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Opinion

SEC Enforcement Push to Spotlight Individuals

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SEC chair Mary Jo White has emphasized in recent public remarks the importance of bringing charges against individuals to the overall effectiveness of the Securities and Exchange Commission's enforcement program.

This should put professionals who prepare mutual fund disclosure documents on high alert, but it's not only the legal department at risk. The SEC could also apply this principle to a range of violations and fund personnel working in various roles. White's comments are a reminder that individuals who are involved in a violation of law by the fund or its investment advisor could face consequences themselves.

White indicated that the SEC intends to adopt a new approach in seeking to hold individuals liable for violations of securities laws under Section 20(b) of the Securities Exchange Act of 1934. That section makes it illegal for a person to violate that act "through or by means of any other person."

In her remarks, White noted that Section 20(b) gives the SEC a potentially powerful tool to bring enforcement actions against people who might not be liable under Rule 10b-5 as a result of the Supreme Court's decision in the Janus Capital Group v. First

Derivative Traders case. The majority ruling found that the parent of a mutual fund investment advisor could not be held liable to private plaintiffs under Rule 10b-5 for false statements included in mutual fund prospectuses. The court's rationale was that the fund, rather than its advisor, was the "maker" of the statements.

For the SEC, the Janus case and the majority's interpretation of Section 10(b) set a troubling precedent hindering the regulator's ability to impose liability on individuals involved in preparing statements in a fund's disclosure documents.

But a footnote to that case, and the SEC's renewed focus on a separate section of '34 Act, means that individuals the regulator believes to be responsible for misleading statements or other violations could find themselves in the enforcement division's cross hairs.

Although the Janus decision insulated individuals under Section 10(b), a footnote in the decision expressly acknowledges that the opinion does not address personal liability under Section 20(b). In other words, if an individual violates the 1934 Act through another person or entity, such as a fund, 20(b) provides an avenue for liability, even though 10(b)(5) does not, because of the precedent set by the Janus decision.



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The SEC has rarely used Section 20(b), as White concedes. And there isn't much case law related to Section 20(b) claims, so it is unclear what a prosecutor must prove to establish liability. White has also stated that Section 20(b) does not require the SEC to prove an underlying violation by a fund in order to establish liability for an individual, such as an employee of an advisor.

At least one court has taken a different view. It may be difficult for the SEC to prove an underlying violation of the Exchange Act if the fund that makes a misleading statement lacks knowledge that the statement was misleading, relevant case law suggests.

In the past, the SEC has sought to bring a broader range of actions against individual defendants by alleging negligent securities fraud under Section 17(a) of the Securities Act of 1933. In those cases, individual defendants have already argued that the Supreme Court's Janus decision also applies to Section 17(a), and at least one court has agreed. If followed by other courts, that could limit the scope of the SEC's enforcement actions against individuals.

The mutual fund industry has yet to see the full impact of the SEC's "new" enforcement theory. The Janus ruling notwithstanding, individuals involved in the preparation of false or misleading statements in fund prospectuses and shareholder reports may still face liability. White's recent statements reinforce that. The SEC could also potentially apply this principle to individuals suspected of having caused other 1934 Act violations through another person or entity, including a fund.

As a result, all fund personnel should remain vigilant to prevent violations of the securities laws by funds, and in particular, individuals involved in the preparation of mutual fund disclosure documents must ensure their accuracy and completeness.

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