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SEC Changes Approach With New Broken-Windows Policy

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On Sept. 10, the U.S. Securities and Exchange Commission (SEC) brought an unprecedented 28 charges against corporate insiders for a combined monetary penalty of $2.6 million for failure to timely file Section 16 and Section 13(d) and Section 13(g) reports. This so-called "enforcement sweep" suggests that the SEC has changed its approach to combating insider-trading violations and is, for the first time, using untimely filings of required disclosure reports as proxies for insider-trading violations. In the past, the SEC used its resources to attack a few heavyweight offenders in the hopes of deterring insider trading through harsh sentences. By aiming for quantity over quality, the SEC has demonstrated a greater willingness to pursue suspected violations of varying degrees.

The penalties sought in the September enforcement actions pale in comparison to the long prison sentences that the SEC has sought in the past. Since 2003, six violators of insider-trading rules have each received prison sentences ranging between seven and 12 years. By contrast, the charges filed by the SEC brought Sept. 10 sought monetary fines against each alleged violator of less than $375,000.

The SEC's new enforcement sweep signals an increase in the SEC's aggressiveness with respect to enforcing insider-trading rules and related filing requirements. The SEC stated that the enforcement actions are meant "to send a clear message about the importance of these filing provisions" and to demonstrate that the SEC "will vigorously police these sorts of violations through streamlined actions."

The recent enforcement actions are consistent with the stated policy of SEC Chair Mary Jo White to focus on lesser infractions of federal securities law as a strategy to ensure that major violations are not overlooked or ignored. Under this policy, known as the "broken windows" policy because of its similarity to the popular policing theory, the SEC will prosecute egregious reporting violations even if no fraudulent conduct is involved.

The recent enforcement actions focused on violators of two types of reporting requirements under the Securities Exchange Act of 1934, as amended, namely Section 16(a) and Section 13(d) and (g) disclosures. Section 16(a) of the Exchange Act requires executive officers, directors and certain beneficial owners of more than 10 percent of a registered class of a company's stock to report transactions that result in a change in beneficial ownership within two business days following the date of the transaction on a Form 4. Transactions that must be reported on a Form 4 include purchases and sales of securities, exercises and conversions of derivative securities, and grants or awards of securities by a company under an equity compensation plan. Certain limited transactions are eligible for deferred reporting on a Form 5 after the company's fiscal year end. Sections 13(d) and 13(g) of the Exchange Act require any direct or indirect beneficial

owner of more than 5 percent of any issuer's outstanding equity securities to report such beneficial ownership. Depending on the circumstances, the person or group of persons may file the short-form Schedule 13G instead of the long-form Schedule 13D.

The reporting requirements under Section 16(a) and Section 13(d) or (g) of the Exchange Act may be enforced against individuals and entities alike and apply irrespective of the violator's intent or whether profits are actually realized. Any failure to timely file a required beneficial ownership report, even if inadvertent, constitutes a violation of these filing requirements. SEC investigators decided to focus on the reporting of ownership and transactions because of escalating concerns about poor levels of compliance with insider-trading rules. As a result of investigating the failure to meet reporting obligations, the SEC charged 13 officers and directors, five individual shareholders, 10 major shareholders of public companies and six companies.

The agency says it used algorithms to identify insiders who it found repeatedly broke securities rules requiring trades to be reported promptly. According to the SEC's Division of Enforcement, the SEC relied on "quantitative analytics [to] identif[y] individuals and companies with especially high rates of filing deficiencies." The SEC's reliance on these quantitative algorithms suggests that these types of enforcement sweeps will continue to occur in the future. Accordingly, the SEC's recent enforcement actions should serve as a cautionary tale to those public companies, officers, directors and major shareholders who are required to file Section 16(a) and Schedules 13(d) and (g) reports.

Though the SEC's enforcement sweeps are a new method of deterring insider trading, the SEC has not given up on fighting for long sentences for serious violators. Just one day before the September enforcement sweep, a federal court sentenced a portfolio manager to nine years in prison for insider trading. The individual was found guilty of accessing and using the results of a nonpublic drug trial to make investment decisions. In addition, U.S. Attorney General Eric Holder Jr. announced Sept. 17 that the U.S. Department of Justice is going to take stronger actions to combat insider trading. Holder stated, "The buck needs to stop somewhere where corporate misconduct is concerned."

In response to the SEC's heightened sensitivity to insider-trading violations, companies as well as insiders must take meticulous care in timely filing reports under Section 16(a) and Section 13(d) and (g). Companies and their counsel should consider processes and procedures that can ensure that all insider transactions are promptly reported.

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