SEC Whistleblower Advocates

Award Winning Attorneys

Knowledge is Power:

The Securities Law Primer

In addition to the information contained in this Primer, we encourage readers to visit our website to review Frequently Asked Questions about the SEC Whistleblower Program, the securities laws enforced by the SEC and our Firm.

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Introduction

At SEC Whistleblower Advocates, we work to protect and empower SEC whistleblowers, so they can successfully report securities violations—without personal or professional regrets. As first-hand witnesses to wrongdoing, whistleblowers are a formidable opponent to corruption. Their courageous actions safeguard jobs and investors, ensure fair markets and facilitate capital formation. When courageous individuals speak out against wrongdoing, we stand up, we step closer and use every tool in our arsenal to make their voices heard.

The federal securities laws are vast, complex and rapidly changing. For most SEC whistleblowers, the stakes are simply too high to risk blowing the whistle without being familiar with the securities laws. This Primer is an introduction to the most important securities laws.

Because knowledge is power.

I. Laws governing the securities industry

A. Securities Act of 1933

The Securities Act of 1933 (the "'33 Act") was the first major piece of legislation enacted by Congress to address issues resulting in the stock market crash of 1929. The legislation encompassed two primary goals: (i) to ensure investors received financial and other important information about securities offered to the public; and (ii) to prevent deceit, misrepresentation, and other fraudulent activities in the offering and sale of securities.

1. Registration

To accomplish its objectives, the '33 Act mandates that all securities offered for sale in the United States must either be registered with the Securities and Exchange Commission ("SEC" or the "Commission"), or qualify for an exemption. To register, a company must submit a registration statement to the SEC for approval, which the SEC will also make available for public inspection. That registration statement must contain, in general, the following information:

- descriptions of the company and its business;
- a description of the security offered for sale (equity or other interest(s) represented, dividend rights, voting rights, etc.);
- information about the amount of capital being raised, including the number of shares being issued and the offering price of those shares;
- information about the management of the company; and
- financial statements certified by independent accountants.

2. Prospectus Requirement

A company offering securities for sale to the public must also submit a prospectus to the SEC and to each potential purchaser of the securities a document called a prospectus. The prospectus contains much of the same information as a registration statement, but can omit details such as recent sales of unregistered securities and indemnification of directors and officers, as well as exhibits of documents incorporated by reference in the registration statement and financial statement schedules.

3. Prohibition of False or Misleading Statements

The purpose of the registration and the prospectus is to ensure potential investors can obtain enough information about a company and the securities being offered for sale to make an informed investing decision. However, the SEC cannot verify or vouch for the accuracy of all such information disclosed by issuers. Thus, the '33 Act provides investors with certain rights to recover investment losses if it can be established that disclosures were inaccurate or incomplete.

Specifically, the '33 Act prohibits an issuer of securities from making any untrue statement of material fact, or failing to state a material fact necessary to make disclosed information not misleading. The concept of materiality is an important one in the securities laws and will be discussed more completely below. But in short, information is material if an average investor would consider it important in making an investment decision. Accordingly, the '33 Act requires an issuer to speak truthfully and completely in its registration statement and prospectus.

B. Securities and Exchange Act of 1934

While the '33 Act largely seeks to regulate the initial offering of securities by the issuer, the Securities Exchange Act of 1934 (the "Exchange Act") primarily regulates transactions of securities in the secondary market—sales that take place after a security is initially offered by a company. Such transactions often take place between parties that do not include the issuer, such as trades executed by retail investors through brokerage firms. To protect purchasers of securities in these transactions, the Exchange Act established the SEC, created a mandatory disclosure process that forces companies to make periodic filings containing important information with the SEC, and established further rules prohibiting fraudulent and deceptive conduct.

1. Creation of the Securities and Exchange Commission

Among other things, the Exchange Act established the SEC and empowered it with broad authority over all aspects of the securities industry. This includes the power to investigate and prosecute violations of the securities laws, as well as the power to regulate and oversee brokerage firms, transfer agents, clearing agencies, and U.S. securities exchanges, such as the New York Stock Exchange and NASDAQ.

2. Corporate Reporting

Through the Exchange Act, the SEC also requires periodic reporting of information by companies that have publicly traded securities. Pursuant to this authority, the SEC requires issuers meet certain criteria to file annual and other periodic reports with the SEC. The most common types include the Form 10-K (annual reports), Form 10-Q (quarterly reports), and Form 8-K (event-based reports). The reports contain information such as a review of the company's performance for the reporting period, audited financial statements, and management's discussion and analysis of the company's performance and future expectations.

The general criteria leading to periodic reporting requirements include listing securities on a U.S. securities exchange or meeting a size threshold of total assets greater than $10 million with a class of equity securities held by 2,000 or more persons, or 500 or more persons who are not accredited investors. A public offering without listing on a securities exchange also triggers periodic reporting requirements, though these are somewhat less extensive.

3. Proxy Solicitations

The Exchange Act also governs the disclosure of information to shareholders for purposes of shareholder votes on the election of directors and the approval of other corporate actions, such as mergers. To ensure compliance with disclosure rules, this information, contained in proxy materials, must be filed with the Commission in advance of any solicitation of shareholder votes. Solicitations, whether by management or shareholder groups, must disclose all material facts concerning the issues on which shareholders are asked to vote.

4. Tender Offers

The Exchange Act requires disclosure of material information by anyone seeking to acquire more than 5 percent of a company's securities by direct purchase or tender offer. Such an offer is often extended in an effort to gain control of the company. As with the proxy rules, this allows shareholders to make an informed decision on whether to tender their shares pursuant to the offer.

5. Prohibition of Fraudulent and Deceptive Conduct

One of the key aspects of the Exchange Act is its prohibition of the "use or employ" of any "manipulative or deceptive device or contrivance" in connection with the purchase or sale of a security. Pursuant to the SEC's rulemaking authority, the SEC adopted Rule 10b-5 to implement this statutory prohibition. In general, Rule 10b-5 prohibits fraudulent conduct of any kind in connection with a securities transaction. These provisions are the basis for many common types of securities violations, and will be discussed more fully below. Unlike the prohibition of false and misleading statements in registration statements and prospectuses, the conduct proscribed by these provisions must involve the intent to deceive.

C. Trust Indenture Act of 1939

This Trust Indenture Act generally prohibits debt securities—such as bonds, debentures, and notes—from being offered for sale to the public without a formal written agreement, known as a trust indenture. This restriction, however, only applies to debt issues that are valued at over $5 million. In addition, the Trust Indenture Act requires that a trustee be appointed to all bond issuers so that, should the issuer become insolvent, the appointed trustee may seize the bond issuer's assets and sell them in order to recoup the bondholders' investments.

D. Investment Company Act of 1940

The Investment Company Act of 1940 regulates investment funds, such as mutual funds, that engage in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public. The regulation is designed to minimize conflicts of interest that arise in these complex operations. Under the act, these companies must disclose their financial condition and investment policies to investors when their stock is initially sold, and then on a regular basis thereafter. The act does not permit the SEC to directly supervise the investment decisions or activities of these companies or judge the merits of their investments. The disclosure of material information to investors is the focus.

E. Investment Advisers Act of 1940

The Investment Advisers Act of 1940, with certain exceptions, requires that firms or individuals compensated for advising others about securities investments must register with the SEC and conform to regulations designed to protect investors. After a 1996 amendment, only advisers who have at least $25 million of assets under management, or who advise a registered investment company, must register with the Commission. Like other securities laws, registered investment advisers must disclose material information to clients and must refrain from engaging in fraudulent or deceptive conduct in connection with their services.

F. Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 mandated a number of reforms to enhance financial disclosures made by public corporations and combat corporate and accounting fraud. A few of the more prominent of these reforms include the creation of the "Public Company Accounting Oversight Board" (the "PCAOB") to oversee the activities of independent auditors, the requirement that all audited financial statements be certified as accurate by a corporation's senior management, and the requirement that companies establish internal control and reporting systems to uncover fraud in financial reporting.

G. Dodd-Frank Wall Street and Consumer Protection Act

On July 21, 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), the most significant financial reform effort since the Great Depression. Among many other things, Dodd-Frank created the Financial Stability Oversight Council to identify risks to the United States' financial stability that may arise from the activities of large, interconnected financial companies; promote market discipline and eliminate expectations of government bailouts; and respond to emerging threats to the country's financial stability. Another important aspect of Dodd-Frank is the requirement that hedge funds managing over $100 million as investment advisers register with the SEC. Finally, Dodd-Frank added Section 21F to the Exchange Act, which required the SEC to enact a whistleblower program to pay financial rewards to individuals who provide information about possible securities violations to the SEC. To that end, the SEC created the new Whistleblower Program, as Regulation 21F under the Exchange Act, which became effective on August 12, 2011.

H. Jumpstart Our Business Startups Act of 2012

The "JOBS" Act was enacted to help smaller businesses raise funds in public capital markets by minimizing regulatory requirements. It required the SEC to issue studies and write relevant rules on capital formation, disclosure, and registration requirements. The SEC's related rulemaking has addressed these areas by, inter alia, lifting a general ban on solicitation for certain private securities offerings and amending rules to permit crowdfunding.

II. Securities fraud

A. Anti-Fraud Provisions of the Securities Laws

The securities laws broadly prohibit fraudulent activities of any kind in connection with the offer, purchase, or sale of securities. These provisions are the basis for many, if not most, types of enforcement actions brought by the SEC. Some of the more important anti-fraud provisions are discussed below.

1. Section 10(b) and Rule 10b-5 of the Exchange Act

The most important and most widely invoked anti-fraud provisions of the securities laws are Section 10(b) of the Exchange Act and Rule 10b-5 promulgated under that section. Together, these provisions are the principal statutory weapons against fraud.

Section 10(b) of the Exchange Act is the statutory basis for prohibiting fraud and deception in the purchase and sale of securities. It provides, in relevant part, that:

It shall be unlawful for any person, directly or indirectly . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Pursuant to its rulemaking authority, the SEC promulgated Rule 10b-5 to implement the prohibition against fraud and deception set forth in Section 10(b). The rule (codified at 17 C.F.R. § 240.10b-5) is one of the most important rules promulgated by the SEC and prohibits any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security. Specifically, the rule provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To 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 the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

2. Section 17(a) of the '33 Act

A key anti-fraud provision in the '33 Act, Section 17(a) provides for liability for fraudulent sales of securities. This section provides, in part, that it is unlawful to "employ any device, scheme, or artifice to defraud," "obtain money or property" by using material misstatements or omissions, or "engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." The language of Section 17(a) was followed closely by the drafters of Section 10(b) and Rule 10b-5 of the Exchange Act. The SEC has the power to enforce this provision, though Section 10(b) and Rule 10b-5 are more widely used to prosecute fraudulent securities transactions.

3. Section 206 of the Investment Advisers Act

This provision generally makes it unlawful "to employ any device, scheme, or artifice to defraud any client or prospective client"; to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client"; or to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative."

In addition, Section 206(3) makes it unlawful for an investment adviser to engage in a securities transaction with a client for its own account, absent the client's prior consent. In other words, an adviser, acting for its own account, cannot buy a security from, or sell a security to, the account of a client, without the client's permission. Nor can the adviser arrange—i.e., act as a broker—a transaction between different advisory clients or between a brokerage customer and an advisory client.

B. Elements of a Securities Fraud Claim

The SEC has the power to enforce these provisions by filing a lawsuit in federal court or in an administrative proceeding (see Section VI, following). To succeed in such an enforcement action, the SEC must establish the following:

- that the defendant made a misstatement of fact, or omitted to state a fact which, under the circumstances, was necessary to make what was said not misleading;
- the misstatement or omission was material;
- the misstatement or omission was made in connection with the purchase or sale of a security; and
- scienter—meaning that the defendant acted knowingly and with the intent to deceive.

III. Materiality

The concept of materiality is central to the SEC's enforcement of securities laws. Due to a crushing case load and limited resources, the SEC can investigate only the most significant cases. Moreover, it is not sufficient to establish a claim for securities fraud that the defendant made a false statement or omitted to state a fact. Rather, the misstatement or omission must have related to information that is "material." There is a large body of law regarding this concept, but the leading cases, and the two accepted theories of materiality, are discussed below.

A. Leading Cases

1. TSC Industries, Inc. v. Northway, Inc.

In *TSC Industries*, the U.S. Supreme Court formulated its first binding standard for determining materiality. The case involved a shareholder vote on a proposed merger, and whether the shareholders were provided enough information prior to the vote. The shareholders claimed the proxy solicitation (the information on the merger) was false and misleading because it omitted certain material information. The *TSC Industries* Court thus undertook to determine whether, in fact, the missing information was material.

After examining different approaches taken by lower courts, the *TSC Industries* Court created the following standard:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.

The *TSC Industries* Court further explained that, for determining materiality of information under this standard, there must be a substantial likelihood that it would have assumed actual significance in the decision of a reasonable shareholder, or been viewed by such a shareholder as having "significantly altered the 'total mix'" of information available.

2. *Basic v. Levinson*

While the *TSC Industries* case was decided in the context of proxy solicitation, the later Supreme Court decision of *Basic v. Levinson* held that the same materiality standard applies to the more common Section 10(b) and Rule 10b-5 fraud claims.

Both of these decisions make clear that the issue of materiality is a mixed question of law and fact, and the Basic Court clarified that the fact-based inquiry depends on the particular circumstances of the case. This point has been repeatedly emphasized since then; information that is highly material regarding one company, may not be with respect to another. Also, an omission of even material information may not support a claim. As noted in the relatively recent Supreme Court decision of *Matrixx Initiatives, Inc. v. Siracusano*:

it bears emphasis that § 10(b) and Rule 10b–5(b) do not create an affirmative duty to disclose any and all material information. Disclosure is required under these provisions only when necessary 'to make ... statements made, in the light of the circumstances under which they were made, not misleading.' . .. Even with respect to information that a reasonable investor might consider material, companies can control what they have to disclose under these provisions by controlling what they say to the market.

B. Theories of Materiality

1. Quantitative

Misrepresentations or omissions often occur in the audited financial statements filed with the SEC. When this type of financial fraud occurs, one method courts have used to determine whether the misstatement or omission was material is to quantify the amount of the misstatement or omission. This is quantitative materiality. Quantitative materiality measures misstatements and omissions by quantifying them as a percentage of the company's reported earnings or losses.

Some courts and the SEC have identified a 5% deviation from actual reported earnings as a "rule of thumb" in determining whether a misstatement or omission is material. In other words, without considering all relevant circumstances, a deviation of less than 5% with respect to a particular item on a company's financial statements may create an assumption that a related misstatement or omission is not material.

Both the courts and the SEC agree, however that quantitative benchmarks cannot be exclusively relied on to assess materiality. Thus, misstatements are not necessarily immaterial simply because they fall beneath a numerical threshold such as 5%.

2. Qualitative

As just noted, even quantitatively small misstatements and omissions can be deemed material when all relevant circumstances are considered. Qualitative materiality is the consideration of these relevant circumstances. In its Staff Accounting Bulletin No. 99, the SEC provides a non-exhaustive list of qualitative factors that could affect the materiality of a misstatement or omission. These factors are not legally binding, but are widely referenced by courts when considering the materiality of information.

According to SEC Staff Accounting Bulletin No. 99, considerations that may well render material a quantitatively small misstatement or omission include:

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate;
- whether the misstatement masks a change in earnings or other trends;
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise;

- whether the misstatement changes a loss into income or vice versa;
- whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability;
- whether the misstatement affects the registrant's compliance with regulatory requirements;
- whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements;
- whether the misstatement has the effect of increasing management's compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation; and
- whether the misstatement involves concealment of an unlawful transaction.

This non-exhaustive list of qualitative factors could affect the materiality of even a quantitatively small misstatement or omission.

IV. Statute of limitations

In the civil context, which covers SEC enforcement actions, a statute of limitations is a law barring a claim after a specified period, generally based on the date when the claim accrued. Statutes of limitations require diligent prosecution of claims that are or should be known, in order to foster predictability, accuracy and finality in legal affairs.

A. Governing Statutes

The principal statute of limitations for SEC enforcement actions is set forth in 28 U.S.C. § 2462, which is a "catch all" statute of limitations for actions brought by federal agencies in federal court. Under Section 2462, the SEC has five years to bring an enforcement action seeking civil penalties from the date that the claim first accrued. Enforcement actions based on insider trading violations are governed by the Exchange Act, 15 U.S.C.A. § 78u-1(d)(5), which also sets a five-year limitation.

B. Scope

The above-described statutes of limitations are broadly applicable, and the five years begin to run upon the occurrence of the conduct giving rise to the claim.

An extension may be possible in some cases/on some legal theories, but the availability of such in enforcement actions has become highly questionable, and should not be relied on except as a last resort. The legal theories that can support an extension include the continuing violation doctrine, the fraudulent concealment doctrine, and the discovery rule. The continuing violation doctrine operates so that conduct occurring before the limitations period can remain actionable because it is part of a continuing unlawful practice which extended into the limitations period. The fraudulent concealment doctrine may toll a claim where measures are taken (beyond the perpetration of underlying fraud, which by nature is self-concealing) to hinder the prosecution of said claim. The discovery rule holds that the statute of limitations does not begin to run until a claim is discovered, or could have been discovered with reasonable diligence. However, the Supreme Court recently held in *Gabelli v. SEC* that the discovery rule does not apply in enforcement actions subject to 28 U.S.C. § 2462, underscoring that the five-year limitation period is best regarded as strict/absolute rule.

V. Common types of securities violations

Securities violations come in many shapes and sizes. Some may seem self-evident, and others highly technical. Maintaining fairness in the marketplace is the unifying theme. The following are the major categories of violations.

1. Corporate Disclosures and Financials

   Corporate disclosures and financial violations often relate to false or misleading financial statements that have been filed with the SEC in either a company's registration statement, prospectus, or as part of any other of the company's required filings under the Exchange Act.

   Failures to make required filings would also fall under this category. This type of fraud often occurs when a company uses accounting tricks to increase the reported earnings and revenues for a particular reporting period.

   Another common scenario is when companies engage in manipulative business transactions that have the effect of altering revenues, expenses, earnings, and/or losses for a reporting period. Sometimes these transactions might even be legal, but they are used unlawfully.

   A violation under this category could also occur when a company fails to speak truthfully when discussing its financial results e.g., in press releases or analyst or investor presentations. Additional examples include undisclosed conflicts of interest, corporate governance/legal matters, or revenue impact of one-time events.

2. Offering Fraud

   Offering fraud generally occurs when an individual (or group of individuals) makes misrepresentations and/or omissions of material fact to potential investors in a new company.

   An example of this type of fraud is when individuals will contact potential investors and attempt to induce them into investing in a new, unknown company, by making false claims about the company. Another common type of offering fraud is a Ponzi scheme, where investors are paid returns from their own money or from the money invested by subsequent investors, rather than from any actual profit earned. The operator of the scheme induces new investors by paying unusually consistent or abnormally high returns to older investors. Pyramid schemes are also an example of offering fraud.Offering fraud generally occurs when an individual (or group of individuals) make misrepresentations and/or omissions of material fact to potential investors in a new company. An example of offering fraud is individuals contacting potential investors and attempting to induce them into investing in a new, unknown company, by making false claims about the company. Another common type of offering fraud is a Ponzi scheme, where investors are paid returns from their own money or from the money invested by subsequent investors, rather than from any actual profit earned. The operator of the scheme induces new investors by paying unusually consistent or abnormally high returns to older investors. Pyramid schemes are also an example of offering fraud.

3. Market Manipulation

   Market Manipulation is the interference with the free and fair operation of the market by engaging in conduct that creates an artificial price or maintains an artificial price for a security. Some examples of market manipulation include:

   - **Pump and Dump**

     Where owners of a security spread false information so that the price of the security will increase (the pump). When the price of the security does increase based on these false rumors, the owners who spread the false information sell off their shares, making a profit (the dump).

   - **Bear raid**

     Attempt by investors to move the price of a stock opportunistically by selling large numbers of shares short. The investors pocket the difference between the initial price and the new, lower price after this maneuver. This technique is illegal under SEC rules, which stipulate that every short sale must be on an uptick.

- **Wash Trading**
  Wash trading involves the simultaneous or near-simultaneous selling and repurchase of the same security for the purpose of generating activity and increasing the price.
- **Matched orders**
  Orders to buy or sell securities that are entered with knowledge that a matching order on the opposite side has been or will be entered.
- **Painting the tape**
  Placing successive orders in small amounts at increasing or decreasing prices.
- **Spoofing/Layering**
  Tactic that has been used by high frequency traders to manipulate prices, spoofing is the placing of a bid or offer with the intent to cancel before execution. "Layering" is a form of spoofing in which the trader places multiple orders on one side of the book, in order to create a false impression of heavy buying or selling pressure.

4. Insider Trading

Insider Trading refers generally to the buying or selling of a corporate security while in possession of material information about that corporation that is not known to the public.

Often, this information is obtained by corporate insiders who have access to this material information based on their position inside the organization. That insider then buys or sells the securities based on that information. Insider trading may also occur when a corporate insider "tips" the nonpublic information to someone outside of the organization, and that person then buys or sells securities. In that case both the "tipper" of the information and the "tippee" (the person receiving the information) are liable for illegal insider trading. Insider trading is unlawful because trading while having special knowledge is unfair to other investors who don't have access to such knowledge. An example of illegal insider trading is when an executive at Company A learned, prior to a public announcement, that Company A will be taken over, and bought shares in Company A knowing that the share price would likely rise.

5. Trading and Pricing

Trading and pricing violations involve any number of trading techniques that are illegal under the securities laws. These include:

- **Front running:** The buying or selling of securities while knowing that another investor is about to make a trade that will influence the price of the security. For example, buying stock in Company A knowing that another investor is about to make a very large purchase of the same stock, causing its price to increase.
- **Cherry-picking:** Where an investment professional with both proprietary and management operations delays trade allocations until after results are in, and then allocates in an unfair manner (i.e., takes more successful trades in the proprietary account and sticks the managed accounts with most of the losers).
- **Market timing:** A trading "arbitrage" strategy that seeks to take advantage of pricing inefficiencies in mutual funds and similar vehicles, which are generally priced only once per day. For example, a market timer may learn that changes in the price of securities traded on a foreign exchange have not yet been incorporated into the price of a mutual fund's shares, and buy or sell the shares on that basis. This violation turns on whether proper disclosure is made to investors.
- **Marking the Close:** Buying or selling a security near the close of the day's trading in order to affect the closing price.
- **Late trading:** This occurs when a mutual fund permits certain customers to purchase shares in the fund after trading has closed for the day. Because mutual fund prices are set once a day, a customer who purchases after trading is closed can do so at that day's price and not at the following day's price.

- **Pooling:** An agreement among a group of people delegating authority to a single manager to trade in a specific stock, for a specific period of time, and then to share in the resulting profits or losses.
- **Freeriding:** Buying a stock in a cash account and selling before paying for it.
- **Stock parking/kiting:** Forms of collusion between trading parties in which a trade is entered into with a side agreement that the seller will buy back the stock from the buyer at a later time (done to meet/avoid disclosure obligations), or that they will disregard settlement obligations so that one party can exploit the delay and continue to trade based on a position that should no longer be available.
- **Naked shorting:** Shares are sold short without arrangements made to borrow them to deliver, then seller intentionally fails to deliver within the standard three-day settlement period
- **Churning:** When a broker engages in excessive buying and selling of securities in a customer's account chiefly to generate commissions that benefit the broker.

6. Foreign Corrupt Practices Act (FCPA)

The FCPA prohibits the offer, payment, or promise to pay money or anything of value—i.e., a bribe—to any foreign official in an effort to win or retain business from that foreign official's government. It is not a violation of the FCPA, however, if: (i) the payments are legal under the written laws of the country in which the payments are made; or (ii) the payment is a reasonable expenditure directly related to the conducting of business with a foreign government.

7. Unregistered Offerings

With limited exception, offerings of securities in the U.S. must be registered with the SEC. An offering that is not registered, or that fails to meet/adhere to the requirements for exemption, constitutes a violation (and sales, or attempted sales, are a serious crime).

Non-public offerings are among the more common exceptions to the registration requirement. This exemption, sometimes referred to as the "private placement" exemption, is established by Section 4(a)(2) of the Securities Act, and generally applies to offerings in which purchasers are informed, "sophisticated investors" who have agreed not to resell the securities to the public.

Notwithstanding these general parameters, however, this exemption leaves much to interpretation, and thus a safe harbor is included in Rule 506 of Regulation D. In addition, in Rules 504-506, Regulation D sets forth some other common exceptions to registration, which generally turn on one or more of the following:

- the size/duration of the offering (e.g., an offering of $1 million or less over a 12-month time period faces the least restrictions in qualifying for exemption);
- the means of solicitation (public advertising is often a hitch);
- the level of disclosure provided; and
- the characteristics of the investors and/or the securities.

8. Market Events

"Market events" refer to disruptions or aberrations in the securities markets, such as an unexpected interruption in trading on a securities exchange, a liquidity crisis or a "flash crash."

While not all such market events represent securities violations, the SEC has brought enforcement actions against exchanges and related entities where the market event was caused or exacerbated by the exchange's failure to follow relevant SEC or internal rules. The SEC and other federal agencies conduct surveillance of trends and dealer and investor positions to help determine whether market events are indicative of fraudulent activities.

9. Municipal Securities

Municipal securities are debt securities issued by state and local governments in the United States, and are generally used to fund items such as infrastructure, schools, libraries, and other general municipal expenditures. Securities laws require dealers in municipal securities to disclose material information about the securities to investors and prohibit any person from making a false or misleading statement of material fact, or omitting to state any material fact, in connection with the offer, purchase, or sale of any municipal security. Thus, a failure to comply with these laws in connection with the purchase or sale of municipal securities is an actionable securities violation subject to SEC enforcement.

10. Other Violations

Many other types of securities law violations commonly occur, beyond those described in the above categories. There are basic theft/misappropriation cases, such as advance fee cases, in which a fee is collected (and not refunded) for a securities-related service that is never provided, or cases in which securities accounts are hacked.

Certain types of market participants are subject to specialized regulation because of their sensitive roles. Brokers are prohibited from the use of high pressure sales tactics including cold calling, and they cannot make unauthorized trades. Brokers with discretionary authority and investment advisers must be responsive to their clients and prudently manage accounts (subject to a fiduciary duty), structuring them with suitable choices for each client/investor. Broker-dealers that also serve as custodians cannot commingle securities owned by their clients in accounts with securities owned by the firm. There are numerous other operational requirements for such firms/professionals, and fees for services must be properly negotiated or noticed/disclosed and generally cannot be excessive (or unnecessary, in the case of administrative fees).

Market makers must stand ready on a regular and continuous basis to buy and sell a minimum amount of those stocks they make markets in, at a publicly quoted price.

Regulation National Market System promulgated by the SEC to improve U.S. exchanges requires, among other things, timely disclosure of trade information by exchanges to increase fairness in price execution.

Last, but certainly not least, employer retaliation against employees who blow the whistle on perceived violations of securities laws is itself a violation.

VI. Types of enforcement actions and remedies

The SEC is authorized to bring enforcement actions to punish violations of the federal securities laws. The SEC can do so by either filing a civil action in federal district court, which will be presided over by a federal district judge and be subject to the Federal Rules of Civil Procedure, or by initiating an administrative proceeding before an Administrative Law Judge.

A. Civil Actions

If the SEC pursues a civil action in federal district court, the SEC may seek the following remedies:

1. Civil Injunction

The SEC may obtain a civil injunction prohibiting any person or corporation from continuing to violate, and/or from committing future violations of, the federal securities laws. To obtain an injunction, the SEC must show that the person or corporation has violated or is about to violate the securities laws, and a reasonable likelihood of future violations. Unlike private litigants, the SEC is not further required to show irreparable injury or that there is an adequate remedy at law.

When considering whether to issue an injunction, courts generally look to the following factors:

- the nature of the conduct;
- the degree of scienter (bad intent) involved;
- the defendant's ability to violate the law in the future; and
- the degree to which the defendant has recognized the wrongfulness of his or her conduct.

2. Disgorgement

Disgorgement is simply the repayment by the defendant of money obtained as a result of wrongful conduct. It may also include losses avoided as a result of the unlawful conduct. Examples of improperly obtained money subject to disgorgement include:

- profits made or losses avoided from insider trading;
- proceeds obtained from illegal securities distributions;
- bonuses based on improperly recognized revenues; and
- assets that were misappropriated.

The SEC will also seek, and receive if disgorgement is awarded, prejudgment interest on the disgorged sums.

3. Civil Penalties

The SEC also has the authority to obtain civil monetary penalties from individuals and entities that have violated the securities laws. These penalties are above and beyond any disgorgement the defendant must pay. The amount of a civil penalty depends upon the nature of the violation and whether or not the defendant is an individual or an organization.

4. Barring Service as an Officer or Director

Finally, the Commission may obtain an order from the district court prohibiting an individual from serving in the future as an officer or director of a public company. Such orders require a showing of egregious misconduct and are usually sought in circumstances where the individual has misappropriated corporate assets.

B. Administrative Proceedings

Administrative proceedings are proceedings held before an administrative law judge (ALJ), who is a full-time SEC employee. Decisions of the ALJ can be appealed to the Commission and from there to the United States Court of Appeals. Thus, the trial is entirely an "in-house" proceeding with far more restricted rights of discovery and of appeal than in a standard civil trial. There are technically different types of administrative proceedings, depending on the types of persons who can be prosecuted under them and the types of sanctions sought. Practically, however, the SEC will generally invoke authority for all types of administrative proceedings so that it could impose the broadest range of sanctions in one proceeding.

1. Cease and Desist Proceedings

The SEC has the authority under federal law to seek cease and desist orders against public companies and their officers in an administrative proceeding. In these proceedings, the SEC may seek several different types of cease and desist orders, including orders:

- requiring that persons who are violating the securities laws "cease and desist" from continuing the unlawful conduct;
- of "cease and desist" from causing another person's violation of the securities laws;
- compelling disgorgement of ill-gotten gains, as in a civil action, and an accounting to ensure that the disgorgement is accurate;

- requiring affirmative corrective action, such as requiring a corporation to adopt new internal control policies; and
- prohibiting any person from acting as an officer or director of any company with registered securities or required to make periodic filings with the SEC under the Exchange Act.

2. Civil Monetary Penalties

The Commission may also seek monetary penalties in an administrative proceeding. This authority is limited to proceedings brought under sections 15, 15B-15D, and 17A of the Exchange Act. In addition, monetary sanctions can only be imposed upon a finding that the respondent party has:

- willfully violated any provision of the federal securities laws (including the rules and regulations thereunder);
- willfully aided, abetted, counseled, commanded, induced, or procured a violation by another person;
- willfully made or caused to be made materially false or misleading statements in a report filed with the SEC; or
- has failed reasonably to supervise another person who commits such a violation.

3. Revocation of Licenses and Bars from the Industry

In an administrative proceeding, the Commission may also suspend or revoke a securities license from any regulated person, and bar a regulated person from working in the securities industry. Grounds for such sanctions generally involve: willful violations of the securities laws, or willfully aiding and abetting another person's violation; convictions of crimes; and/or failures to supervise others to prevent violations of the securities laws.

4. Proceedings to Correct Filings

The SEC can order a company that is required to make periodic filings under the Exchange Act to issue corrected filings upon a finding that previously issued filings contained false and misleading statements.

5. Disciplining Professionals

The SEC has the authority to discipline lawyers, accountants, and other professionals who practice before the Commission. Specifically, the Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any professional who is found:

- not to possess the requisite qualifications to represent others;
- to be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or
- to have willfully violated, or willfully aided and abetted the violation of, any provision of the federal securities laws.

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In addition to the information contained in this Primer, we encourage readers to visit our website to review Frequently Asked Questions about the SEC Whistleblower Program, the securities laws enforced by the SEC and our Firm.

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