



# Whistleblowing in the Corporate World Series: Part II

## *Securities Law Primer*

# Presenter

[www.SECwhistlebloweradvocate.com](http://www.SECwhistlebloweradvocate.com)



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# Ten Common Questions About the Federal Securities Laws

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- What constitutes a security?
- What laws govern the securities industry?
- What is the international reach of the U.S. securities laws?
- What are the most common types of securities law violations?
- What is the statute of limitations for bringing an SEC enforcement action?
- Is the possible securities violation legally material?
- Is there evidence of intentional misconduct?
- What types of actions can be brought to enforce the securities laws?
- If an SEC enforcement action is successful, what remedies are available?
- Where can potential whistleblowers and other interested parties learn more about the securities laws and the SEC enforcement process?

# What constitutes a security?

- **Section 2(a)(1) of the Securities Act of 1933:**

“any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security’”
- **Similar definitions can be found in other federal securities statutes, including Section 3(a)(10) of the Securities and Exchange Act of 1934**

- *SEC v. W. J. Howey Co.* test:
  - An investment contract is a “security” if “the person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.” *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946)
- Elements of the test:
  - An investment in money
  - A common enterprise
  - Expectation of a profit
  - Solely from the effort of others

# What laws govern the securities industry?

# Securities Law Sources

[www.SECwhistlebloweradvocate.com](http://www.SECwhistlebloweradvocate.com)

- Federal Statutes
- Federal Case Law
- SEC Rulemaking
- Self-Regulatory Organizations
- State “Blue Sky” Laws



# Key Federal Securities Statutes

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- Securities Act of 1933 (“Securities Act”)
- Securities and Exchange Act of 1934 (“Exchange Act”)
- Trust Indenture Act of 1939
- Investment Company Act of 1940
- Investment Advisors Act of 1940
- Sarbanes-Oxley Act of 2002
- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”)

- Regulates the public issuance of securities
- Two main objectives:
  - Ensure that investors received adequate financial and other important information about securities being offered to the public
  - Ensure that the information is accurate and reliable
- Key provisions:
  - Requires the Registration of Securities to Issued
  - Securities Must be Sold Pursuant to a Prospectus
  - Creates Liability for False and Misleading Statements in a Registration Statement or Prospectus

- Established the Securities and Exchange Commission
- Regulates the activities of public companies
  - Imposes requirement of periodic corporate reporting
  - Regulates proxy solicitation and tender offers
- Mandates registration of broker dealers
- Regulates the purchase and sale of securities in the secondary markets
- Prohibits false and deceptive conduct in connection with securities transactions

# Trust Indenture Act

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- Requires a trust indenture for the sale of bonds and other debt securities worth over \$5 million
- Requires the appointment of a trustee to all bond issuers

- Regulates investment companies
  - Entities that are engaged primarily in the business of investing, reinvesting or trading in securities, or are engaged in that business and more than 40% of their assets consist of investment securities
  - Example: Mutual Funds
- Requires every investment company to register with the SEC
- Registered investment companies must file annual reports with the Commission disclosing information about their financial condition and investment policies to investors
- Imposes certain restrictions on the trading activities of investment companies

# Investment Advisors Act

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- Requires firms or individuals who advise others about securities investments to register with the SEC
- Applies only to advisors that manage at least \$25 million in assets, or that advise a registered investment company
- Prohibits fraudulent or deceptive conduct by investment advisors in connection with their services

# Sarbanes-Oxley Act

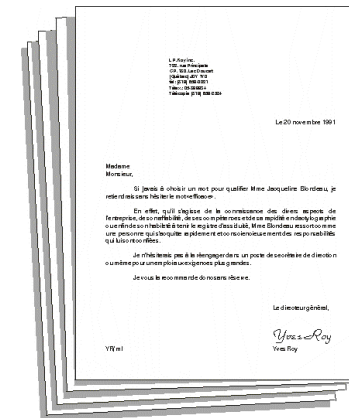
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- Created the Public Company Accounting Oversight Board
- Requires that all audited financial statements be certified as accurate by a corporation's senior management
- Requires companies to establish internal control and reporting systems to uncover fraud in financial reporting

# Dodd-Frank Act

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- Created the Financial Stability Oversight Council
- Requires hedge funds managing over \$100 million in assets as investment advisers to register with the SEC
- Required the SEC to establish a whistleblower program for individuals who provide information about possible securities violations, which offers:
  - Anonymous reporting
  - Robust employment protections
  - Significant monetary rewards





# What is the international reach of the U.S. securities laws?

# Reach of the SEC Whistleblower Program

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- With few exclusions or qualifications, a whistleblower can be any individual or group of individuals – regardless of citizenship.
- Eligible securities violations may occur anywhere in the world
- Potential international violators can be individuals or organizations (public or private)
- Jurisdictional Nexus: investors, investments, operations, employees or clients in the United States
- International Information Sharing

# Registration of Securities Offerings

- Public offerings to U.S. investors by foreign issuers are subject to the registration requirements of the Securities Act.
- Foreign purchasers of securities issued in the U.S. have the same rights as U.S. purchasers.
- U.S. issuers may issue classes of securities to foreign investors that are restricted from U.S. investors without registering under the Securities Act.

# Application of Section 10(b) and Rule 10b-5 thereunder

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- *Morrison v. National Australia Bank*
  - Holding: As a general rule, the anti-fraud provisions of the Exchange Act apply only to transactions in securities listed on domestic exchanges and domestic transactions in other securities.

What are the most common  
types of securities law violations?

- Primary Liability-occurs when all the requirements of a federal securities law violation have been met by the defendant.
  - Section 10(b) and Rule 10b-5 of the Exchange Act
  - Section 17(a) of the Securities Act
- Secondary Liability-occurs when all the requirements of a federal securities law violation have not been met by the defendant but a theory of secondary liability applies.
  - Section 20(a) of the Exchange Act (control person liability)
  - Section 20(e) of the Exchange Act (aiding and abetting liability)

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

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In connection with the purchase or sale of any security, 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.

# Section 17(a) of the Securities Act

In connection with the offer or sale of any security, 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 obtain money or property by means of any untrue statement of a material fact or any omission 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 transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.



# Section 20(a) of the Exchange Act (Control Person Liability)

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- To establish a control person violation, the SEC must establish:
  - A primary violation of the Exchange Act;
  - Defendant had direct or indirect control over the person engaged in the primary violation;
- Affirmative Defense: A defendant will not be found liable if a court determines that he/she “acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.”

# Section 20(e) of the Exchange Act (Aiding and Abetting)

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- To establish an aiding and abetting violation, the SEC must establish:
  - A primary violation of the Exchange Act;
  - Defendant was knowing or reckless; and
  - Substantial assistance was provided by the defendant to the person engaged in the primary violation.
    - Nature of act
    - Amount of assistance
    - Presence or absence of the defendant at the time of misconduct
    - Relation to the primary violator
    - Duration of the assistance provided

# Common Securities Violations

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- Market Manipulation
- Offering Fraud
- Financial Fraud
- Insider Trading
- Trading and Pricing
- Foreign Corrupt Practices Act
- Municipal Securities Fraud

Market manipulation is the interference with the free and fair operation of the market by engaging in transactions and other practices that create or maintain an artificial price for a security. Examples include:

- **Churning**
  - Placing of both buy and sell orders for the same security at about the same price in order to create the appearance of increased trading activity, thereby increasing its 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
- **Pump and Dump**
  - Spreading false information to increase the price of a security, then selling shares at the increased price

Offering fraud involves making material misrepresentations and/or omissions to potential investors in connection with an offering of securities. Examples include:

- **Unregistered Offering**
  - The securities being sold are not registered with the SEC as required under the Securities Act
- **Ponzi Scheme**
  - Investors are paid returns from their own money or from the money invested by subsequent investors, rather than from any actual profit earned
- **Affinity Fraud**
  - Targets members of an identifiable group, such as religious or ethnic communities, in order to induce those members to invest in a fraudulent investment opportunity

- Financial fraud occurs when a public company files materially false or misleading financial statements with the SEC. Examples include:
  - Misleading disclosures
  - Misclassifications
  - Improper recording of transactions
  - Overstatements
  - Understatements

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

Two theories of insider trading:

- **Classical Theory**
  - Involves corporate insiders who have access to material, nonpublic information based on their positions inside a corporation
- **Misappropriation Theory**
  - Involves third parties who acquire material, nonpublic information about a corporation based on some relationship of trust with the source of the information

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

- **Market Timing/Late Trading**
  - When a mutual fund permits select customers to purchase shares in the fund after trading has closed for the day
- **Wash Trades**
  - Involve the buying and selling the same security for the purpose of generating activity and increasing the price
- **Marking the Close**
  - Buying or selling a security near the close of the day's trading in order to affect the closing price
- **Front Running**
  - Buying or selling a security while knowing that another investor is about trade, or an analyst will make a recommendation, that will influence the price of the security



# Foreign Corrupt Practices Act (FCPA)

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- 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.
- Affirmative Defenses:
  - The payments are legal under the written laws of the country in which the payments are made; or
  - The payment is a reasonable expenditure directly related to the conducting of business with a foreign government.

- Municipal securities fraud occurs when materially false or misleading statements are made to investors in connection with the purchase or sale of debt securities issued by state and local governments in the United States.

What is the statute of limitations for bringing an SEC enforcement action?

- 28 U.S.C. § 2462:
  - A “catch all” statute of limitations for actions brought by federal agencies in federal court
  - SEC has five years to bring an enforcement action seeking civil penalties from the date that the claim first accrued

- **Discovery Rule**
  - Common law rule that applies only to fraud claims
  - Holds that the statute of limitations for a fraud claim does not accrue until the fraud is discovered, or could have been discovered with reasonable diligence
- **Fraudulent Concealment/Equitable Tolling**
  - Temporarily suspends the statute of limitations clock, even though a claim has already accrued, if the defendant took affirmative steps to conceal the wrongful conduct
  - Applies to non-fraud claims also
  - SEC or private plaintiff must plead facts establishing that the defendant took affirmative steps to conceal the wrongful conduct

Is the possible securities violation legally material?

# Materiality Requirement

- Securities laws only prohibit misstatements and omissions that are “material”
- When is a misstatement or omission “material”?
  - *TSC Industries, Inc. v. Northway, Inc.*: Information is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to invest.
  - *Basic v. Levinson*: There must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.

- Quantitative
  - Quantifies the amount misstated or omitted as a percentage of the reported earnings or losses
  - “Rule of Thumb”: More than 5% deviation from actual reported financial measure is material
  - Generally, not appropriate to rely on quantitative measure alone
- Qualitative
  - All the relevant circumstances surrounding besides the quantitative measure of the misstatement or omission
  - SEC Staff Accounting Bulletin No. 99: non-exhaustive list of qualitative factors that could affect the materiality of information
  - Factors could turn a quantitatively small misstatement or omission into a material misstatement or omission



# Is there evidence of intentional misconduct?

“[A] mental state embracing intent to deceive, manipulate, or defraud.”

*Ernst and Ernst v. Hochfelder*

# Types of Intentional Misconduct

- A showing of intentional or reckless conduct is required to establish fraud in connection with violations of Sections 17(a)(1) of the Securities Act and 10(b) of the Exchange Act. Scierter can be established with evidence of:
  - Intentional or knowing conduct—e.g., knowingly making a false statement
  - Recklessness—conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care
- A showing of negligence is sufficient to establish fraud in connection with violations of Sections 17(a)(2)-(3) of the Securities Act
  - Negligence—failure to use such care as a reasonably prudent and careful person would use under similar circumstances

- A plaintiff bringing a securities fraud case must plead facts establishing a “strong inference” that the defendant acted with scier. This can be accomplished by alleging:
  - facts that show the defendants had both a motive and opportunity to commit fraud; or
    - Motive involves concrete benefits that could be realized by the misconduct
    - Opportunity is the means and likely prospect of achieving concrete benefits
  - facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness

What types of actions can be brought to enforce the securities laws?

- Criminal enforcement actions by federal and state law enforcement authorities
- Civil enforcement actions by the SEC
- SEC administrative proceedings
- Civil actions by private investors

If an SEC enforcement action is successful,  
what remedies are available?

- Prohibits the continuing and future violation of the federal securities laws
- The SEC must show a past, current, or imminent violation of the securities laws, and a reasonable likelihood of future violations
- No requirement of irreparable injury or inadequate remedies at law
- Court considers several factors when considering whether to issue an injunction



- The repayment of money obtained as a result of the wrongful conduct
- May also include losses avoided as a result of the unlawful conduct
- Examples of disgorged funds:
  - Profits or losses avoided from insider trading
  - Proceeds from illegal securities distributions
  - Bonuses paid based upon improperly recognized revenues
  - Assets that were obtained through misappropriation
- Includes prejudgment interest on disgorged sums

- Monetary penalties above and beyond any disgorgement ordered
- Amount depends on the nature of the violation and whether defendant is an individual or organization

- **Officer and Director Bar**
  - An individual prohibition from serving as an officer or director of a public company.
- **Penny Stock Bar**
  - An individual prohibition from being involved in enumerated ways with low-priced speculative securities.

Where can potential whistleblowers and other interested parties learn more about the securities laws and the SEC enforcement process?

# Additional Resources

www.SECwhistlebloweradvocate.com

## SECWhistleblowerAdvocate

WHISTLEBLOWER PROGRAM | CORPORATE ETHICS | RESOURCES | ABOUT US

 REQUEST CASE EVALUATION



In this era of corporate scandal, the world needs more truth tellers. History has consistently shown that law enforcement authorities cannot effectively and efficiently police the marketplace without the assistance of private individuals and entities. Labaton Sucharow is dedicated to helping responsible organizations establish a culture of integrity and courageous whistleblowers to report possible securities violations—without regrets.

 SEC Insider's Guide

 SEC Whistleblower Program Handbook

 Securities Law Primer

 SEC Whistleblower Eligibility Calculator

 SEC Whistleblower Sanctions Database

### Recent Op-Ed in USA Today Examines Ethical Breakdown in Financial Services Industry

Jordan Thomas - Monday, September 10, 2012

On September 5th, nestled between columns dissecting the presidential political drama as it unfolds, *USA Today* made space for another critical topic: *How Wall Street Creates Criminals*. In this column, Cornell Law professor Lynn Stout and I address how and why the financial services industry has lost its moral compass, and the necessary first step for recovery: accountability. Building on data gathered in Labaton Sucharow's recent survey of the US & UK Financial Services industry, *Wall Street, Fleet Street, Main Street: Corporate Integrity at a Crossroads*, we argue that Wall Street has to admit that it has a corporate ethics problem and then take bold measures to change it.

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### A Powerful Partnership in Full Swing: SEC Issues First Award to Whistleblower

Jordan Thomas - Thursday, August 23, 2012

#### In the News

-  Bloomberg Law—The SEC Whistleblower Program's Annual Report
-  Fox Business—Will Whistleblower Rules Help SEC Investigations?
-  Labaton Roundtable—Global Impact of U.S. Financial Reforms

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**For the People,  
By the People:**  
The SEC Whistleblower Program & Establishing a Culture of Integrity

# 5 Insider Tips For Potential SEC Whistleblowers

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1. Know the odds
2. Attempt to identify violations
3. Legally collect evidence
4. Be prepared
5. Timing matters



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