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The Protocol for Broker Recruiting Develops a Life of Its Own in the Courts

By Nelson S. Ebaugh

Brokers move from one brokerage firm to another with remarkable frequency. The difficulty with moving so often, however, is that a broker ordinarily has obligations to his or her old firm under nondisclosure provisions, nonsolicitation provisions, and noncompete agreements that constrain his or her activities upon joining a competing firm. Not surprisingly, the tension created between honoring post-employment obligations and making a living as a broker at a new firm has led to many lawsuits and arbitration proceedings. For years, brokerage firms regularly filed suit to seek injunctive relief enforcing the post-employment obligations of departing brokers. Over time, however, brokerage firms became tired of the repeated litigation. In addition, brokerage firms understood that courts caught on to their wildly inconsistent positions in such litigation. The same brokerage firm that would sue a departing broker to enforce restrictive covenants would turn around in another case and argue that equivalent covenants—signed by one of the firm's new brokers while at that broker's previous firm—were unenforceable.

Large brokerage firms, recognizing that just about as many brokers with books of business

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The Fourth Circuit Weighs Competing Inferences of Outside Auditor Scienter under the PSLRA

By Matthew L. Mustokoff

Almost two years ago, the U.S. Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* held that in determining whether a securities-fraud plaintiff has adequately alleged the "strong inference" of scienter (or fraudulent intent) required under the Private Securities Litigation Reform Act (PSLRA), courts must take into account "plausible opposing inferences," and that to survive a motion to dismiss, a complaint must be "cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[1] To that end, *Tellabs* instructed that a district court's job "is not to scrutinize each allegation in isolation but to assess all the allegations holistically."[2] The U.S. Court of Appeals for the Fourth Circuit recently became the first circuit court to apply the *Tellabs* paradigm in the accountant-liability context.[3] In a decision arising out of the multi-billion-dollar accounting fraud by Dutch supermarket conglomerate Royal Ahold, N.V., the Fourth Circuit performed a comparative analysis of the competing inferences of scienter

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were coming to their firms as leaving their firms, called a truce. In 2004, Merrill Lynch, Pierce, Fenner & Smith, Inc., the Smith Barney division of Citigroup Global Markets Inc., and UBS Financial Services Inc., entered into the Protocol for Broker Recruiting. Subsequently, hundreds of brokerage firms and registered investment advisers have signed the protocol. In general, the protocol provides that a broker can move from a firm that has signed the protocol to another firm that has signed the protocol with that broker's list of clients, as long as the broker did not take any client files with. Under the protocol, the broker is allowed to contact and solicit all of his or her old clients immediately upon joining the new firm, but not before. If the broker followed the protocol's guidelines when moving to a new brokerage firm, the old employer agreed that it would not attempt to enforce restrictive covenants against the broker.

On the whole, the protocol has been a success. It has reduced the amount of litigation related to broker departures. Over the years, however, the protocol has created a benefit for non-protocol firms who use the protocol as a tool to battle protocol firms on the enforceability of nondisclosure, nonsolicitation, and noncompete agreements.

Invoking the Protocol as a Defense

Not all brokerage firms have signed the protocol. Consequently, it is not unusual for a broker to leave a protocol firm to work for a non-protocol firm. When moving to a non-protocol firm, most brokers attempt to take the same information that they could take under the protocol. Perturbed with this movement of brokers and their client lists, protocol firms vigorously seek to enforce the terms of broker post-employment obligations when the broker has gone to a non-protocol firm. In response, brokers have turned to an unlikely defense against such actions: the protocol itself.

In *Merrill Lynch v. Brennan*,[1] three brokers left Merrill Lynch to work for Bear Stearns & Co. The brokers took client lists with them to Bear Stearns. At Bear Stearns, the brokers used the client lists to solicit their old clients from Merrill Lynch. Merrill Lynch claimed that the brokers had violated various employment agreements, and the firm sought a temporary restraining order against the brokers. The brokers argued that when Merrill Lynch entered into the protocol, Merrill Lynch "agreed that brokers will move from firm to firm, and has provided the means to do so. It cannot now complain that the conduct authorized in the protocol impugns its business interests." The court agreed. The court held that Merrill Lynch "tacitly" acknowledged that when a broker leaves with protocol information to join another firm (whether it be a protocol firm or a non-protocol firm), the departure does not cause "irreparable harm" to the protocol firm.[2] Because proof of "irreparable harm" was necessary to obtain a temporary restraining order against the broker that left to work for a non-protocol firm, the court denied the protocol firm's request for injunctive relief.

In another case where a protocol firm sought injunctive relief against a broker that joined a non-protocol firm, *Smith Barney v. Griffin*,[3] the court went a step further. In this case, the broker left Smith Barney to join New York Life. On her first day with New York Life, the broker called a number of her old clients and urged them to move their accounts from Smith Barney to New York Life. Later that day, she received a letter from Smith Barney's counsel reminding her that she was bound by a nonsolicitation agreement and instructing her not to solicit any of her old clients for six months. Subsequently, Smith Barney sought a preliminary injunction against the broker. As in *Brennan*, the *Griffin* court held that Smith Barney's entry in the protocol demonstrated an absence of irreparable harm. The court, however, did not stop there; it also held that the protocol demonstrated that the information that the broker left with was not even confidential.[4] The court made the following remarks in reaching its conclusion:

> Under the Protocol, Smith Barney permits Client Information to be freely taken by departing financial advisors who leave for another signatory financial institution, even though this information is characterized as confidential in information in its Contract with [the departing broker]. . . . Smith Barney cannot have it both ways—it cannot declare this information to be confidential and, at the same time, permit this information freely to be taken to 38 other financial institutions by departing financial advisors.
>
> Moreover, by allowing its departing financial advisors to leave with the Client Information, Smith Barney is effectively declaring that it does not consider this Client Information to be "Nonpublic personal information" under the federal Gramm-Leach-Bliley Act. . . .[5]

Because of the decisions in *Brennan* and *Griffin*, several other courts have adopted their holdings when confronted with similar fact patterns. However, not all courts have adopted these holdings. In *Wachovia Securities, L.L.C. v. Stanton*,[6] the court expressly rejected the holdings in *Brennan* and *Griffin.*

Strict Construction of the Protocol

As in *Brennan* and *Griffin*, the *Stanton* court confronted a protocol firm's request for injunctive relief against one of its brokers that joined a non-protocol firm. In *Stranton*, the broker left Wachovia to join Century Securities Associates, Inc. Upon joining Century Securities Associates, the broker began soliciting her old clients from Wachovia. Wachovia sought a temporary restraining order and a preliminary injunction to restrain the broker from soliciting her old clients. Departing from *Brennan* and *Griffin*, the *Stanton* court held that the protocol did not allow the departed broker to take confidential information to her new firm.[7] In reaching this conclusion, the court honed in on the provision in the protocol that provides "*where both the former firm and the new firm are signatories*, a departing registered representative may solicit his or her clients to move to the registered representative's new firm."[8] The court strictly construed this provision and made the following observations:

> That provision does not mean, however, that there is no need for a non-solicitation covenant when the former firm is a signatory, but the new firm is not a signatory. Where both parties are signatories, they have essentially agreed to reciprocal "poaching" of registered representatives and the registered representative's clients from the former firm, apparently on the assumption that they will gain as much as they lose in the exchange. On the other hand, where the new firm is not a signatory, the old firm has no reciprocal benefit to look forward to, and a prohibition on solicitation of clients by a departing registered representative is still reasonably necessary to protect the former firm's client base from "poaching" by the new, non-Protocol firm.[9]

In addition to finding that protocol information constituted trade secrets subject to employee covenants, the *Stanton* court held that the protocol does not demonstrate an absence of irreparable injury. The court stated that if the protocol firm had established violations of the applicable covenants, then irreparable harm could have been presumed under common law and injunctive relief could have been issued against the departed broker.[10]

It is noteworthy that the *Stanton* court went out of its way to rebut the rationales for the holdings in *Brennan* and *Griffin*. After all, the *Stanton* court found that Wachovia had not established a likelihood of success on any of its claims and therefore, was not entitled to a temporary restraining order against the broker. The court could have stopped there without considering the protocol's effect if any. But the court took it upon itself to explain exactly why it disagreed with the holdings in *Brennan* and *Griffin*.

Not surprisingly, protocol firms have cited the *Stanton* opinion often in cases to enforce restrictive covenants. But at the moment, a majority of opinions that have addressed the foregoing issues and have been assigned to a reporter for publication or that are available on an electronic database (e.g., Westlaw) have adopted the holdings in *Brennan* and *Griffin* in lieu of those in *Stanton*.[11]

Conclusion

No appellate court has addressed the issues examined above. It will be interesting to see if an appellate court adopts the reasoning in *Brennan* and *Griffin* or the contrary reasoning in *Stanton*. However, it will probably be a while before an appellate court has the opportunity to review the foregoing issues. In general, a temporary restraining order cannot be appealed. In addition, parties often decline to appeal a trial court's ruling on a request for a preliminary injunction. After all, by the time an appellate court has reviewed an order granting or denying a preliminary injunction, the issue is usually moot. Finally, claims for breach of employee covenants are usually resolved through arbitration. And appellate courts ordinarily do not review the legal reasoning of an arbitration panel. Consequently, brokerage firms may be citing one or more of the cases discussed above to support their respective positions for a long time.

> In response, brokers have turned to an unlikely defense against such actions: the protocol itself.

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1. 2007 WL 632904 (N.D. Ohio 2007).
2. *Id.*
3. 23 Mass. L. Rptr. 457, 2008 WL 325269 (Mass. Super. 2008).
4. *Id.* at *6–*7.
5. *Id.* (citations omitted).
6. 571 F. Supp.2d 1014 (N.D. Iowa 2008).
7. *Id.* at 1039–40.
8. *Id.* at 1039 (italics in original).
9. *Id.* at 1040.
10. *Id.* at 1046.
11. Smith Barney v. Burrow, 558 F. Supp.2d 1066 (E.D. Cal. 2008); Merrill Lynch v. Baxter, 2009 WL 960773 (D. Utah 2009); Smith Barney v. Darling, 2009 WL 1544756 (E.D. Wis. 2009).

Outside Auditor Scienter

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urged respectively by the shareholder-class plaintiffs and Royal Ahold's outside auditor, Deloitte & Touche.[4]

The plaintiffs claimed that Deloitte was knowingly or at least recklessly complicit in Ahold's fraudulent accounting because, among other things, it failed to procure sufficient documentary evidence to corroborate representations by Ahold management that Ahold held a controlling stake in various joint ventures, thus enabling Ahold to record revenue from those ventures that it did not control. The Fourth Circuit rejected the plaintiffs' claim, holding that any inference of scienter the plaintiffs would have the court draw from these allegations was outweighed by the fact that Ahold and its Maryland-based subsidiary, U.S. Foodservice, Inc. (USF), went to great lengths to deceive Deloitte by concealing documents that would have brought the fraud to light. As the court explained, "[s]eeing the forest as well as the trees is essential"; that is to say, Deloitte's failure to ferret out the fraud must not be considered in isolation from Ahold's efforts to cover up the fraud.[5]

The *Deloitte* decision is significant in underscoring the point that while an outside auditor's failure to satisfy accounting guidelines and best practices may give rise to a claim for negligence under state law, such a failure is not actionable under the anti-fraud provisions of the federal securities laws absent a showing that the auditor acted with a reckless oblivion in the face of detectable misconduct. The decision also illuminates an increasingly common fact pattern in securities-fraud suits—the deception by corporate defendants of their accountant codefendants—a fact pattern that, in the lexicon of *Tellabs*, begs the question: Which inference is the more plausible—were the accountants victims of the fraud, or its facilitators?

The Ahold Frauds

The Royal Ahold fraud was one of the largest perpetrated in recent memory. In 2005, following almost three years of class-action litigation, Ahold announced a $1.1 billion settlement on behalf of all defendants with the exception of the two outside auditor defendants—Deloitte & Touche LLP (Deloitte U.S.) and Deloitte & Touche Accountants (Deloitte Netherlands). Following this settlement and some initial discovery, the plaintiffs filed a motion to amend the original complaint, attaching a proposed amended complaint against the Deloitte defendants. District Judge Catherine Blake (D. Md.) denied the motion, holding that the amended complaint failed to satisfy the PSLRA's heightened "strong inference" requirement for pleading scienter. The appeal to the Fourth Circuit ensued.

The allegations against the Deloitte entities revolved around two separate frauds that permitted Ahold to overstate earnings exceeding $24.8 billion in revenues and $1.1 billion in net income.

The Joint-Venture Fraud

The first fraud involved the improper "consolidation" by Ahold of the total revenues of five joint ventures in which Ahold did not actually hold a controlling stake. The plaintiffs claimed that Ahold represented to Deloitte Netherlands that it possessed the requisite control of the joint ventures to allow Ahold to recognize all of the revenues from the various entities. When Deloitte Netherlands expressed concern that Ahold's representations of control might be insufficient to permit the consolidation of revenue, Ahold, with the blessing of Deloitte Netherlands, drafted and effectuated a series of "control letters" to be countersigned by its joint-venture partners, stating that in the event of a disagreement or impasse with respect to a particular issue between Ahold and the joint-venture partner, Ahold would have the final vote. The original joint-venture agreements did not indicate that Ahold—a 50 percent stakeholder in four of the ventures and a 49 percent stakeholder in the remaining venture—controlled the ventures. Deloitte Netherlands viewed these countersigned control letters as evidence sufficient to justify the consolidation of revenues.

Approximately two years later, Deloitte Netherlands learned of a "side letter" between Ahold and one of its joint-venture partners, Canica, in which Canica disavowed the control letter purporting to identify Ahold as the controlling partner. Just a week after representatives of both Deloitte entities told Ahold in a meeting that it lacked the necessary control for consolidation, Ahold revealed for the first time a string of similar side letters contradicting control letters for three other joint ventures. Two days later, Ahold announced its intention to restate its revenues as a result of the improper consolidations, and its common stock price dropped 60 percent.

The Promotional-Allowances Fraud

The second alleged fraud involved the false reporting by USF of income from promotional allowances (PAs), or rebates provided to USF by vendors in an effort to encourage promotion of their products. The plaintiffs alleged that USF, with Deloitte U.S.'s assistance, prematurely recognized the revenues on these PAs and inflated its reported income. In connection with Deloitte U.S.'s attempt to verify USF's PA revenues after identifying weaknesses in USF's internal system for recording income, USF refused to produce several vendor contracts and make members of management available for interviews. The Deloitte U.S. auditor responsible for the review subsequently prepared a draft report describing USF management's failure to cooperate with the audit. The auditor's supervisor, a Deloitte U.S. partner, suggested the report be softened to simply reflect Deloitte U.S.'s inability to obtain supporting documentation for the audit and not mention management's obstructive conduct.

Eventually, Deloitte U.S. discovered that USF had been overstating its PA income. After a full investigation, USF's chief marketing officer, Mark Kaiser, was convicted, and two other executives pled guilty to federal securities fraud. The indictment against Kaiser alleged that he had concealed the existence of several vendor contracts from Deloitte U.S., and the plea colloquies of the other executives included admissions that they induced vendors to sign false audit confirmations that misstated PA payments to USF.

Deception of Auditors Negates Inference of Scienter

The Fourth Circuit began its legal analysis by describing the comparative approach enunciated by the *Tellabs* court for weighing allegations of scienter under the PSLRA's "strong inference" requirement. The court explained that the PSLRA's heightened pleading requirement "is not meant to prevent litigants with meritorious claims from continuing to uncover fraud," but rather, "aims to weed out meritless claims at the pleading stage, without forcing defendants to go through a potentially costly discovery process."[6] The *Deloitte* court noted that while *Tellabs* instructs district courts to weigh competing inferences of scienter, taking into account "'plausible nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff,'" the high court's comparative analysis and the "strong inference" language in the PSLRA "still leave unanswered the question of exactly what state of mind satisfies the scienter requirement of a 10b-5 action."[7] Indeed, the Supreme Court acknowledged in *Tellabs* that it has never considered the question of whether scienter can be established by a showing of recklessness.[8] Lack of Supreme Court guidance notwithstanding, the *Deloitte* court made clear that under the law of the Fourth Circuit, a reckless act will suffice to meet the PSLRA's test, but that "a showing of mere negligence" will not suffice.[9] To that end, the Fourth Circuit framed the issue on appeal as follows:

> Thus, the question is whether the allegations in the complaint, viewed in their totality and in light of all the evidence in the record, allow us to draw a strong inference, at least as compelling as any opposing inference, that the Deloitte defendants either knowingly or recklessly defrauded investors by issuing false audit opinions in violation of Rule 10b-5(b) or 10b-5(a) and (c). If we find the inference that defendants acted innocently, or even negligently, more compelling than the inference that they acted with the requisite scienter, we must affirm.[10]

Turning first to the joint-venture fraud, the court recited the plaintiffs' allegations that the Deloitte defendants knowingly or recklessly permitted Ahold to recognize the revenue for the various joint ventures because Ahold's oral representations that it controlled the joint ventures and the subsequent control letters produced by Ahold were insufficient evidence of control under Dutch and U.S. generally accepted accounting principles (GAAP). As for the side letters from the joint-venture partners contradicting the control letters, the plaintiffs contended that they were "irrelevant" to the analysis because the control letters themselves never effectively amended the original joint-venture agreements. The court rejected this claim, finding no basis to infer that either Deloitte entity harbored a knowing or reckless intent regarding the joint-venture fraud. As the court explained, "[t]he most plausible inference that one can draw from the fact that Ahold concealed the side letters from its accountants is that the accountants were uninvolved in the fraud."

> Which inference is the more plausible—were the accountants victims of the fraud, or its facilitators?

The Fourth Circuit acknowledged that "[w]ith perfect hindsight," the argument could be made that Deloitte should have insisted on stronger evidence of control from Ahold and that Deloitte's acceptance of Ahold's unsupported representations that it controlled one of the joint ventures for which Ahold never produced a control letter was akin to negligence. Yet the court concluded that "the evidence as a whole leads to the strong inference that defendants were deceived by their clients into approving the consolidation," thus outweighing any inference that Deloitte had been complicit in Ahold's misrepresentations or "so reckless in their duties that their audit 'amounted to no audit at all.'"[11] In so holding, the court underscored the difference between negligence and fraud, explaining that Deloitte's carelessness notwithstanding, the fact that Ahold provided Deloitte with false evidence of control of the joint ventures negates any inference of fraudulent intent:

> *In order to establish a strong inference of scienter, plaintiffs must do more than merely demonstrate that defendants should or could have done more.* They must demonstrate that the Deloittes were either knowingly complicit in the fraud, or so reckless in their duties as to be oblivious to malfeasance that was readily apparent. The inference we find most compelling based on the evidence in the record is not that the defendants were knowingly complicit or reckless, but that they were deceived by their client's repeated lies and artifices. Perhaps their failure to demand more evidence of consolidation was improper under accounting guidelines, but that is not the standard, which "requires more than a misapplication of accounting principles."[12]

The Fourth Circuit's ruling underscores the boundary line separating negligence and fraud in the accountant context.

The court then turned to the PA fraud claim. The plaintiffs alleged that Deloitte U.S. knowingly turned its head the other way when it ignored a litany of "red flags," including USF's substandard internal controls to record PA income and USF management's refusal to provide documentation during the PA audit. The court was quick to point out that rather than ignore USF's internal-control deficiencies, Deloitte U.S. raised the issue with USF management and pursued a confirmation process to verify the PA numbers by insisting on corroborating evidence from USF's outside vendors. In response to the plaintiffs' assertion that the confirmation process was "unsound" because, among other things, Deloitte U.S. accepted confirmation letters from the vendors' sales executives as opposed to senior financial officers, the court found that the opposing inference to be drawn is that the auditors were looking to expose revenue inflation, not conceal it. The court reasoned that "even if the confirmation process was somewhat flawed . . . , the larger fact remains that the PA fraud went undetected initially only because USF and its vendors conspired to lie to Deloitte U.S. and to conceal important documents" and that "[i]ndeed, it was Deloitte U.S.'s confirmation process itself that ultimately revealed the fraud."

As the court explained, "[s]eeing the forest as well as the trees is essential"; in other words, that Deloitte failed initially to uncover the fraud must be viewed in the larger context of Ahold's repeated efforts to hide the fraud:

> With respect to both frauds, plaintiffs point to ways that defendants could have been more careful and perhaps discovered the frauds earlier. But plaintiffs cannot escape the fact that Ahold and USF went to considerable lengths to conceal the frauds from the accountants and that it was the defendants that ultimately uncovered the frauds. The strong inference to be drawn from this fact is that Deloitte U.S. and Deloitte Netherlands lacked the requisite scienter and instead were deceived by Ahold and USF. That inference is significantly more plausible than the competing inference that defendants somehow knew that Ahold and USF were defrauding their investors. It is not an accountant's fault if its client actively conspires with others in order to deprive the accountant of accurate information about the client's finances.[13]

Based on this reasoning, the Fourth Circuit affirmed the district court's denial of the plaintiffs' motion for leave to amend their complaint against the Deloitte defendants. The court made clear that it was not establishing "blanket immunity for accountants for otherwise actionable statements with a strong inference of scienter," but that "in this case, the stronger and more plausible inference is that the Deloittes were, like the plaintiffs, victims of Ahold's fraud rather than its enablers." In that regard, the Fourth Circuit concluded, "[p]laintiffs' action is the paradigm situation to which the PSLRA and *Tellabs* were meant to apply."

Conclusion

For defense lawyers who remain apprehensive about the lower courts' interpretation of *Tellabs* and its "holistic" approach to gauging scienter, the Fourth Circuit's *Deloitte* decision illustrates how *Tellabs*' comparative analysis—with its emphasis on examining the allegations of a securities-fraud complaint collectively, as opposed to examining individual allegations in isolation—can result in the dismissal of a claim, particularly when the acts of one defendant are juxtaposed against the acts of another. In light of Ahold's efforts to deceive Deloitte, it is perhaps neither extraordinary nor surprising that the court found that Deloitte lacked the requisite intent. Nonetheless, the Fourth Circuit's ruling marks an important development in the still nascent, post-*Tellabs* jurisprudence and underscores the boundary line separating negligence and fraud in the accountant context. ✺

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1. 127 S. Ct. 2499, 2510 (2007).
2. *Id.* at 2511.
3. While the Sixth Circuit previously addressed a securities-fraud claim against an outside auditor after the issuance of *Tellabs*, the court did not expressly apply the comparative analysis espoused by *Tellabs* to the auditor claim. *See* Ley v. Visteon Corp., 543 F.3d 801 (6th Cir. 2008).
4. *Pub. Employees Ret. Assoc. of Colo. v. Deloitte & Touche LLP*, ___ F.3d. ___, 2009 WL 19134 (4th Cir. Jan. 5, 2009).
5. *Id.* at *11.
6. *Id.* at *7.
7. *Id.* at *8 (*quoting Tellabs*, 127 S. Ct. at 2511).
8. *See Tellabs*, 127 S. Ct. at 2507 n.3 ("We have previously reserved the question whether reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5. Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required. The question whether and when recklessness satisfies the scienter requirement is not presented in this case.").
9. 2009 WL 19134, at *8. The circuit courts are essentially uniform in holding that in an action alleging a primary violation of section 10(b) of the Securities Exchange Act of 1934, a private plaintiff can establish scienter by demonstrating either knowing misconduct or recklessness. *See, e.g.,* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 601 (7th Cir. 2006); *In re* Stone & Webster, Inc., Sec. Litig., 414 F.3d 187, 195 (1st Cir. 2005); Novak v. Kasaks, 216 F.3d 300, 310 (2d Cir. 2000). The *Deloitte* court reiterated the standard for recklessness in the Fourth Circuit: "We have defined a reckless act in the § 10(b) context as one 'so highly unreasonable and such an extreme departure from the standard of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *Id.* (*quoting* Ottman v. Hangar Orthopedic Group, Inc., 353 F.3d 338, 344 (4th Cir. 2003)).
10. *Id.*
11. *Id.* (quoting SEC v. Price Waterhouse, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992)).
12. *Id.* (quoting *Price Waterhouse*, 797 F. Supp. at 1240) (emphasis added).
13. *Id.* at *11.

SEC Enforcement Actions and Potential Civil Liability for Failures to Make Timely Filings

By Peter M. Saparoff, Breton Leone-Quick, & Brian P. Dunphy

As with any economic downturn, the past couple of years have seen a growing number of small public companies struggling to comply with the costly section 13 disclosure requirements.[1] Even in good times, companies with smaller market capitalizations face compliance costs that are disproportionate to their overall revenues when compared with larger public companies. When capital markets dry up, these costs sometimes result in companies being faced with a difficult decision of using their now limited cash to make payroll (or meet other critical operating costs) or to make timely Q and K filings.

Among the most significant reasons for a company to make timely filings is to be able to meet the listing requirements for whatever national securities exchange that lists that company's securities. That issue is not directly addressed by this article, as it has received significant analysis already. Rather, this article focuses primarily on Securities and Exchange Commissions (SEC) enforcement actions against untimely filers, and provides an overview of whether these proceedings really do protect investors, along with a discussion of a possible loophole in the SEC's enforcement mechanisms that insulates small public companies from the most adverse consequences of such an enforcement action.

Available Remedies for Untimely Filings

A failure to make timely filings under section 13 of the Securities Exchange Act subjects companies to the typical range of sanctions for any violations of the securities laws. These sanctions include an injunction,[2] an administrative cease-and-desist order,[3] or a civil penalty.[4] But none of these sanctions is particularly attractive to the SEC when faced with a small public company whose filings may be untimely because of cash-flow or other legitimate business issues. An injunction or a cease-and-desist order would do little to remedy the problem, as impossibility of complying with such an injunction (by reason of lack of money) would be a defense to any subsequent enforcement proceeding.[5] For the same reason, a civil penalty does not offer much of an advantage. Not only must the SEC consider the ability of a company to pay as part of its imposition of a penalty,[6] but the SEC also weighs the potential impact its actions would have on shareholders. In the cases where a company is struggling to stay afloat, payment of a civil penalty would divert funds the company may need to—ironically—stay up to date with its filings and preserve shareholder value.

Reflecting these realities, it turns out that the SEC's most frequently used remedy in cases involving untimely filings under section 13 is section 12(j) of the Securities Exchange Act.[7] This section provides that:

> [t]he Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security. . . .[8]

The section also prohibits any member of a national securities exchange, broker, or dealer from using interstate commerce "to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked. . . ."

Another remedy frequently used by the SEC when faced with an issuer who has been unable to make timely filings is section 12(k), which provides that "[i]f in its opinion the public interest and the protection of investors so require," the SEC can summarily suspend trading in any security for 10 days, and any security traded on a national securities exchange for 90 days, provided that the SEC gives notice to the president, who does not disapprove of the decision.[9]

A brief view of the legislative history of section 12 helps provide important context for current enforcement actions under sections 12(j) or (k).

History of Section 12

As originally enacted, section 12 contained only one way for an issuer to register its securities. Section 12(b) provided that an issuer "may" register its securities with a national securities exchange by filing an appropriate application with the exchange.[10] Such registration is a requirement before the securities may be traded on that exchange.[11]

In 1965, the Exchange Act was amended by adding, inter alia, section 12(g),[12] which requires that certain issuers that had not registered with a national securities exchange to register their shares with the SEC. The purpose of this amendment was to subject issuers who were selling their securities over the counter (OTC) to the reporting obligations of section 13.[13] Section 12(g), however, is not applicable to all issuers. The section itself exempts issuers as long as at the end of each fiscal year, they have fewer than 500 holders of record and less than $1 million in assets.[14] The SEC later passed a rule that raised the level of assets needed to claim an exemption to registration under Rule 12(g). The current version of this rule exempts from the registration requirements any issuer with less than $10 million in assets on the last day of their fiscal year.[15] Such issuers who register their securities under either section 12(b) or section 12(g) then become subject to the reporting requirements in section 13.[16]

In 1975, the Exchange Act was amended to include section 12(j), which, as discussed above, allows the SEC to suspend or revoke the registration of any security made pursuant to section 12(g).[17] The primary legislative history for this act is silent as to the purpose of this section.[18] It appears, however, that the section was intended to allow the SEC to essentially halt the trading of any OTC security that it had previously registered.

Enforcement Proceedings under Sections 12(j) and (k)

A vast majority of enforcement actions initiated under section 12(j) occur only after a company has failed to make any section 13 filings for several years. Many of these enforcement actions are unopposed. One reason for the lack of opposition is that many of the companies are actually defunct and no longer conduct any business.

As an initial matter, it should be noted that a revocation proceeding under section 12(j) is only directed towards a section 12(g) registration. While section 12(j) does not settle this issue explicitly, and some commentators have suggested that section 12(j) proceeding can be used to revoke a section 12(b) registration, the more reasonable reading of the statute is that this is not the case. First, a section 12(b) registration is not a registration directly with the SEC, but rather a registration with a national securities exchange. This leads to the reasonable inference that the SEC is only capable of revoking a registration that has been registered with it pursuant to section 12(g). Further, section 12(d) already allows the SEC to withdraw or strike a registration with a national securities exchange, so it would be unnecessary for section 12(j) to reach securities registered under section 12(b).

In any event, the SEC initiates section 12(j) proceedings regularly. Presumably, these actions are brought on the rationale, as articulated on the face of the statute, that revocation of registration is necessary to protect investors.[19] The SEC has also specifically observed how "many publicly traded companies that fail to file on a timely basis are 'shell companies' and, as such, attractive vehicles for fraudulent stock manipulation schemes."[20] Additionally, the SEC has recognized that the primary harm to current and potential investors resulting from a failure of the issuer to make timely filings is an inability to have access to material information about the issuer's business. While this may be a valid concern, how effective is a section 12(j) proceeding at really remedying this concern? Potentially, not very much.

With respect to existing investors, deregistration will actually harm those shareholders as they will lose liquidity for their shares. And, as a result of this loss of liquidity, the value of their shares will also decline. As other commentators have noted, suspension or revocation of securities is a "draconian" measure and deprives shareholders of an exchange market.[21] The SEC casually sweeps this very real harm aside by explaining how harm to existing shareholders should not be the determining factor whether to impose revocation; the SEC instead seems to emphasize the interests of future investors.[22] But does a section 12(j) proceeding really do anything to benefit potential investors? Or, more specifically, do any benefits to potential investors outweigh the harm to current investors? Given that section 12(j) can only be used to protect investors, an argument could be made that the harm to current investors must be outweighed by any benefit or protection to potential investors for the SEC to initiate such a proceeding.

> Any argument that a section 12(j) proceeding can or does protect potential investors is highly speculative, and in some respects, inaccurate.

Simply put, any argument that a section 12(j) proceeding can or does protect potential investors is highly speculative, and in some respects, inaccurate. It appears that the SEC uses section 12(j) proceedings to halt the trading of an issuer's security to prevent any new investors from being harmed through their purchase of those securities. The first problem with this rationale is that it could be seen as overly paternalistic. For example, does an investor who purchases securities of an issuer with knowledge that that issuer has not made any recent section 13 filings really need (or deserve) protection? And what about investors who specifically want to invest in spite of the lack of recent filings? Shouldn't they be allowed to decide for themselves? Putting these issues aside, the fundamental premise of the SEC's rationale (i.e., that a section 12(j) proceeding will prevent the public trading of an issuer's securities) is also flawed.

As discussed above, an issuer who has already missed several deadlines for its section 13 filings has likely already been delisted from a national securities exchange, and trading in its securities has been relegated to the OTC markets. And, as discussed above, any issuer with less than $10 million in assets can voluntarily deregister its securities under section 12(g). Upon such a voluntary deregistration, the issuer can still have its securities listed on all but the highest OTC tier because a voluntary deregistration is not subject to the ban on trading that results from a section 12(j) revocation. So an issuer can completely subvert the SEC's attempts to halt the trading in its securities by simply deregistering. It should also be noted that most of the issuers that the SEC pursues by its own admission—"shell companies"—would certainly qualify for deregistration. Of course, it is possible that listing on anything but the highest OTC can have some sort of impact on the value of an issuer's securities, but this is speculative, especially considering the fact that several of the tiers that do not require registration still require a certain level of transparency and public disclosure, making them potentially still attractive to investors.[23] Section 12(j) proceedings therefore do not really provide an effective mechanism to shut down shell companies or other small issuers the SEC thinks may pose a threat to potential investors if those issuers simply deregister at any time before the SEC seeks a revocation order.

A perfect illustration of how this cat-and-mouse game plays out took place just recently. In an administrative proceeding initiated under section 12(j) against Consumers Financial Corporation (CFC), the SEC sought suspension or revocation of the section 12(g) registration of CFC's securities.[24] But almost five months prior to the date when the SEC issued its Order Instituting Proceedings (OIP), CFC filed a Form 15 seeking a voluntary deregistration of its shares under section 12(g)(4) because it had fewer than 300 shareholders.[25] Under section 12(g)(4), such a voluntary deregistration is effective 90 days from the date of filing the Form 15.[26] CFC's deregistration of shares, therefore, was already effective prior to when the SEC issued its OIP seeking such a deregistration. When the administrative law judge (ALJ) pointed out this fact to the SEC, the SEC sought to amend its OIP to allow it to revoke CFC's voluntary deregistration of its securities.[27] While the ALJ allowed the amendment, CFC's gambit appeared to have at least extended the time during which its securities could be traded by requiring the SEC to first invalidate its voluntary deregistration and then reinitiate proceedings to revoke that registration. CFC also may be able to use this time to come up to date with its filings (at which point the SEC has less leverage for a permanent revocation of the section 12(g) registration). In any event, if CFC succeeds in defeating the SEC's attempts to invalidate its voluntary deregistration, then that move will pay off by eliminating the risk of the SEC being able to permanently halt trading in CFC's securities.

Another irony of a section 12(j) proceeding against an issuer who has not been timely with its filings is that the punishment *is* the crime in the sense that once an issuer is no longer registered under section 12, it is likely no longer required to make section 13 filings.[28] So the proceeding that the SEC most frequently uses against issuers for not making timely filings, oddly enough, results in those issuers being exempted from having to make those filings. Even more bizarre is the fact that a deregistration does not prohibit an issuer from resuming making section 13 filings if it wishes to do so voluntarily.[29]

Finally, it should be noted that while the SEC can use section 12(k) to suspend trading of any security (whether it is registered or not, and whether it is traded on a national securities exchange or not), this is not a permanent fix given the limited duration on the length of the suspension.

Is the SEC Overstepping Its Authority?

Given the analysis above, it appears that in most instances, section 12(j) proceedings, which can only be initiated to protect investors, do not provide any protection to investors, and the SEC's sparse analysis of this issue contains substantial holes.

So why does the SEC continue to initiate such proceedings? The only logical reason is that the SEC does so specifically to try and shut down public companies by either making them dissolve or go completely private—both of which harm current investors, and neither of which would seem to benefit any potential investors except in the most paternalistic sense. If this is truly the motivation, then a significant question arises as to whether the SEC is overstepping its authority by purportedly acting to "protect investors" when what it is really doing is making judgment calls on whether a company should have its securities publicly traded or not.

Contesting a Section 12(j) Proceeding

Setting aside whether section 12(j) proceedings have any relevance anymore (or any true consequences on the target company), companies do, on occasion, choose to contest such proceedings. Given that in every one of these cases, the issuer has already failed to make numerous section 13 filings, the only real defense in a section 12(j) proceeding is to argue that section 12(j) sanctions (i.e., deregistration) are not warranted.

The SEC considers the familiar *Steadman*[30] factors when deciding whether deregistration is an appropriate sanction. These factors are:

1. the seriousness of the issuer's violations
2. the isolated or recurrent nature of the violations
3. the degree of culpability involved
4. the extent of the issuer's efforts to remedy its past violations and ensure future compliance
5. the credibility of its assurances, if any, against further violations[31]

No one of these factors is dispositive,[32] and the severity of the sanction depends on the facts and the circumstances of each case.[33]

The first factor is the seriousness of the issuer's violations.[34] Many of the cases filed by the SEC seeking suspension or revocation of securities involve a litany of missed filings over a period of years. In one recent case, the SEC issued an order against nine companies, some of whom had not filed a report since 2000.[35] In another, the SEC filed an OIP against 17 companies, nearly all of which had not filed between 18 and 31 reports.[36] In another, the company failed to file 22 consecutive periodic reports over five years.[37] The company was also 65 months late in filing the financial statements for its last filing, a form 10-KSB that it filed without financial statements.[38]

The next factor—whether the violations are isolated or recurrent—is similar to the first.[39] As discussed above, where an issuer has failed to file periodic reports for a period of time, and its failure is recurrent, the SEC has apparently been more willing to seek revocation or suspension of the security.

The next consideration is the degree of the issuer's culpability. While there is no scienter requirement to prove a violation of section 13(a), the SEC has viewed a long history of failing to comply with filing requirements as evidencing a high degree of culpability. For example, the SEC has decided that a company had a high degree of culpability "where neither a change of management," the institution of proceedings, nor an order temporarily suspending trading in the company's stock "has made any difference in the Company's long history of ignoring its reporting obligations."[40]

An issuer's efforts to remedy past violations have met with success defending against revocation actions. And a recent administrative proceeding under section 13(a) suggests that a company would be advised to become current in its filings. There, an ALJ favorably viewed a company's efforts to complete late filings and imposed no further sanction on the company after it became current in its filings.[41]

Finally, the SEC considers the credibility of assurance against future violations. The SEC has found assurances lacked credibility where a company represents that it had completed filing all its overdue reports for the period alleged in the OIP, but failed to address a deficiency in a filing concerning the improper scope limitation, which remains outstanding.[42] In another case, the SEC found a company's assurances lacked credibility where the company stated that it did not want to expend these funds to complete its outstanding filings unless it was given a "90-day window" to return to compliance. There, the SEC believed that the company's position reflected a "highly troubling attitude towards SEC reporting requirements" because compliance with those requirements is mandatory and suggested the company lacked the resources to prepare the requisite filings.[43]

Conclusion

While section 12(j) was seemingly enacted to allow the SEC the opportunity to eliminate public trading of a company's securities, the mechanism that the section provided to do this (i.e., deregistration) is ineffective at doing so if an issuer chooses (and is eligible) to deregister itself before the SEC seeks to revoke its registration. In such cases, and absent clear authority from Congress (through an amendment to the Exchange Act) to close this possible loophole, the decision as to whether to go dark or go private—for the time being—should remain with the directors and shareholders of an issuer, especially when considering that

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Erosion of the Fiduciary-Duty Requirement in Insider-Trading Actions

By Joel M. Cohen, Mary Kay Dunning, & Gregory H. Shill

Every decade or so, a new wave of interest in prosecuting insider trading emerges. We see this now. Just as the tides of interest in insider trading ebb and flow, so too do the contours of the offense itself. Given the present environment, of course, one would expect regulators to step up insider-trading enforcement, and they have.[1] This growing regulatory aggressiveness has coincided with judicial relaxation of the elements of insider-trading violations. Ensuring proper enforcement without inhibiting the free flow of information that regulators and the courts have historically recognized as vital to healthy markets truly has become a high-wire act.

Taken together, two insider-trading cases decided last year—*SEC v. Cuban*[2] and *SEC v. Dorozhko*[3]—are a product of the Securities and Exchange Commission's (SEC) success in expanding the scope of insider-trading liability under, respectively, the so-called misappropriation theory of insider trading and an entirely new theory, affirmative misrepresentation. The cases are noteworthy because they depart from established Supreme Court precedent requiring the breach of a traditional fiduciary or similar duty as an element of the offense. That element had helped foster the "certainty and predictability" long considered necessary to enforcement of the securities laws.[4] For example, under *Cuban*, a confidentiality agreement between an investor and a company may now be deemed sufficient to satisfy the fiduciary-duty requirement even where the parties lacked a preexisting fiduciary relationship, as long as the agreement contains a promise not to trade on the nonpublic information.[5] Likewise, *Dorozhko* extends insider-trading liability to outsiders lacking a fiduciary or similar relationship to the company where the outsider misappropriates confidential information through an "affirmative misrepresentation."[6] Although *Cuban* is currently under Fifth Circuit review and may yet be cabined, the *Dorozhko* decision is unreviewable and remains the law of the Second Circuit.[7]

By undermining the duty requirement, these decisions also move insider-trading jurisprudence toward the parity-of-information theory of insider-trading liability that the Supreme Court has twice rejected as a basis for liability.[8] And they move the law toward imposing a general duty on market participants to refrain from trading while in possession of material nonpublic information—a rule the Court has explicitly and repeatedly rejected.

Background of Insider-Trading Law

Section 10(b) of the Securities Exchange Act of 1934 makes unlawful the use, "in connection with the purchase or sale of any security . . . , [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . "[9] Rule 10b-5, the SEC's primary regulation implementing section 10(b), makes it unlawful, in connection with the purchase or sale of a security, to "employ any device, scheme, or artifice to defraud," to "make any untrue statement of material fact or [omission]," and to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."[10]

The Supreme Court has embraced two complementary theories of insider trading interpreting section 10(b) and its implementing rules. The first, recognized in *Chiarella v. United States*[11] and known as the classical theory, provides that corporate insiders are forbidden to trade on confidential information in violation of a fiduciary duty to their company's shareholders. The *Chiarella* Court emphasized that a central indication of corporate-insider status is whether the actor is under a fiduciary duty to the shareholders of his or her company. The Second Circuit, which was the court below, had adopted a broad definition of duty, assigning a fiduciary duty to "anyone," not merely insiders, receiving material nonpublic information; the Supreme Court explicitly rejected that definition.[12] Three years later, in *Dirks v. SEC*, the Court reaffirmed that interpretation and reiterated that a predicate of insider-trading liability is "the existence of a fiduciary relationship."[13]

The second theory of insider trading, known as the misappropriation theory, was recognized by the Supreme Court in *United States v. O'Hagan*[14] and extended insider-trading liability to corporate outsiders: Those who misappropriate, and then trade on, confidential information in violation of a duty of trust or confidence owed to the source of the information may be found liable under section 10(b).[15] Thus, the Court held, a law-firm partner who is aware of a regulated client's still-private plans to acquire stock in another company may not trade on that information.[16]

These two theories of insider-trading liability share the common requirement of breach of a fiduciary or fiduciary-like duty under section 10(b), a requirement now challenged by *Cuban* and *Dorozhko*. Under *Cuban*, a private contract may now be deemed sufficient to meet this requirement, and under *Dorozhko*, it may be discarded entirely.

Cuban

Last year, the Northern District of Texas in *SEC v. Cuban* addressed whether a breach of a fiduciary duty arising by agreement can serve as the basis for insider-trading liability under the misappropriation theory.[17] In March 2004, defendant Mark Cuban bought 600,000 shares of Mamma.com, becoming a 6.3 percent shareholder, the company's largest. According to the SEC, in the spring of 2004, the CEO of Mamma.com telephoned Cuban and told him that he had confidential information about the company to share; Cuban allegedly agreed that he would keep the information confidential. The CEO then told Cuban about a planned private investment in public equity (PIPE) offering and asked him whether he wanted to participate in it. Cuban reacted angrily to the news, stating that he disliked PIPEs because they dilute existing shareholders, and, at the end of the call exclaimed, "Well, now I'm screwed. I can't sell." The next day—and before the planned PIPE was publicly disclosed—Cuban sold his entire position in Mamma.com, avoiding losses that would have exceeded $750,000.

The SEC brought an insider-trading complaint against Cuban under the misappropriation theory, alleging that he had agreed to maintain the information about the PIPE in confidence and then violated that agreement by selling his Mamma.com shares in advance of the PIPE announcement. Cuban responded that the SEC's claims were baseless because the alleged confidentiality agreement did not establish a fiduciary duty owed to the CEO, who had informed Cuban of the PIPE. To establish misappropriation liability by agreement, Cuban argued, the agreement must arise in the context of a preexisting fiduciary or fiduciary-like relationship, or it must create such a relationship.

In rejecting Cuban's argument, the district court held that a fiduciary duty can be implied by contract regardless of whether a fiduciary-like relationship preceded the agreement. The deception that underlies misappropriation-theory liability merely constitutes the undisclosed breach of a duty not to use another's information for personal gain; nothing in *O'Hagan* precludes the establishment of duty by agreement, the *Cuban* court concluded.[18] The *Cuban* court held that a confidentiality agreement, coupled with a duty to refrain from trading on the confidential information, could give rise to the requisite fiduciary duty. The court ultimately dismissed the SEC's complaint, finding that the SEC had failed to adequately plead that Cuban entered into the type of agreement necessary to establish a duty.[19]

While many commentators viewed the *Cuban* decision as a significant setback for the SEC, the court's acceptance of the SEC's view that a preexisting fiduciary-like relationship is not necessary to establish misappropriation liability may in the long term presage a significant opportunity for the commission. *Cuban* permits parties operating outside the confines of the traditional fiduciary relationship to be deemed to have assumed the functional equivalent if they enter a contract imposing duties of confidentiality and non-use of information.[20]

> The court's acceptance of the SEC's view may in the long term presage a significant opportunity for the commission.

In its opening brief to the Fifth Circuit, the SEC argued that a confidentiality agreement need not contain a non-use component because inherent in a promise to maintain confidentiality is a promise to abstain from trading on the information.[21] The commission urges that the promise of confidentiality preserves the value of the information for its rightful owner, and the improper use of that information destroys its value. Accordingly, the SEC argues, such use constitutes misappropriation.[22]

The SEC overreaches in its *Cuban* briefs. The commission first argues that fiduciary duties can be created by agreement. Then the commission argues that the relationship created by the agreement need not even be fiduciary per se, because parties can contract to the "functional equivalent" of such a relationship. Both of these arguments are a stretch on the facts pled in *Cuban*. By agreeing to keep confidential the information he was about to hear, the SEC argues, Cuban entered into a special relationship with the Mamma.com CEO. Yet all the pled facts suggest the two were in an arms-length business relationship lacking any of the traditional indicia of a fiduciary relationship, such as dominance or control. At a minimum, the relationship Cuban entered into with the Mamma.com CEO is not the type of relationship Congress, regulators, and courts have traditionally considered within the reach of section 10(b).[23]

The SEC's expansionist views are not limited to its duty-by-agreement argument, however. In a footnote at the very end of its opening brief, the commission attempted to persuade the court that Cuban violated section 10(b) by communicating material nonpublic information about Mamma.com merely by selling a large block of shares.[24] While practitioners before the SEC know well that its staff frequently view large-block stock purchases, coupled with other factors, as circumstantial evidence of illicit trading based on inside information, the SEC contends here that a trade's large size alone can support a "reasonable inference" that Cuban breached the alleged confidentiality agreement that would be sufficient to defeat a motion to dismiss. This argument—construing the act of trading as communication—should serve as a warning to the marketplace and practitioners that the SEC will continue to push the bounds of insider-trading liability as far as possible.

In his opposition brief, Cuban concedes that a confidentiality agreement may give rise to section 10(b) liability, but maintains that to create the requisite duty, it must impose a duty of disclosure to the source of the information.[25] Absent an affirmative obligation to inform the information source of plans to breach the agreement, the recipient of the information is free to trade on it, Cuban argues. He further maintains that even breach of such an agreement does not automatically give rise to a federal securities-fraud charge; under section 10(b), the SEC must still prove deception in connection with the sale of a security, and mere "failure to perform a contractual promise, even without excuse, is not evidence of fraud." Finally, he argues that parties should be able to engage in efficient breaches of contracts without risking violations of the securities laws, and that the SEC is exceeding its regulatory authority by treating breach of a bare confidentiality agreement as insider trading and by seeking to use the federal securities laws to punish those with an unfair advantage in the marketplace regardless of how they acquired it.[26]

The *Dorozhko* action, perhaps even more than *Cuban*, reflects the SEC's efforts to weaken or even eliminate the fiduciary-duty requirement from insider-trading law.

Four prominent law professors submitted a brief as amici curiae in *Cuban*, expressing their concern that the district court's decision "could result in precedent with detrimental effects on corporate law and the national securities markets."[27] The amici argue that the Supreme Court has consistently required a breach of a fiduciary duty or similar duty of trust or confidence for insider-trading liability to arise, and that the SEC's attempt to impose liability in the absence of such a breach is an impermissible expansion of section 10(b)'s prohibition on insider trading. Stripped of its fiduciary duty element, the amici argue, a section 10(b) charge no longer properly alleges securities fraud: "The SEC's position in this case . . . essentially converts each breach of a confidentiality agreement into a fraudulent act, something that is beyond the SEC's power under the Exchange Act." They caution that allowing insider-trading liability to be predicated on a confidentiality agreement would lead to the potential that anyone who receives confidential information could be investigated or charged by the SEC. "One can anticipate that market participants will become more reluctant to receive confidential information if it brings an increased risk of liability or parties will attempt to address the regulatory uncertainty in their contractual terms."

Dorozhko

The *Dorozhko* action, perhaps even more than *Cuban*, reflects the SEC's efforts to weaken or even eliminate the fiduciary-duty requirement from insider-trading law. On October 17, 2007, Oleksandr Dorozhko, a Ukrainian national and resident, hacked into Thomson Financial's servers and accessed confidential quarterly earnings reports on a company called IMS Health. He gained access to the data while the markets were still open and purchased about $42,000 worth of IMS "put" options.[28] Shortly after the market closed that day, IMS announced that its earnings were 28 percent below the expectations of Wall Street analysts. The next morning, the price of IMS stock sank 28 percent almost immediately, and within minutes after the market opened, Dorozhko sold all his IMS options. Dorozhko's trades—he realized a profit of nearly $287,000 overnight—caught the attention of his brokerage house, which reported his activity to the SEC. After securing a temporary restraining order freezing the proceeds of Dorozhko's sales of IMS options, the SEC moved for a preliminary injunction against Dorozhko. The district court denied the SEC's motion, holding that "Dorozhko's alleged 'stealing and trading' or 'hacking and trading' does not amount to a violation of Section 10(b) because Dorozhko did not breach any fiduciary or similar duty 'in connection with' the purchase or sale of a security."[29] Without a breach of a fiduciary duty, the district court concluded, there was no deception under section 10(b).

In a decision that has attracted wide criticism from the securities bar, the Second Circuit reversed, holding that where insider-trading liability is predicated on an "affirmative misrepresentation," there is no fiduciary-duty requirement. The court acknowledged that the SEC's claim against Dorozhko, an outsider of IMS, was "not based on either of the two generally accepted theories of insider trading"[30]—the classical and misappropriation theories, both of which require a fiduciary or similar duty. However, the court concluded that Supreme Court precedent did not "establish[] a fiduciary-duty requirement as an element of *every* violation of Section 10(b),"[31] and held that the SEC's claim could be proper if the fraud alleged was "deceptive" within the meaning of section 10(b).[32] Thus, it blessed a new, third theory of section 10(b) liability: acquiring material, nonpublic information via an "affirmative misrepresentation" (here, by hacking into a computer's security system) and then trading on it, with or without a duty exceeding the ordinary obligation in commercial dealings not to mislead.[33]

By dispensing with the fiduciary-duty requirement of existing section 10(b) jurisprudence, the *Dorozhko* court's "affirmative misrepresentation" theory removes the duty limitation from both currently accepted theories. A virtue of the classical theory is that it "center[s] on the fiduciary relationship between insiders and shareholders," and in so doing, "it narrow[s] substantially the categories of persons covered by Rule 10b-5's prohibition."[34] Similarly, liability under the complementary misappropriation theory, the Court emphasized in *O'Hagan*, is "limited to those who breach a recognized duty."[35] The *Dorozhko* court held that those Supreme Court precedents merely establish that nondisclosure in breach of a fiduciary duty is *sufficient* to satisfy section 10(b)'s "deception" element, not *necessary*, and found "no precedent of the Supreme Court or of our Court that forecloses or prohibits" what it termed "the SEC's straightforward theory of fraud."[36] It noted the general "obligation in commercial dealings not to mislead," whether or not in the face of a duty, and approved "affirmative misrepresentation [a]s a distinct species of fraud" actionable under section 10(b).

The *Dorozhko* decision, which has attracted fierce criticism and was labeled "egregious" by a well-known securities-law professor,[37] is a major win for the SEC because it eliminates the fiduciary-duty requirement where the theory of insider trading is based on a misrepresentation. Furthermore, although the computer hacking involved in *Dorozhko* constituted an obvious affirmative misrepresentation in the ordinary sense of those words, the Second Circuit did not give much guidance on what types of conduct might fall into that category. The decision thus helps push section 10(b) jurisprudence down the slippery slope: It permits the SEC to simply characterize alleged illegal trading as an "affirmative misrepresentation" whenever it cannot adequately establish the existence of a fiduciary relationship. Historically, the fiduciary-relationship element has required the SEC to meet exacting pleading standards; now, regulators have license to charge many acts of garden-variety fraud or financial unfairness under the nebulous rubric of "affirmative misrepresentation." Conceivably, that could embrace any fraud involving the purchase or sale of securities, not merely the prototypical Section 10(b) charge where insiders exploit "inside information for personal advantage []as a normal emolument of corporate office."[38]

Moreover, the elimination of the fiduciary-duty requirement in cases where liability can be premised on misrepresentation has the potential to strain the scarce resources of regulators and the courts. Although there is no fiduciary duty element expressed in the text of section 10(b), insider-trading liability historically has required the existence of such a duty in part to reflect the judgment of regulators, the public, and the courts that it is the inappropriate and deceptive use of *special* relationships that the federal securities laws target. Many state and federal statutes prohibit theft, computer tampering, and other kinds of fraud, and could be used to bring cases against individuals like Dorozhko who hack computer systems to gain material nonpublic information on which they trade.

Conclusion

The *Cuban* and *Dorozhko* decisions evidence a shift in insider-trading jurisprudence away from its roots in deterring and punishing those who abuse special relationships at the expense of shareholders and into a murkier area where the SEC is policing general financial unfairness that has traditionally been considered beyond its authority to regulate. The *Cuban* decision allows for complete strangers in arms-length negotiations to be judicially determined to have become fiduciaries by agreement, and the *Dorozhko* decision allows for insider-trading liability to arise even in the complete absence of a fiduciary relationship. *Cuban* and *Dorozhko* have so weakened the fiduciary-duty element of the insider-trading offense that it is now unclear whether such a duty is even required for liability to apply. As it stands, this trend toward "duty-free" pleading requirements augurs greater uncertainty for market participants, and the imprecision makes it more difficult for even sophisticated actors to "order[] their actions in accordance with legal requirements."[39]

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1. *See*, *e.g.,* Robert Khuzami, Director, Division of Enforcement, U.S. SEC, "Remarks at AICPA National Conference on Current SEC and PCAOB Developments (Dec. 8, 2009), *available at* www.sec.gov/news/speech/2009/spch120809rsk.htm (extolling expanded enforcement of insider trading laws).
2. 634 F. Supp. 2d 713 (N.D. Tex. 2009).
3. 574 F.3d 42 (2d Cir. 2009).
4. *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 180 (1994) (quotation marks omitted).
5. 634 F. Supp. 2d at 725.
6. 574 F.3d at 51.
7. The Second Circuit remanded the case to the Southern District of New York; Dorozhko failed to reply to the SEC's motion for summary judgment, and the district court granted the SEC's motion on March 24, 2010.
8. *See* Chiarella v. United States, 445 U.S. 222, 233 (1980) (rejecting parity-of-information argument as "depart[ing] radically from the established doctrine" without support in requisite "explicit congressional intent"); Dirks v. SEC, 463 U.S. 646, 656–57 (1983) ("reaffirm[ing]" validity of this principle); *see also* Brief of Allen Ferrell et al. as Amici Curiae at 10–12, SEC v. Cuban, No. 09-10996 (5th Cir. filed Apr. 2, 2010) (discussing the Court's consistency on this issue) ("*Cuban* Amicus Appellate Brief").
9. Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (Section 10(b)).
10. SEC Employment of Manipulative and Deceptive Devices Rule, 17 C.F.R. § 240.10b-5 (Rule 10b-5).
11. 445 U.S. 222 (1980).
12. *Chiarella*, 445 U.S. at 231–32; *see id.* at 231 n.14 ("A duty arises from the relationship between parties, . . . and not merely from one's ability to acquire information because of his position in the market.").
13. 463 U.S. 646, 653 (1983) (internal quotation marks omitted). This decision also extended the classical theory of liability to tippees of insiders.
14. 521 U.S. 642 (1997).
15. *Id.*; see Tyler J. Bexley, *Reining in Maverick Traders: Rule 10B5-2 and Confidentiality Agreements*, 88 Texas L. Rev. 195, 195 (2009). Rule 10b5-2 supplies a non-exhaustive definition of circumstances in which a person has a such a duty. SEC Selective Disclosure and Insider Trading Rule, 17 C.F.R. § 240.10b5-2 (10b5-2).
16. *See O'Hagan*, 521 U.S. at 648–49.
17. 634 F. Supp. 2d at 722.
18. *Id.* at 725 (*O'Hagan* does not prevent a misappropriator from being "held to [confidentiality] terms created by his own agreement rather than to a duty triggered merely by operation of law due to his relationship with the information source").
19. The SEC alleged only that Cuban had agreed to keep the PIPE information confidential, not that he had agreed to abstain from trading on it. *Id.* at 730–31.
20. The result is troubling because it allows the establishment of duty by contract under the misappropriation theory in that breach of that contract is no ordinary breach, (i.e., one capable of triggering ordinary contract liability). Instead, under *Cuban*, such a breach now constitutes a violation of the federal securities laws, which may even include criminal penalties.
21. Brief of Securities and Exchange Commission at 23, *SEC v. Cuban*, No. 09-10996 (5th Cir. filed Jan. 25, 2010) (SEC opening brief).
22. *See* SEC opening brief at 23. The SEC argues that a confidentiality agreement induces another party to provide property (i.e., confidential business information), which the provider has the exclusive right to use and therefore comprehends an expectation that the recipient of the information will not exploit the information for his or her own benefit. Brief of Securities and Exchange Commission at 2, *SEC v. Cuban*, No. 09-10996 (5th Cir. filed Apr. 12, 2010) (SEC reply brief). "All that is needed for potential liability under the misappropriation theory is a duty to the provider not to use the information for personal benefit, such that a duty of disclosure arises and makes the undisclosed trading deceptive." *Id.* at 4.
23. *See, e.g., Dirks*, 463 U.S. at 655 n.14 ("The basis for recognizing [a] fiduciary duty [of outsiders] is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.").
24. SEC opening brief at 40 n.10.
25. Brief of Mark Cuban at 8, *SEC v. Cuban*, No. 09-10996 (5th Cir. filed Mar. 26, 2010).
26. *Id.* at 20–23. *See also Chiarella*, 445 U.S. at 232 ("[N]ot every instance of financial unfairness constitutes fraudulent activity under § 10(b).").
27. *Cuban* Amicus Appellate Brief at 1. These amici were part of the group of five law professors who filed an amicus curiae brief in the district court.
28. *Dorozhko*, 574 F.3d at 44. "Put" options convey the right, but not the obligation, to sell a particular asset at a predetermined price by a certain date. *Id.* at 44 n.1.
29. SEC v. Dorozhko, 606 F. Supp. 2d 321, 324 (S.D.N.Y. 2008).
30. *Dorozhko*, 574 F.3d at 45.
31. *Id.* at 48 (emphasis added).
32. *Id.* at 45. The court remanded the case for consideration of whether the defendant's conduct "dece[ived]" Thomson Finan-

cial's computers or merely exploited a weakness in their security.

33. *See id.* at 49–50.

34. Nagy, *Insider Trading* article, at 1326; see also *Cuban* Amicus Appellate Brief at 11.

35. *O'Hagan*, 521 U.S. at 666.

36. *Dorozhko*, 574 F.3d at 49.

37. *See* Stephen M. Bainbridge, *The Second Circuit's Egregious Decision in SEC v. Dorozhko*, July 29, 2009, ProfessorBainbridge.com, *available at* www.professorbainbridge.com/professorbainbridgecom/2009/07/the-second-circuits-recent-decision-in-sec-v-dorozhko-available-here-dealt-with-one-of-the-questions-left-open-by-the.html. Professor Bainbridge is one of the amici who filed briefs in support of Cuban in the district court and Fifth Circuit.

38. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961).

39. *Dirks*, 463 U.S. at 658 n.17.

Failures to Make Timely Filings
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this loophole is only available to small issuers that bear a disproportionate impact of the public filing requirements when compared with larger companies. ✺

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1. 15 U.S.C. § 78m.
2. *Id.* at § 78u(d).
3. *Id.* at § 78u-3(a).
4. *Id.* at §§ 78u(d)(3), 78u-2(a); Note that it is a violation of the Securities Exchange Act for any officer, director, or holder of a security of an issuer to hinder, delay, or obstruct the making or filing of any document, report, or information an issuer is required to file. *Id.* at § 78t(c). In addition, any person who willfully violates any provision of the Securities Exchange Act may be subject to fines or imprisonment. *Id.* at § 78ff(a).
5. SEC v. Ormont Drug & Chem. Co., Inc., 739 F.2d 654, 655 (D.C. Cir. 1984) (finding that impossibility of performance is a defense to contempt).
6. 15 U.S.C. § 78u-2(d).
7. *Id.* at § 78l(j).
8. *Id.*
9. *Id.* at § 78l(k).
10. *Id.* at § 78l(b).
11. *Id.* at § 78l(a).
12. A.A. Sommer, Jr., Federal Securities Exchange Act of 1934 § 4.01[2] n.23 (Matthew Bender, Rev. ed. 2009).
13. *Id.*
14. The section also exempts certain types of securities from registration.
15. 17 C.F.R. § 240.12g-1; *see also* 17 C.F.R. § 240.12h-1 for other exemptions.
16. 15 U.S.C. § 78m(a).
17. S. 249, 94th Cong. (1975).
18. *Id.*
19. 15 U.S.C. § 78l(j).
20. *In the Matter of Amitelo Communications, Inc., et al.*, Admin. Proc. File No. 3-11831, at 2 (Mar. 10, 2005).
21. Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 4, 1891–92 (3d ed. rev. vol. 2000).
22. *See, e.g., In the matter of Gateway Int'l Holdings, Inc.*, Admin. Proc. File No. 3-11894, at 7 (May 31, 2006).
23. For a description of the different OTC tiers, *see generally*, www.otcmarkets.com/pink/otcguide/investors_market_tiers.jsp.
24. *In the Matter of Consumers Financial Corp.*, Admin Proc. No. 3-13628 (Feb. 22, 2010).
25. *Id.* at 1–2.
26. *Id.*
27. *Id.* at 2.
28. There are other provisions in the Securities Exchange Act that require section 13 filings by issuers even if those issuers no longer have registered securities under Rule 12. For example, section 15(d) of the Securities Exchange Act requires any issuer that has filed a registration statement to make section 13 filings. 15 U.S.C. § 78o(d). Although, section 15(d) exempts issuers with fewer than 300 record holders. *Id.*
29. Compliance & Disclosure Interpretations, Securities Exchange Act, § 116 at Question 116.03.
30. Steadman v. SEC, 603 F.2d 1126, 1139–40 (5th Cir, 1979).
31. *In the Matter of America's Sports Voice, Inc.* Admin. Proc. File No. 3-12329, at 3 (Mar. 22, 2007) (applying factors set forth in *Gateway*); *Gateway*, Admin. Proc. File No. 3-11894, at 4; *In the matter of* E-Smart Techs. f/k/a Plainview Labs. Inc., Admin. Proc. File No. 3-10977, at 7 (Feb. 3. 2005) (applying factors).
32. E-Smart Techs., Admin. Proc. File No. 3-10977, at 7.
33. Berko v. SEC, 316 F.2d 137, 141–42 (2d Cir. 1963).
34. *See, e.g., Gateway*, Admin. Proc. File No. 3-11894, at 4; *see also America's Sports Voice, Inc.* Admin. Proc. File No. 3-12329, at 3; E-Smart Techs., Admin. Proc. File No. 3-10977, at 7.
35. *In the Matter of PCC Group, Inc. et al.*, Admin. Proc. File. No. 3-13762 (February 23, 2010); *see also In the Matter of Platinum and Gold Inc.*, Admin Proc. File No. 3-13783 (February 18, 2010) (listing delinquent reports, with some periodic reports delinquent more than 100 months).
36. In the Matter of Alcohol Sensors Int'l, Ltd. et al., Admin Proc. File No. 3-11513, at 2–6 (June 8, 2004).
37. *America's Sports Voice, Inc.,* Admin. Proc. File No. 3-12329, at 3. (Mar. 22, 2007).
38. *Id.*
39. *See, e.g., America's Sports Voice, Inc.* Admin. Proc. File No. 3-12329, at 3; *Gateway*, Admin. Proc. File No. 3-11894, at 4; E-Smart Techs., Admin. Proc. File No. 3-10977, at 7.
40. *America's Sports Voice, Inc.* Admin. Proc. File No. 3-12329, at 3.
41. E-Smart Techs., Admin. Proc. File No. 3-10977, at 8. In that case, after the revocation of the registration of the company's common stock, the company caught up on its filings. *Id.* The case was remanded for reconsideration to determine whether revocation remained appropriate in light of the company's filings of all its late reports. *Id*. On remand, the judge denied the staff's renewed request for revocation of the registration of the common stock of the company and imposed no sanction for the company's violations of the periodic reporting requirements of the Exchange Act. *Id*.
42. *Gateway,* Admin. Proc. File No. 3-11894, at 7.
43. *America's Sports Voice, Inc.* Admin. Proc. File No. 3-12329, at 3–4.

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