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Deterring SEC 'Shoot From The Hip' Enforcement

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Law360, New York (March 11, 2013, 12:20 PM ET) -- The U.S. Securities and Exchange Commission's recent action against "Certain Unknown Traders in the Securities of H.J. Heinz Company" has garnered significant press attention, in no small part because of the sheer size of the alleged unrealized profit ($1.8 million), and the name-recognition of the parties involved (Warren Buffet, Berkshire Hathaway and America's favorite ketchup company, H.J. Heinz).

The SEC's action in Heinz is no anomaly, as the commission has aggressively and arguably recklessly adopted a shoot-from-the-hip strategy in filing enforcement actions against purported foreign traders before conducting any substantive investigation — beyond the allegation of "highly suspicious trading" — to determine whether it can ultimately prove the elements for insider trading.

Indeed, our research indicates that the SEC has filed 13 such cases since 2008, against 35 different defendants. A review of a number of these cases reveals that while the SEC has been successful in trumpeting its initial application for emergency relief through a press release and perhaps a quote from a high-ranking official, in a number of these cases the SEC is ultimately unable to support its allegations at the close of discovery, and seeks to have the case dismissed without prejudice.

On Feb. 15, 2013, the SEC filed a complaint and application for emergency relief seeking to freeze the assets of certain unknown traders who purchased call option contracts of H.J. Heinz Company the day prior to a Feb. 14 announcement that Heinz would be acquired by an investment consortium of Berkshire Hathaway and 3G Capital Partners for $72.50 per share, a nearly 20 percent increase from Heinz's closing price on Feb. 13.

According to the SEC's allegations, the unknown traders purchased 2,533 out-of-the-money June $65 call options (for a total investment of $90,000) through an omnibus account located in Zurich, Switzerland, on Feb. 13. Because Heinz's stock had consistently traded around $60 per share, the call options represented a bet that, over the next four months, Heinz's stock would increase $5, or 7.5 percent. The bet, of course, paid off: The day the acquisition was announced, the June $65 calls shot up from $0.40 to $7.33, an increase of over 1,700 percent, translating to a monetary gain from $90,000 to over $1.8 million.

While any rational observer would concede that this trading is "highly suspicious" (as the SEC's complaint takes pains to constantly point out), suspicious trading, standing alone, is insufficient to prove insider trading. Beyond the "suspicious trading," however, the remainder of the SEC's complaint is premised on "information and belief" allegations rather than substantive facts to plead the requisite elements of an insider trading action.

For example, the SEC pleads on "information and belief" that the "unknown traders of Heinz securities were in possession of material, nonpublic information about the proposed acquisition of Heinz." The SEC also pleads on "information and belief" that the material, nonpublic information "was disclosed to them by a person or persons who tipped such information with the expectation of receiving a benefit." Unsurprisingly, the SEC also pleads on "information and belief" that the unknown defendants "knew ... or should have known that their trading was in breach of a fiduciary duty ... owed to the shareholders of Heinz" or "misappropriated in breach of a fiduciary duty."

Whether the SEC will ultimately be able to support its "upon information and belief" allegations in the Heinz matter remains to be seen. But the fact that the SEC filed the action with relatively boilerplate allegations is not surprising in light of the SEC's newfound litigation strategy in such cases: The SEC reaps the benefits of favorable press on the initial filing and, if it is ultimately unable to support its allegations at the close of discovery, it dismisses the action without prejudice.

In at least one instance, the commission issued a press release blaming the slow pace of foreign discovery for its dismissal motion, and promised to continue investigating privately, likely through the issuance of a Formal Order of Investigation. This litigation strategy is a win-win for the SEC. Even if the SEC must seek dismissal of the action without prejudice at the close of discovery, it is left in the exact same position as when it first filed the action — it can continue investigating privately and refile the action if it uncovers new evidence (which conveniently has not happened yet in any of the cases where the SEC secured dismissal without prejudice).

This article argues that the SEC's newfound litigation strategy in such foreign defendant insider trading cases filed on an emergency basis is in need of a significant deterrent. The article advocates a few such deterrents, including encouraging federal district court judges to either deny the initial application for emergency relief on mere boilerplate allegations, or deny the SEC's motion for dismissal without prejudice if it is ultimately unable to support its allegations at the close of discovery.

Analyzing the Initial Application for Emergency Relief

Because the SEC's initial application for emergency relief is brought on an ex parte basis, a federal judge is without the benefit of an adverse party challenging the sufficiency of the SEC's application. Yet the initial application may be quite speculative and/or selective in the evidence it presents, raising concerns as to whether the SEC was entirely forthcoming and, if not, if the requested relief actually would have been denied if the federal judge was presented with all materially relevant facts.

For example, in SEC v. One or More Unknown Purchasers of Securities of Telvent GIT, SA, No. 11-cv-03794 (S.D.N.Y.), the SEC filed an action for emergency relief against certain unknown traders who had purchased shares and options of Telvent GIT SA, on April 29, 2011, and May 27, 2011, prior to an announcement on June 1, 2011, that Telvent would be acquired by Schneider Electric. The initial complaint alleged that on April 29, 2011, an omnibus account purchased 400 call options with various strike prices, and on May 27, 2011, purchased 800 July 2011 call options with a $35 strike price (which apparently represented 52 percent of the volume in that particular options series that day). When the Telvent acquisition was announced on June 1 at a price of $40.00 per share, the options obviously increased in value, netting the unknown traders profits of $475,000.

The SEC had no additional material allegations beyond the trading summarized above to support either its complaint or its application for a temporary restraining order freezing assets. Indeed, in the declaration submitted by an SEC market surveillance specialist in support of the application, the specialist remarked that "the timely purchasing of short to medium term out-of-the-money call options representing a large percentage of daily trading volume and open interest within days of a major corporate announcement followed be [sic] the immediate liquidation of the position upon public release of the announcement, as set forth above, is highly unusual and suspicious behavior."

The market surveillance specialist concluded that "[t]his behavior is typically a strong indication of trading based on knowledge of material non-public information or insider trading." The SEC brought the emergency application on June 3, 2011, a mere two days after the acquisition announcement, and without identifying any of the following information: An alleged tipper, any theory as to how the material, nonpublic information may have been misappropriated, or any reason to believe that the information was passed or misappropriated in breach of a fiduciary duty.

At face value, there are material omissions in the SEC's emergency application which make it suspect that it could show a likelihood of success on the merits, or that an inference could be drawn that the defendant violated the federal securities laws. See Smith v. SEC, 653 F.3d 121, 128 (2d Cir. 2011) (reciting standard for obtaining an asset freeze).

To begin, the trading in Telvent was not that suspicious when compared against Telvent's trading volume and price movement, key details the SEC left out in its emergency application. On April 26, the total volume of Telvent shares traded was merely 18,100; on April 27, still two days before the unknown traders' first purchase, the volume in Telvent increased over 100 percent from 18,100 to 36,500. By April 28, the volume reached 202,900, an increase of 455.89 percent from the April 26 volume.

By April 29, the volume hit 1,250,200, now a 516 percent increase from the volume on April 26, and the stock price increased 4.76 percent. Thus, when these unknown traders initially bought Telvent options on April 29, the volume and stock price on Telvent were appreciating — clearly, the market anticipated some good news about the stock. Against this backdrop, it is hardly "suspicious," let alone "highly suspicious," that a trader purchased 50,000 shares of Telvent common stock and 700 Telvent call options on April 29 at strike prices of $30 and $35 (some of the options were “in-the-money” and others were not too far “out-of-the-money” because the stock was trading around $30).

The unknown traders' additional purchases on May 27, 2011, slightly less than one month later, were also hardly "suspicious." First, the omnibus account sold 300 call options on May 27 for meager gains. Second, it rolled over 300 options to July 17 expiration. Third, the account purchased an additional 500 call options. Had the unknown traders possessed material nonpublic information about the acquisition, they would have presumably held on to the 300 options rather than rolling them over to July because those options did not expire until the third week of June anyhow, meaning they could have been exercised on June 1 (the day of the announcement). Further, the purchase of an additional 500 call options is not suspicious in light of the fact that Telvent's stock price had steadily been increasing and its volume remained robust since April 29.

In addition to leaving out any reference to Telvent's stock price or volume history, the SEC's emergency application also left out any reference to the public representation by Abengoa, Telvent’s parent company, that it was looking to sell Telvent. The original complaint alleged that there "was no public information available concerning the contemplated acquisition before the Unknown Purchasers bought Telvent securities." Yet Abengoa had announced as long back as November 2008 that it was studying the sale of its majority stake in Telvent. Indeed, since that announcement, Abengoa had slowly sold off pieces of its stock in Telvent to the point that in 2011, after multiple sales, it was left with a 40 percent interest in the company. Unsurprisingly, when the sale of the remaining stake in Telvent was finally announced in June, 2011, Abengoa opined on a conference call with investors that the sale was "completely coherent with a strategy that [Abengoa has] shared with [the market] in past calls."

All of the information summarized above was readily available to the SEC at the time it filed its initial emergency application, but the SEC either chose to ignore the information or failed to study it when rushing to file its complaint within two days of the acquisition announcement. Indeed, it does not appear that this information was brought to the attention of the court that granted the SEC's initial emergency application on an ex parte basis, and if it was, the application clearly should have been denied.

Where is the Telvent case now? The owner of the omnibus account and his fund intervened in the SEC action to assert his innocence and seek to lift the freeze order. Nearly a year after the initial complaint was filed, and after (i) the defendants informally produced substantial discovery, (ii) the SEC received discovery from foreign entities and governments, and (iii) the owner appeared for a deposition, the SEC moved to dismiss the action without prejudice. See SEC's May 21, 2012, Letter to Judge Griesa, Dkt. No. 61-17 ("Because the SEC has been unable to discover a source of material nonpublic information in connection with defendants' trading activity in Telvent, the SEC hereby moves the Court for leave to voluntarily dismiss the above-captioned matter without prejudice, pursuant to Fed. R. Civ. P. 41(a)(2).")

Conveniently, the SEC initially filed its motion by letter brief directly with Judge Griesa rather than through the court's ECF system so that it would not appear on the public docket. The letter surfaced when defendants cross-moved for summary judgment, and attached the SEC's letter as an exhibit. Although the motions for dismissal and summary judgment are currently pending, the damage to defendants has already been inflicted. The SEC's allegations were picked up by the New York and Switzerland press, causing serious reputational and professional injury to defendants, including the loss of the company's Lebanese banking license (where it is located), essentially destroying its business.

Analyzing the Motion to Dismiss without Prejudice vs. the Motion for Summary Judgment

One reason the SEC has not hesitated in bringing such actions on an emergency ex parte basis is that it knows it can easily secure dismissal without prejudice down the road if it is ultimately unable to gather evidence through discovery to prove its allegations. Indeed, the SEC did just that in three foreign defendant insider trading cases. See SEC v. Compania Internacional Financiera SA, No. 11-cv-4904 (SDNY 2011)*, Telvent, and SEC v. Yang, No. 12-cv-02473 (N.D. Ill. 2012) (dismissal without prejudice upon consent).

The SEC takes full advantage of the fact that the legal standard for dismissal is arguably unfairly skewed toward the SEC: Courts will grant dismissal absent a showing that defendants will suffer substantial prejudice as a result. A.V. by Versace Inc. v. Gianni Versace SPA, 261 F.R.D. 29, 31 (S.D.N.Y. 2009) (emphasis added). The prospect of a second lawsuit does not qualify as substantial prejudice; rather a defendant must show "legal" prejudice. SEC v. Universal Express Inc., No. 04-cv-2322, 2007 WL 2245509, *1 (S.D.N.Y. Aug. 3, 2007).

Indeed, our research indicates that the SEC has filed contested motions to dismiss actions without prejudice on at least five occasions within the Southern District of New York; in four of those five occasions, the motions were granted. See SEC v. Oakford Corp., et al., 181 F.R.D. 269 (S.D.N.Y. 2008); Universal Express, 2007 WL 2245509; SEC v. Chakrapani (S.D.N.Y. June 29, 2010); Compania, 2012 WL 1856491.

In fact, in the one instance where the SEC's motion was denied, the case had been pending since 1985, the motion was brought in 2000, and even in dismissing the action with prejudice the court offered the commission the opportunity to advise if it intended to proceed with the litigation before the dismissal became effective. SEC v. Monarch Funding Corp. (S.D.N.Y. Nov. 30, 2000).

It is difficult for a defendant to meet the "legal prejudice" standard in an SEC action dismissed at the close of discovery because there is often no legal prejudice that would result from the SEC refiling its action. See Oakford, 181 F.R.D. at 273 (remarking that "it is the SEC that will suffer the greatest prejudice if the Court grants its motion, since the statute of limitations ... will no longer toll.")

Yet there is, of course, substantial reputational and business prejudice which will result but is not required to be considered by the court. See e.g. Compania, Defendants' Br. in Opposition to Motion to Dismiss Without Prejudice, Dkt. No. 110 at *16 (noting that "not only did numerous U.S. press sources cover the SEC's filing of the complaint," but also the principal of hedge fund defendants had "been subject to negative press in his home country of Switzerland") and id. at *17 (citing declaration from hedge fund defendant attesting that "should the SEC's motion for dismissal without prejudice be granted ... current [hedge fund] investors will also likely redeem from the Fund, because the few who remain (if any) could be liable for all potential future liabilities (including legal fees and costs to defend yet another SEC action).")

In addition (or in the alternative) to considering substantial prejudice, the Second Circuit has enunciated five factors a district court must consider when ruling on a motion to dismiss without prejudice: (1) plaintiff's diligence in bringing the motion; (2) any undue vexatiousness on plaintiff's part; (3) the extent to which the suit has progressed, including the defendant's effort and expense in preparation for trial; (4) the duplicative expense of relitigation; and (5) the adequacy of plaintiff's explanation for the need to dismiss. Zagano v. Fordham University, 900 F.2d 12, 14 (2d Cir. 2000).

Surely, some of these factors could favor a defendant challenging the SEC's motion to dismiss without prejudice. See e.g. Oakford, 181 F.R.D. at 271-72 (finding that the SEC was not diligent in bringing motion and acted with undue vexatiousness because it acted as if it was going to participate in full discovery but moved to dismiss when the time came for actually producing reciprocal discovery).

More often, however, a district court will find that (i) a motion to dismiss without prejudice filed at the close of discovery is diligent, (ii) there is no undue vexatiousness on the part of the SEC, (iii) the defendant has not engaged in preparation for trial anyhow, and (iv) there would be limited expense of relitigation because the fees incurred in discovery would be valuable to a future litigation. See e.g. Compania, Memorandum & Opinion, Dkt. No. 131 at * 10 ("Nor is there any evidence that the Commission has maintained these claims for any reason other than to fulfill its mission and protect the investing public"); Chakrapani (S.D.N.Y. June 29, 2010) ("where the 'bulk' of [the defendant's] legal expenses [of $800,000] were incurred through 'document collection, organization, and the review of nearly one million pages of documents obtained from the SEC and from many non-parties ... [s]uch work surely can be re-used in a future criminal or civil action.")

The motion to dismiss without prejudice has become the SEC’s guaranteed escape route to avoid an otherwise inevitable adverse ruling on the merits. Indeed, if the motion to dismiss without prejudice were denied and the matter proceeded to summary judgment with only the "suspicious trading," a federal judge would have no choice but to grant defendant summary judgment. See e.g. SEC v. Horn (N.D. Ill. Dec. 16, 2010) ("it is not enough for the SEC simply to identify suspicious trading and ask a jury to infer that it was the product of insider trading"); see also SEC v. Sanchez, No. 10-cv-05268, Dkt. No. 135 (Memorandum Opinion & Order), *18 (N.D. Ill. Dec. 28, 2011) ("[defendant] convincingly argues that the SEC has not produced enough circumstantial evidence to go to trial. In every tippee insider trading case cited by the SEC, the SEC established facts that showed contact between an identified insider and the alleged tippee."); SEC v. Gonzalez de Castilla, 184 F.Supp.2d 365, 380 (S.D.N.Y. 2002) ("even if the purportedly suspicious timing of [defendant's] trades were sufficient to establish an issue of fact as to whether [defendant] traded on the basis of nonpublic information, the SEC's Rule 10b-5 claim ... must be dismissed because of the failure to establish a duty or breach.")

A dismissal without prejudice strips a defendant who has likely already suffered substantial reputational and business damage from an otherwise inevitable summary judgment ruling implicitly vindicating his innocence in finding that the SEC had insufficient evidence to proceed to trial. The Compania case is illustrative.

On July 15, 2011, the SEC filed an emergency action alleging that two hedge funds had traded on material, nonpublic information in Arch Chemicals Inc. ahead of a July 11, 2011, announcement that Arch would be acquired by Lonza Group, a Swiss company. As usual, the SEC relied solely on the "suspicious trading" to support its initial allegations and request for an asset freeze.

After an extensive six month discovery process, the commission admitted in an interrogatory response that it "ha[d] not identified the specific Insider(s) who leaked material nonpublic information about Lonza's acquisition of Arch" to defendants (assuming arrogantly that there even was an inside leak), and subsequently proposed a stipulated dismissal without prejudice to defendants, which was refused. Defendants opposed the SEC's motion, and cross-moved for summary judgment.

In moving for dismissal without prejudice, the SEC largely argued that the six month discovery schedule, to which the commission had agreed at the outset of the case, did not ultimately provide sufficient time for the commission to complete its investigation. In opposing the commission's motion, defendants noted that sixteen depositions had been conducted, over thirty-six (36) different parties — including the target and acquiring company — had produced documents, and, quite critically, the commission had represented to the court merely days before the conclusion of fact discovery that it would not seek to extend the discovery end date.

Ultimately, the court sided with the SEC's claims about needing additional time for discovery. See Memorandum & Opinion, Dkt. No. 131 at *12 ("In light of the Commission's inability to obtain critical information during the discovery period, the Court concludes that dismissal without prejudice is in the interest of justice. The Commission's mandate is to protect investors, and a full and complete investigation is in the interest of the investing public.")

It is telling, however, that while the commission could have simply asked the court to extend the discovery end date, it instead sought to dismiss the entire action without prejudice. A dismissal negated any court oversight of discovery, permitted the SEC to investigate privately without having to share discovery with defense counsel, and, perhaps most critically, permitted the case to disappear with a whimper if the SEC was ultimately unable to find evidence supporting its initial boilerplate allegations. Indeed, at the time the SEC filed its motion for dismissal without prejudice, SEC spokesman John Nester declared that a "dismissal without prejudice will allow [the SEC] to continue our investigation without the limitation of a court deadline." (emphasis added).

Nester's spin — a clear attempt to paint the SEC's motion as a smart tactical decision rather than the desperate attempt to avoid an adverse judgment on the merits that it was — ignored the obvious: The SEC could have investigated without the limitation of a court deadline from the start. Of course, the SEC never needed to file an action on boilerplate allegations in the first instance, especially because the assets would not remain frozen after the dismissal without prejudice anyhow.

On the day the court issued its decision dismissing the action without prejudice, the SEC reaffirmed in a press release that this "would permit the full and complete investigation of the underlying facts by the Commission." It is unclear how the court's jurisdiction impeded the commission's ability to conduct a "full and complete investigation" in the first instance. The SEC has yet to refile the action.

Proposed Reforms to Provide a Deterrent to the SEC's Litigation Strategy

The SEC's success rate in these foreign defendant insider trading cases filed on an emergency basis is hardly impressive. With eight of the 35 defendants to be named in such actions, the SEC either secured a stipulation of dismissal without prejudice or filed a contested motion for such dismissal. Among the 13 total such actions, in four the SEC either moved to dismiss without prejudice entirely or lost on summary judgment.

While the fact that the SEC has ultimately sought to dismiss a number of these defendants without prejudice is troubling, the critical problem at this juncture is that the SEC has no realistic deterrent to filing such actions — and collaterally destroying reputations and businesses — because the SEC can simply move to dismiss without prejudice if its boilerplate allegations eventually do not pan out.

This current problem has been recognized by other defense counsel in similar situations. See e.g. Yang, Def. Br. In Support of Joint Motion to Dismiss, Dkt. No. 43 at *14 ("Although the SEC has numerous tools at its discretion to conduct extensive, nonpublic investigations of perceived market misconduct, those tools were not utilized here. Instead, the SEC chose to file suit against ... defendants with virtually no factual support. This is an untenable strategy that the SEC seems to be increasingly comfortable with in cases involving foreign nationals, despite lacking the ability to support their claims down the road.")

Indeed, if the SEC's decision to file such cases is left unchecked, any foreign defendant or foreign omnibus account which executes a profitable trade in a U.S. security near an acquisition announcement runs the risk of having assets frozen overnight, along with an SEC action seeking disgorgement, penalties and injunctive relief. Private institutions will likely, as a result of the allegations alone, close down the defendant's un-frozen brokerage accounts and stop doing business with defendant altogether.

The reforms this article proposes are actually quite simple and can be implemented by judicial discretion, as opposed to congressional action or SEC rulemaking (while the authors are not opposed to such reforms, they are skeptical of their chances). First, courts faced with such actions should exercise greater discretion at the ex parte stage to determine if emergency relief is justified, including analyzing the trading history in the subject security to determine if the purchases were truly "highly suspicious."

Indeed, as reflected in Telvent, securities will often experience a run-up prior to an acquisition announcement, and thus purchases immediately prior to that announcement do not ipso facto support an inference of insider trading. As a related matter, judges who subsequently inherit cases where such ex parte relief was initially granted should not shy away from sua sponte sanctioning or otherwise scolding the SEC if, later in the litigation, it becomes clear that the SEC withheld material information at the ex parte stage to secure the emergency relief.

Second, as in Compania cited above, if the SEC obtains emergency relief including a freezing of assets on an ex parte basis, proceeds through substantial discovery, and then is still ultimately unable to support its allegations, a federal court should not strictly adhere to the Zagano factors or shy away from dismissing with prejudice. Rather, federal courts should take into consideration the serious nature of the SEC's boilerplate allegations, the rushed basis upon which the SEC brought the action, and the fact that the SEC is unable to support its allegations at the close of discovery.

As Judge Jed Rakoff noted in Oakford, while the Court of Appeals has required district courts to consider the Zagano factors, this does not mean that "other concerns may not in the end be significant." 18 F.R.D. at 273. In these types of cases, "substantial prejudice" should include loss to reputation, good will, and potential destruction of business. Indeed, it is not primarily the threat of future litigation which such defendants fear, but the damage to business and reputation they needlessly must live because a federal court never vindicated their consistent claim that there was no insider trading.

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**The authors represented defendants Compania and Coudree in this action.*