was charged with improperly recording transactions in contravention of U.S. GAAP and failing to implement sufficient internal accounting controls. The case against the chief executive officer is ongoing.

The St. Joe Company. On October 27, the SEC settled charges against The St. Joe Company (St. Joe) and its former chief executive officer, former chief financial officer, former chief accounting officer and two former directors of accounting for materially overstating earnings and assets in 2009 and 2010.[165] The officers are alleged to have, among other violations, repeatedly failed to properly conduct impairment testing of St. Joe's real estate developments and take required write-downs on such properties, including failing to disclose in its SEC filings material changes to the company's business strategy for two of its largest real estate projects, failing to inform its auditors of material facts related to the impairment testing and failing to maintain adequate books and records with respect to the impairment testing.

Key Takeaways

Focus on Controls and Procedures. Directors and senior management should regularly review and evaluate the sufficiency of current policies and procedures regarding disclosure controls and internal control over financial reporting. If not already in place,

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companies should establish a disclosure committee and implement a bottom-up disclosure process. Senior management should focus on "tone-at-the-top" and ensure that employees involved in the disclosure process are appropriately trained.

Maintain Substantive Engagement with Outside Auditors. Directors (and audit committee members specifically) should engage with outside auditors in a comprehensive "walkthrough" of the financial statements each quarter. Specific inquiry should be made as to whether in the course of the auditor's review they had been made aware of or uncovered any potential red flags or other undisclosed issues. Further, directors should satisfy themselves that the auditors have been granted access to all company documents, information and personnel as requested and that the auditors believe that the company's internal finance and audit function are appropriately staffed.

Don't Fly Solo on Complicated Legal or Accounting Matters. Outside legal counsel and independent experts should be consulted on sensitive and/or complicated disclosure or accounting-related questions. Of note, the Director of the SEC Division of Enforcement stated that the MusclePharm audit committee chair had "subjected himself to liability when he substituted his wrong interpretation of SEC rules for the views of experts the company had hired, resulting in an incorrect disclosure."

Sweat the Small Stuff. Recent enforcement actions have focused on inadequate corporate formalities surrounding approvals and execution of transactions and the maintenance of corporate records, such as manual signature pages for SEC filings. Management should ensure proper procedures are in place for obtaining and documenting appropriate approvals and maintaining required records.

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SEC Targets Corporate Insiders with Violating Beneficial Ownership Reporting Requirements

Earlier this year, the SEC announced that it had charged eight officers, directors and/or major shareholders, in connection with three separate transactions, for failing to amend their Schedules 13D in a timely manner to reflect steps they had taken towards a going-private transaction.[166] The 13D actions follow on the heels of actions against late Section 16 form filers last year, as discussed in Volume 2, Issue 1 of this Update.

Under Regulation 13D, beneficial owners who hold more than 5% of a company's stock are required to "promptly" amend their Schedule 13D filings if material changes or developments in the previously disclosed information occur, including changes in the filer's plans or proposals with respect to the issuer. According to the SEC, such "material changes" can take a number of forms. I n the three cases settled by the SEC earlier this year, the changes ranged from informing management of an intention to take a company private and forming a consortium of stockholders to do so, to obtaining waivers from preferred stockholders and determining the form of a going-private transaction.[167] Several of the charged parties had not updated their Schedules 13D for months or even years after the occurrence of the triggering event.

Schedule 13D filers who contemplate taking a company private may sometimes rely on broad statements in the original Schedule 13D filing, which are often phrased to the effect that the filer may decide to pursue a wide range of transactions involving the company in the future. However, the SEC has made clear that it values qualitative disclosure of intent—*i.e.*, that "stale, generic disclosures that simply reserve the right to engage in certain corporate transactions do not suffice when there are material changes to those plans, including actions to take a company private."[168] The SEC's recent actions serve as a reminder that filers should continuously monitor for events that may trigger obligations to update their Schedules 13D, particularly when steps are being taken towards a going private transaction.

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Notes

1. *United States. v. Newman*, 773 F.3d 438, 438 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (Oct. 5, 2015).
2. *Id.* at 450-451.
3. *Id.* at 452-453.
4. *United States v. Conradt*, No. 12-887, 2015 U.S. Dist. LEXIS 16263 (S.D.N.Y. Jan. 22, 2015).
5. *Id.* at *2-3.
6. *Id.* at *4 (quoting *Newman*, 773 F.3d. at 446).
7. *Id.* at *4 (citing *Jimenez v. Walker*, 458 F.3d 130, 142 (2d Cir. 2006).
8. *United States v. Riley*, 90 F. Supp. 3d 176 (S.D.N.Y. March 3, 2015).
9. *Id.* at 184.
10. *Id.* at 183.
11. *Id.* at 185.
12. *Id.* at 185.
13. *Id.* at 186.
14. *Id.* at 186.
15. *Id.* at 186 (quoting Newman, 773 F.3d at 452).
16. *Id.* at 186-89.
17. Order, *United States v. Riley*, No. 15-1541 (2d Cir. May 27, 2015).
18. Motion Order, Granting Motion for Bail, *United States v. Riley*, No. 15-1541 (2d Cir. June 24, 2015); Expedited Scheduling Order, *United States v. Riley*, No. 15-1541 (2d Cir. June 25, 2015).
19. *United States v. Gupta*, No. 11-907, 2015 WL 4036158 (S.D.N.Y. July 2, 2015).
20. *Id.* at *1.
21. *Id.*
22. *Id.* at *2.
23. *Id.* at *3.
24. *Id.*
25. Order denying Motion for Certificate of Appealability, *United States v. Gupta*, No. 11-907 (S.D.N.Y. Aug. 5, 2015).
26. Notice of Appeal, *United States v. Gupta*, No. 11-907 (S.D.N.Y. Aug. 25, 2015).
27. Motion to Vacate under 28 U.S.C. 2255, *United States v. Rajaratnam*, No. 09-1184 (S.D.N.Y. June 16, 2015).
28. Brief for Appellant at *1, *United States v. Martoma*, 2015 WL 493793 (2nd Cir. Feb. 2, 2015).
29. Motion to Vacate under 28 U.S.C. §2255, *United States v. Goffer*, No. 10-0056 (S.D.N.Y. Jan, 22, 2015).
30. *S.E.C. v. Payton*, No. 14-4644, 2015 WL 1538454 (S.D.N.Y. April 6, 2015).
31. *Id.* at *4.
32. *Id.* at *6.
33. *Id.* at *5 (quoting Amended Complaint at ¶56, *SEC v. Payton*, 2015 WL 3549163 (S.D.N.Y. Mar. 16, 2015) .
34. *Id* at *5.
35. 2015 WL 5554788, at *2 (D.N.J. Sep. 21, 2015).
36. Defendant Douglas V. DeCinces's Motion for Reconsideration Due to Decision in *United States. v. Newman* at *1, *United States v. DeCinces*, 2014 WL 10657784 (C.D. Cal. Dec. 19, 2014).
37. 2015 WL 901352, at *15 (N.D. Cal. Mar. 02, 2015).
38. 91 F. Supp. 3d 876,877 (W.D. Ky. Mar. 17, 2015).
39. Brief for Appellant at *1, *United States v. Musante*, 2015 WL 5565039 (4th Cir. Sep. 18, 2015) .
40. Exchange Act Release No. 3682, 2015 WL 5172974 (Sep. 4, 2015).
41. Defendant Mark Megalli's Memorandum of Law in Support of His Motion for Summary Judgment on the Pleadings or, in the Alternative, for Summary Judgment at *1, *SEC v. Megalli*, 2015 WL 1412914 (N.D. Ga. Jan. 29, 2015).
42. 792 F.3d 1087 (9th Cir. July 6, 2015).
43. *Id.* at 1093.
44. *Id.* at 1092.
45. *Id.* at 1093-94 (quoting *Newman*, 773 F.3d at 452).
46. *Salman*, 792 F. 3d at 1094.
47. *United States v. McPhail*, No. 14-10201, 2015 U.S. Dist LEXIS 62096 (D. Mass. May 12, 2015).
48. *Id.* at *9.
49. *Id.*
50. *See S.E.C. v. Yun*, 327 F.3d 1263 (11th Cir. 2003) (finding that that proof of personal benefit is a required element to prove tipper/tippee liability under the misappropriation theory).
51. *In the Matter of Gregory Bolan, Jr. and Joseph Ruggieri*, SEC Release No. 877 (September 14, 2015).
52. *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015).
53. 15 U.S.C. § 77k

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54. Prior to *Omnicare*, the Second and Ninth Circuits had held that a statement of opinion is actionable only if it is both objectively false and not honestly believed. *See Fait v. Regions Financial Corp.*, 655 F.3d 105, 113 (2d Cir. 2011) (statements regarding adequacy of loan loss reserves may give rise to liability under Sections 11 and 12 only if they were "both false and not honestly believed when they were made"); *Rubke v. Capitol Bancorp Ltd*, 551 F.3d 1156, 1162 (9th Cir. 2009) (fairness determination can give rise to a claim under Section 11 "only if the complaint alleges with particularity that the statements were both objectively and subjectively false or misleading").
55. *Omnicare* at 1325.
56. *Id.* at 1327-8.
57. *Id.* at 1327.
58. *Id.* at 1328.
59. *Id.* at 1328-9.
60. *Id.* at 1329.
61. *Id.* at 1330.
62. *Id* at 1330.
63. *Id.* at 1332.
64. *Id.* at 1332.
65. *Id.* at 1333.
66. *Omnicare* at 1332.
67. *See, e.g., In re Merck & Co. Securities, Derivative & "ERISA" Litigation*, 2015 WL 2250472 (D. N.J. May 13, 2015); and *S.E.C. v. Goldstone*, 2015 WL 5138242 (S.D.N.Y. Aug. 19, 2015) ("Goldstone").
68. *See In re Fairway Group Holdings Corp. Securities Litigation*, 2015 WL 4931357 (S.D.N.Y. Aug. 19, 2015). While the defendants' motions' to dismiss were ultimately granted by the court, following the Court's *Omnicare* decision Judge Kaplan denied the defendants' motions to dismiss without prejudice, granted plaintiff leave to file a second amended complaint and leave for defendants to renew their motions to dismiss.
69. *See Belmont Holdings Corp v. Deutsche Bank AG*, 135 S.Ct. 2805 (2015) and *Freidus v. ING Groep, N.V.*, 601 Fed.Appx. 59 (2d. Cir. May 5, 2015).
70. *See, e.g., In re Fairway Group Holdings Corp. Securities Litigation*, 2015 WL 4931357 at 19-20 (applying a single *Omnicare* analysis to Section 11, 12(a)(2) and 10(b) claims). But *see In re Hertz Global Holdings, Inc. Securities Litigation*, 2015 WL 4469143 (D. N.J. July 22, 2015), 10 [footnote 7], in which the primary cause of action was predicated on a Section 10(b) claim. The court in that decision notes "Given that *Omnicare* concerned a claim under a statute not at issue here, it is unclear whether the holding in the case would extent to § 10(b) claims."
71. *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015).
72. *In re NVIDIA Corp. Securities Litigation*, 768 F.3d 1046 (9th Cir. 2014).
73. 17 C.F.R. § 229.303(3)(ii).
74. *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 103 (2d Cir. 2015).
75. *Panther Partners Inc. v. Ikanos Commc'ns, Inc.*, 681 F.3d 114, 119–20 (2d Cir. 2012); *Litwin v. Blackstone Grp., L.P.*, 634 F.3d 706, 716 (2d Cir. 2011).
76. *Stratte-McClure v. Morgan Stanley*, 784 F. Supp. 2d 373, 376 (S.D.N.Y. 2011).
77. *Stratte-McClure v. Morgan Stanley*, No 09-Civ.-2017, 2013 WL 297954 (S.D.N.Y. Jan. 18, 2013).
78. *Id.* at *5-7.
79. *Id.* at *5.
80. *Id.* at *9.
81. 17 C.F.R. § 240.10b-5.
82. *Basic v. Levinson*, 485 U.S. 224, 239, n. 17 (1988).
83. *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993).
84. *Stratte-McClure*, 776 F.3d at 101.
85. 681 F.3d 114.
86. *Id.* at 102.
87. *Id.*
88. *Id.*
89. 485 U.S. 224 (1988).
90. *Stratte-McClure*, 776 F.3d at 102–03 (quoting *Basic v. Levinson*, 485 U.S. at 237).
91. *Stratte-McClure*, 776 F.3d at 103 (quoting Exchange Act Release No. 33-6835, 54 Fed. Reg. 22427, 22430 (May 24, 1989)).
92. *Id.*
93. *Oran v. Stafford*, 226 F.3d 275, 288 (3d Cir. 2000) (citing Exchange Act Release No. 34–26831, 54 Fed. Reg. 22427, 22430 (May 24, 1989)).
94. *Stratte-McClure*, 776 F.3d at 104.
95. *Id.* at 105 (quoting Exchange Act Release No. 33-6835, 54 Fed. Reg. 22427, 22430 (May 24, 1989)) (emphasis omitted).
96. *Id.* (emphasis added).
97. *Id.* at 107–08.
98. 768 F.3d 1046, 1056 (9th Cir. 2014).
99. *Id.* at 1055–56.
100. *Id.* at 1055.

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101. *Stratte-McClure*, 776 F.3d at 103 (quoting *Oran v. Stafford*, 226 F.3d at 288).

102. *Id.* at 104.

103. In 2010, only 21% of SEC actions against public companies were brought as administrative proceedings; for the first three quarters of 2015, that number is 75%. *See* Securities Enforcement Empirical Database, http://www.law.nyu.edu/centers/pollackcenterlawbusiness/seed.

104. Prior to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC only had the authority to commence an administrative proceeding against registered persons with the SEC. *See, e.g.*, *Gupta v. S.E.C.*, 796 F. Supp. 2d 503, 507 (S.D.N.Y. 2011). At that time, the SEC was required to take action in federal court if it sought civil penalties against unregistered persons.

105. *See Order Tilton et al. v. SEC*, No. 15-2103 (2d Cir. Sept. 17, 2015); Brief for the Appellant, *Hill v. SEC*, No. 15-12831 (11th Cir. Aug 4, 2015).

106. Press Release, U.S. Sec. and Exch. Comm'n, SEC Proposes to Amend Rules Governing Administrative Proceedings, (Sept. 24, 2015) , http://www.sec.gov/news/pressrelease/2015-209.html (hereinafter "SEC Press Release"). The proposed changes are subject to a 60-day comment period following their publication in the Federal Register.

107. Amendments to the Commission's Rules of Practice, Exchange Act Release No. 34-75977, 80 Fed. Reg. 60082, 60084, 60085 (proposed Sept. 24, 2015) (to be codified at 17 C.F.R. pt. 201): requiring parties to file "documents electronically through a secure system on the Commission's website," "serve each other electronically," and "exclude or redact sensitive personal information for electronic filings and submissions."

108. Amendments to the Commission's Rules of Practice, Exchange Act Release No. 34-75976, 80 Fed. Reg. 60091, 60092 (proposed Sept. 24, 2015) (to be codified at 17 C.F.R. pt. 201).

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. *See, e.g.*, Peter Henning, *A Small Step in Changing S.E.C. Administrative Proceedings*, The New York Times, DealBook (Sept. 28, 2015), http://www.nytimes.com/2015/09/29/business/dealbook/a-small-step-in-changing-sec-administrative-proceedings.html; Stephen Dockery, *The Morning Risk Report: SEC May Allow Businesses Better Defense*, The Wall Street Journal: Risk & Compliance Journal (Sept. 28, 2015), http://blogs.wsj.com/riskandcompliance/2015/09/28/the-morning-risk-report-sec-may-allow-businesses-better-defense/.

115. *See* Peter Henning, *A Small Step in Changing S.E.C. Administrative Proceedings,* The New York Times, Dealbook (Sept. 28, 2015), http://www.nytimes.com/2015/09/29/business/dealbook/a-small-step-in-changing-sec-administrative-proceedings.html.

116. SEC Press Release.

117. We have previously written about these concerns. *See* Insider Trading & Disclosure Update, Vol. 2, Issue 1, 15-17 (Debevoise & Plimpton, New York, N.Y.), January 2015; Insider Trading & Disclosure Update, Vol. 1, Issue 1, 7 (Debevoise & Plimpton, New York, N.Y.), July 2014.

118. Stop Illegal Insider Trading Act, S. 702, 114th Cong. (1st Sess. 2015).

119. See, e.g., *TSC Industries, Inc., et al. v. Northway, Inc.,* 426 U.S. 438 (1976).

120. Stop Illegal Insider Trading Act, S. 702, 114th Cong. (1st Sess. 2015).

121. The use of the phrases "independently developed" and "publicly available" would introduce questions of meaning

122. Ban Insider Trading Act of 2015, H.R. 1173, 114th Cong. (1st Sess. 2015).

123. Insider Trading Prohibition Act, H.R. 1625, 114th Cong. (1st Sess. 2015).

124. Both the concept of what constitutes a legitimate business purpose and the phrase "expectation of confidentiality" are left undefined by the bill.

125. As with the Reed/Menendez Bill, the question of reasonable foreseeability may present questions requiring judicial interpretation, particularly in remote tippee cases.

126. Scienter has been a required element of a 10b-5 claim for nearly forty years, since the Supreme Court's decision in *Ernst & Ernst v. Hochfelder.*

127. Press Release, U.S. Sec. and Exch. Comm'n, SEC Charges Defendants in Scheme to Trade on Hacked News Releases (Aug. 11, 2015), http://www.sec.gov/news/pressrelease/2015-163.html.

128. Structured Query Language, or SQL, is a standardized computer query language for requesting information from a database.

129. 574 F.3d 42 (2d Cir. 2009).

130. Id. at 51.

131. *Id.* at 50.

132. *Id.* at 51.

133. *Id.* at 50.

134. Complaint at *22, SEC v. Dubovoy, et al., No. 2:15cv06076, 2015 WL 6122261(D.N.J. Aug. 10, 2015).

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135. 17 C.F.R. 240.10b-5.

136. *See Gupta v. S.E.C.*, 796 F. Supp. 2d 503, 507 (S.D.N.Y. 2011).

137. *See SEC Ramping Up Use of Administrative Proceedings in Insider Trading Actions*, Insider Trading & Disclosure Update, Vol. 2, Issue 1, 15–17 (January 2015) . The SEC's Division of Enforcement has issued factors it uses in determining whether to bring actions in federal district court or administrative proceedings. *Division of Enforcement Approach to Forum Selection in Contested Actions*, U.S. Sec. and Exch. Comm'n, http://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf. It explained that, while "there is no rigid formula," it considers: the availability of the desired claims, legal theories, and forms of relief in each forum; whether any charged party is a registered entity or an individual associated with a registered entity; the cost, resource, and time effectiveness of litigation in each forum; and fair, consistent, and effective resolution of securities law issues and matters. Although these factors shed some light on the Commissions considerations when selecting a forum, the ultimate decision is at the SEC's discretion and defendants lack true insight into the process.

138. On September 24, 2015, the SEC issued proposed amendments to the 'Rules of Practice' governing SEC administrative proceedings, which seek to address certain concerns regarding the procedural fairness of the administrative proceedings generally. Taken as a whole, the proposed amendments signal a firm commitment by the SEC to use Administrative Proceedings, in part because of the creation of a new electronic filing system for these actions as well as an enhanced discovery process. *See* Press Release, U.S. Sec. and Exch. Comm'n, SEC Proposes to Amend Rules Governing Administrative Proceedings (Sept. 24, 2015), https://www.sec.gov/news/pressrelease/2015-209.html.

139. We have previously written about these concerns. *See* Insider Trading & Disclosure Update, Vol. 2, Issue 1, 15–17 (January 2015); Insider Trading & Disclosure Update, Vol. 1, Issue 1, 7 (July 2014). However, over 30 U.S. federal government agencies use administrative law judges and administrative proceedings have been utilized by federal agencies for many years. *See Agencies Employing Administrative Law Judges*, Ass'n of Admin. L. Judges, http://www.aalj.org/agencies-employing-administrative-law-judges. Given how engrained administrative proceedings are in the regulatory process, attacks on the use of administrative proceedings generally, are not likely to succeed. *See* William McLucas and Matthew Martins, *How to Rein In the SEC*, Wall Street Journal, (June 2, 2015), http://www.wsj.com/articles/how-to-rein-in-the-sec-1433285747.

140. *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015). The *Bebo* Court held that there was no evidence that Congress intended for plaintiffs "to be able to stop [ongoing administrative] proceedings by challenging the constitutionality of the enabling legislation or the structural authority of the SEC" and required plaintiffs to proceed with the administrative enforcement process before it could appeal an adverse decision by the SEC to the court of appeals. *Id.* at 775. The D.C. Circuit recently reached the same conclusion. *See Jarkesy v. S.E.C.*, 803 F.3d 9, 12 (D.C. Cir. 2015) (affirming the district court's dismissal for lack of jurisdiction).

141. *See* Order, *Tilton v. S.E.C.*, No. 15-2103 (2d Cir. Sept. 17, 2015); Submission of Motion to Stay Proceedings Pending Appeal, *Hill v. SEC*, No. 15-12831 (11th Cir. Aug. 4, 2015); *Duka v. S.E.C.*, No. 15 Civ. 357, 2015 WL 5547463, at *17 (S.D.N.Y. Sept. 17, 2015); Notice of Appeal, *Gray Financial Group, Inc. v. SEC*, No. 1:15-CV-0492-LMM (N.D. Ga. Aug. 19, 2015).

142. *Hill v. SEC*, No. 1:15-CV-1801-LMM, 2015 WL 4307088, at *16 (N.D. Ga. 2015) (quoting *Buckley v. Valeo*, 424 U.S. 1, 132 (1976)).

143. *Id*. at *3.

144. *Id*. at *16.

145. Alison Frankel, *Why the SEC can't easily solve Appointments Clause Problem with ALJs*, Reuters U.S. Edition, June 17, 2015, http://blogs.reuters.com/alison-frankel/2015/06/17/why-the-sec-cant-easily-solve-appointments-clause-problem-with-aljs/.

146. *Duka*, 2015 WL 5547463 at *10 (quoting Order Instituting Administrative Cesase-and-Desist Proceedings, dated Jan. 21, 2015, attached as Ex. 3 to Decl. of Daniel Goldman, dated Jan. 26, 2015).

147. *Id.* at *19.

148. *Id.* at *20.

149. *Tilton v. S.E.C.*, No. 15-CV-2472, 2015 WL 4006165, at *1 (S.D.N.Y. June 30, 2015).

150. *See Id.* ("Plaintiffs are . . . obliged to further litigate their claims in the Commission's administrative forum and seek review, if they so choose, in a circuit court of appeals. Because this court lacks subject matter jurisdiction to decide the merits of Plaintiffs' constitutional claims, their motion is denied and the Complaint must be dismissed.").

151. Order, *Tilton v. SEC*, No. 15-2103 (2d Cir. Sept. 17, 2015) ("On application of the Appellants, the Securities and Exchange Commission proceedings against Appellants are STAYED pending further order of this Court.").

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152. *See* Notice of Appeal , *Gray Financial Group, Inc. v. SEC*, 1:15-CV-0492-LMM (N.D. Ga. Aug. 19, 2015); *Hill v. SEC*, No. 1:15-CV-1801-LMM, 2015 WL 4307088 (N.D. Ga. June 8, 2015).

153. *Hill*, 2015 WL 4307088 at *19.

154. *Id.* at *17.

155. *Duka,* 2015 WL 5547463 at *6; *see Hill v. SEC*, No. 15-12831-CC (11th Cir. Aug. 10, 2015) (SEC's 'Motion to Stay Preliminary Injunction Pending Appeal' is DENIED").

156. Press Release, U.S. Sec. and Exch. Comm'n, SEC Charges Sports Nutrition Company With Failing to Properly Disclose Perks for Executives: Former Audit Committee Chair Among Four Individuals Charged (Sept. 8, 2015), http://www.sec.gov/news/pressrelease/2015-179.html.

157. Press Release, U.S. Sec. and Exch. Comm'n, SEC Charges Bankrate and Former Executives with Accounting Fraud (Sept. 8, 2015), http://www.sec.gov/news/pressrelease/2015-180.html.

158. Press Release, U.S. Sec. and Exch. Comm'n, SEC Charges Video Management Company Executives with Accounting Fraud (Sept. 8, 2015), http://www.sec.gov/news/pressrelease/2015-183.html.

159. Press Release, U.S. Sec. and Exch. Comm'n, SEC Charges BDO and Five Partners in Connection with False and Misleading Audit Opinions (Sept. 9, 2015), http://www.sec.gov/news/pressrelease/2015-184.html.

160. Press Release, U.S. Sec. and Exch. Comm'n, SEC Charges Former Officers of SMF Energy with Fraud (Sept. 25, 2015), http://www.sec.gov/news/pressrelease/2015-210.html.

161. Press Release, U.S. Sec. and Exch. Comm'n, SEC Charges Trinity Capital Corporation and Former Executives with Accounting Fraud (Sept. 28, 2015), http://www.sec.gov/news/pressrelease/2015-215.html.

162. Press Release, U.S. Sec. and Exch. Comm'n, China-Based Company and CEO to Pay $55.6 Million for Inaccurate Disclosures (Sept. 30, 2015), http://www.sec.gov/news/pressrelease/2015-223.html.

163. Press Release, U.S. Sec. and Exch. Comm'n, SEC Charges Executives for Defrauding Investors in Financial Fraud Scheme: Seeks Return of Allegedly Ill-Gotten Executive Compensation (Sept. 30, 2015), http://www.sec.gov/news/pressrelease/2015-224.html.

164. Press Release, U.S. Sec. and Exch. Comm'n, SEC Charges Former Executives with Accounting Fraud and Other Accounting Failures (Oct. 6, 2015), http://www.sec.gov/news/pressrelease/2015-234.html.

165. Press Release, U.S. Sec. and Exch. Comm'n, Developer, Former Top Execs Charged for Improper Accounting of Real Estate Assets During Financial Crisis (Oct. 27, 2015), http://www.sec.gov/news/pressrelease/2015-247.html.

166. Examples of the steps that one party had taken include: discussing with management strategies for going private and committing to assist in efforts to effect a transaction; conducting valuation procedures and discussing preliminary documentation; and studying the feasibility of the transaction, reviewing comparable precedent transactions and discussing the transaction with other significant shareholders.

167. *Id.*

168. *Id.*

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