ALM | LAW.COM

New York Law Journal

SEC Enforcements Highlight Risk of Noncompliance—Gone Are 'You Pay Your Money and Takes Your Chance' Days in the U.S.

By John G. Moon and Kenneth M. Silverman

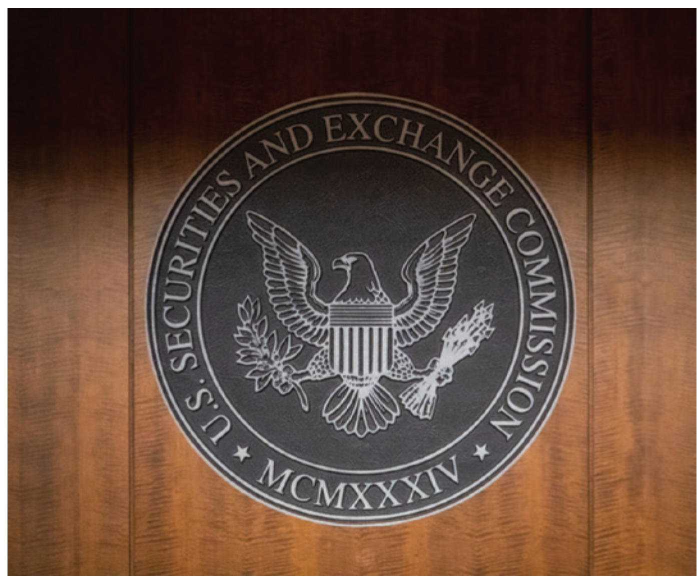
October 4, 2024

The United States has the largest securities market in the world, with a value of over $55 trillion. Foreign entities represent a substantial portion of U.S. market activity—cross-border investors hold approximately 20 percent of all U.S. securities across major asset types, including approximately 17 percent of all equity securities traded on U.S. stock markets.

Foreign portfolio holdings of U.S. securities reached $26.9 trillion as of June 30, 2023, representing a $2 trillion increase from June 2022. During the same period, equity holdings overall increased by $1.5 trillion. [*See* Foreign Portfolio Holdings of U.S. Securities as of June 30, 2023, Department of the Treasury.]

The distinction between types of investing activity by foreign entities is significant. Foreign investment is classified as "direct investment" when it involves "the ownership or control, directly or indirectly, by one person or a group of affiliated persons, of 10 percent or more of the voting stock" of a company. [*Id*.]

Conversely, foreign portfolio investment covers all securities owned by foreign residents, except



if a direct investment relationship exists with the domestic issuer. This article focuses on the regulation of portfolio investment in U.S. equities, by domestic and foreign money managers.

Money managers stand to gain substantially by investing in U.S. markets, due to their liquidity, efficiency and price discovery; however, they must navigate the complex regulatory scheme that fosters those attributes. The Securities Exchange Act of 1934 (Exchange Act), as amended, grants the Securities and Exchange Commission (SEC) the power to govern all securities transactions on the secondary market. Any foreign investor trading in NMS securities (i.e., U.S. exchange-listed equity securities and standardized options) falls under its jurisdiction and is subject to the reporting regime imposed by the SEC.

The extra-territorial nature of the SEC's jurisdiction over foreign money managers runs counter to our conceptions of jurisdiction that are generally based on the use of domestic wires or the mails, or where the defendant corporation is headquartered or registered. Recent SEC enforcement actions highlight the SEC's authority over an offshore money manager who instructs the foreign (non-SEC-registered) broker down the street to buy a U.S.-traded stock, potentially becoming subject to penalties for failing to file an applicable form with the SEC. And the Exchange Act is replete with these reporting requirements.

Less well-known, among those requirements are reports on Forms 13F and 13H. The SEC enacted the Form 13F requirement in 1975, based on the idea that significant investment in capital markets by large institutional investors creates the need for heightened SEC oversight and increased investor access to information. For example, an institutional investment manager that exercises investment discretion over $100 million or more in Section 13(f) securities must file a Form 13F quarterly.

Form 13H was introduced in 2011 as part of the SEC's response to the 2008 financial crisis. This reporting obligation allows the SEC to increase supervision of "large traders" and their trading activity. Through Form 13H reporting, large traders must identify themselves to the SEC which, in turn, allows the SEC to obtain information about large trader activity in U.S. markets, reconstruct trading activity following periods of unusual market volatility, and analyze significant market events for regulatory purposes. Generally, a large trader is a natural or legal person whose transactions in NMS securities equal or exceed either: (i) two million shares or $20 million during any calendar day, or (ii) 20 million shares or $200 million during any calendar month.

Recently, SEC concerns over the influence of large investors on the securities markets have manifested a robust sweep of enforcement actions. On Sept. 17, 2024, the SEC settled 11 cases against institutional investment managers for failing to file required reports on Forms 13F and 13H [SEC Charges 11 Institutional Investment Managers with Failing to Report Certain Securities Holdings, Sept. 17, 2024]. Notably, the SEC Enforcement Staff reached across international borders, including two foreign investors in its sweep.

Nine of the respondents received civil penalties totaling $3.4 million. The remaining entities, which avoided financial penalty, made self-reports to the SEC prior to filing past-due Forms 13F and 13H and cooperated with the SEC's investigations of these violations.

Highlighting the SEC's position that self-reporting is an important factor when determining whether to impose a financial penalty, NEPC LLC evaded financial punishment for its Form 13H violations by self-reporting before remediating delinquent filings. However, NEPC received a monetary fine of $725,000 after it filed 16 Forms 13F in March 2024.

Notably, NEPC appears not to have self-reported its Form 13F violations to the SEC. One entity, a foreign pension fund manager, avoided financial penalty in connection with its delinquent Form 13H and Form 13F filing obligations by self-reporting both delinquencies and cooperating with the SEC's investigation.

In conjunction with the simultaneous institution and settlement of the proceedings, SEC Administrator Jason Burt stated in the SEC's press release, "These resolutions illustrate how seriously the Commission takes non-compliance as well as the benefits a firm may derive from self-reporting its non-compliance." [*Id.*] The decision not to impose monetary penalties on self-reporters underscores the value of self-reporting and cooperating with the SEC in its investigations.

In addition to navigating the SEC's existing regulatory structure, there are new compliance hurdles for both investors and U.S. securities counsel. By virtue of the obligation to file Forms 13F, institutional investment managers are also now subject to a newly minted filing requirement imposed by the Exchange Act.

Approved on Nov. 2, 2022, institutional investment managers were first required to file reports on Form N-PX by August 31, 2024 (with these reports covering the 12-month period ending June 30, 2024) to report to the SEC how proxies were voted on matters related to executive compensation where the institutional investment manager "exercised voting power" over a security. Even if an institutional investment manager did not exercise any voting rights, a notice report indicating that no votes were cast is nonetheless required.

Another new compliance obligation that may affect investors, depending on their trading strategies, is reporting via Form SHO pursuant to Rule 13f-2 promulgated under the Exchange Act. Effective January 2, 2025, a Form SHO filing will be required when an institutional investment manager's short-selling of equity securities exceeds applicable thresholds and triggers the obligation to disclose such positions and activity to the SEC.

To further complicate matters, the universe of securities that are in scope for Rule 13f-2 is substantially broader than "Section 13(f) securities" that are disclosed on Form 13F. Rule 13f-2 requires that short sales of Section 13(f) securities and equity securities issued by privately held issuers and those issued by companies that are only traded outside the United States, be taken into account when calculating whether reporting thresholds are met and, if so, those are subject to reporting on Form SHO.

Depending on an institutional investment manager's trading behavior and levels of shorting activity, it may be subject to a three-fold requirement to file Forms 13F, N-PX and SHO.

The vast amount of cross-border investment in the U.S. securities market and the SEC's ever-evolving reporting structure compels foreign investor compliance teams and U.S. securities counsel to stay informed of potential reporting responsibilities and keep abreast of developments in the law. The costs of failing to do so can be extensive. If an investor is faced with delinquent filings, proactive self-reporting and cooperation with the SEC are critical tools for remediation.

John G. Moon *is a partner at Olshan Frome Wolosky and former SEC branch chief and enforcement attorney.* **Kenneth M. Silverman** *is a corporate partner at the firm.* **Judith R. Renner**, *a corporate associate, assisted in the preparation of this article.*

OLSHAN

OLSHAN FROME WOLOSKY LLP