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Bad Actor Prohibition

Despite His "Bad Acts," Issuers Beneficially Owned by Steven A. Cohen Are Not Precluded From Private Offerings Based on the Bad Actor Rule

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By Vincent Pitaro, *Hedge Fund Law Report*

Steven A. Cohen, the billionaire founder of S.A.C. Capital Advisors, LLC (SAC), has settled SEC charges that he failed reasonably to supervise Matthew Martoma, a portfolio manager who engaged in insider trading in shares of two pharmaceutical companies. The SEC charged that "Cohen received information that should have caused him to take prompt action to determine whether an employee under his supervision was engaged in unlawful conduct and to prevent violations of the federal securities laws. Cohen failed to take reasonable steps to investigate and prevent such a violation." See "SEC Charges Steven A. Cohen With Failing to Supervise Employees Who Allegedly Engaged in Insider Trading" (Jul. 25, 2013).

Without admitting or denying the SEC charges, Cohen has accepted a two-year ban from serving in a supervisory position at a broker, dealer or investment adviser; has agreed to submit his firms to SEC examinations; and has agreed to retain an independent consultant to conduct a compliance review of his investment management companies. Separately, the SEC has issued a no-action letter to the effect that the settlement order will not result in disqualification of companies in which Cohen's funds have invested from relying on Rule 506(b) or (c) of Regulation D for private placements by reason of the "bad actor" rule set forth in Rule 506(d).

The settlement likely brings to a close the SEC's long running investigations of Cohen, SAC and their affiliates and employees. In the press release announcing the settlement, Andrew Ceresney, the Director of the SEC Division of Enforcement, said, "The strong combination of a two-year supervisory bar and additional oversight requirements achieves significant and immediate investor protection and deterrence, while ensuring that the activities of his funds are closely monitored going forward." This article summarizes the terms of the settlement and the related no-action letter. See also "Defense White Paper Refutes SEC's Allegations That Steven A. Cohen Failed to Supervise Employees Accused of Insider Trading and Provides a Behind-the-Scenes Look at SAC Capital's Compliance Program and Culture" (Jul. 25, 2013).

Relevant Background

Steven A. Cohen, the subject of the SEC's Order is the founder of S.A.C. Capital Advisors, LLC (SAC) and its successor, S.A.C. Capital Advisors, L.P. (SAC LP), which once had over $15 billion in

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assets under management. Cohen and SAC controlled a number of other entities involved in the asset management business (Cohen Entities), including CR Intrinsic Investors, LLC (CR Intrinsic) and Sigma Capital Management, LLC (Sigma). Those entities, and two of their portfolio managers: Matthew Martoma and Michael Steinberg, have been embroiled for years in a web of insider trading allegations and charges.

In 2014, Martoma, a CR Intrinsic portfolio manager, was convicted of three counts of securities fraud, in violation of Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934 (Exchange Act) for trading on material nonpublic information concerning pharmaceutical companies Elan Corporation plc (Elan) and Wyeth. See "Fund Manager CR Intrinsic and Former SAC Portfolio Manager Are Civilly and Criminally Charged in Alleged 'Record' $276 Million Insider Trading Scheme" (Nov. 21, 2012).

Martoma has appealed his conviction to the U.S. Court of Appeals for the Second Circuit. In 2013, CR Intrinsic settled SEC insider trading charges arising out of Martoma's trading without admitting or denying the SEC's allegations. See "U.S. District Court Conditionally Approves CR Intrinsic Settlement Wth SEC Despite 'Neither Admit Nor Deny Liability' Provision" (Apr. 25, 2013); and "Five Takeaways for Other Hedge Fund Managers From the SEC's Record $602 Million Insider Trading Settlement With CR Intrinsic" (Mar. 21, 2013).

Separately, in December 2013, Michael Steinberg, a portfolio manager at Sigma, was convicted of trading on inside information concerning Dell that he received from his analyst Jon Horvath. For a comprehensive discussion of the Dell insider trading scheme, see "SEC Files Civil Insider Trading Complaint Against Diamondback Capital Management, Level Global Investors and Seven Individuals Based on Trading in Dell and Nvidia; Diamondback Strikes Non-Prosecution Deal With U.S. Department of Justice and Settles With the SEC for $9 Million" (Jan. 26, 2012).

In the wake of the Second Circuit's landmark ruling in *U.S. v. Newman*, U.S. Attorney Preet Bharara recently announced that he would move to dismiss the insider trading charges against Steinberg. Finally, in November 2013, SAC, SAC LP, Sigma and CR Intrinsic pleaded guilty to securities and wire fraud charges arising out of the alleged insider trading schemes. See also "SAC Capital Entities Indicted for Securities Fraud and Wire Fraud in Connection With Employees' Alleged Insider Trading" (Jul. 25, 2013).

Failure to Supervise

In July 2013, the SEC instituted administrative proceedings against Cohen, alleging that he had failed reasonably to supervise Steinberg and Martoma. Although the original enforcement proceeding was based on Cohen's alleged failure to supervise both Steinberg and Martoma, the Order is based only on the allegations concerning Martoma, presumably because the DOJ has now effectively conceded that Steinberg did not engage in actionable insider trading. For more on a fund manager's supervisory duties, see "Dechert Partners and Venor Capital General Counsel Describe the Scope of Supervisory Liability for Hedge Fund Manager Personnel" (Jul. 11, 2014).

Cohen directly or indirectly owned SAC, which in turn owned CR Intrinsic. The SEC alleged that Cohen had the power to hire and fire Martoma and supervised him. Part of that supervision entailed Martoma's keeping Cohen advised as to Martoma's securities positions and his reasons for taking those positions. Martoma and other portfolio managers received additional compensation when Cohen profited in his own portfolios from their recommendations.

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Martoma allegedly conveyed to Cohen information he had received from Dr. Sidney Gilman, a consultant whom Martoma had retained through an expert network. Gilman was involved in overseeing trials of a drug that Elan and Wyeth were jointly developing and had access to trial results before they were publicly announced. As a consultant to Elan and Wyeth, Gilman had a duty to keep information about the trials confidential. Nevertheless, Gilman allegedly provided Martoma with material nonpublic information about those trials. Based on that information, Martoma at first accumulated substantial long positions in Wyeth and Elan for CR Intrinsic; Cohen followed suit at SAC.

The Order highlights a number of red flags that Cohen allegedly missed or ignored concerning Martoma's trading. For example, in early 2008, two CR Intrinsic analysts "repeatedly" questioned SAC's long positions in Wyeth and Elan and expressed concerns about the source of Martoma's information. Those analysts had received information from another doctor involved in Wyeth/Elan drug trials. When asked about the other doctor's information, Cohen allegedly accepted Martoma's explanation that the analysts' concern was a "non issue."

Then, in July 2008, Martoma allegedly learned from Gilman that, contrary to earlier expectations, the trial results would be unfavorable. Martoma promptly told Cohen that he was no longer "comfortable" with the long positions. Cohen apparently did not question this abrupt change of heart. Instead, in the days before the public announcement of the trial results, SAC and CR Intrinsic liquidated most of their long positions in Wyeth and Elan and established a substantial net short position in Elan. When the trial results were announced, the companies' share prices plummeted and Cohen's funds "collectively reaped profits and avoided losses of approximately $275 million. . . ."

The SEC charged that Cohen had "failed to take prompt action to determine whether an employee under his supervision was engaged in improper conduct and failed to take reasonable steps to prevent violations of the federal securities laws." Cohen also allegedly ignored SAC's code of ethics, which contained "prohibitions of trading on or the misuse of material nonpublic information when communicating with potential sources of market information such as . . . doctors conducting clinical trials. . . ."

For other recent enforcement actions involving failure to supervise, see "Hedge Fund Managers Must Guard Against Illicit Cross Trading to Avoid Significant Penalties" (Jan. 14, 2016); and "Explicit Disclosure of Changes in Hedge Fund Investment Strategy to Investors and Regulators Is Vital to Reduce Risk of Enforcement Action" (Oct. 29, 2015).

Violations and Sanctions

According to the Order, "Cohen failed reasonably to supervise Martoma with a view to preventing Martoma's violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder." Although not stated in the Order, it appears that Cohen is alleged to have violated Section 203(e)(6) of the Investment Advisers Act of 1940 (Advisers Act), which permits the SEC to impose sanctions on a registered investment adviser who "has failed reasonably to supervise, with a view to preventing violations of the provisions of [the federal securities laws and regulations], another person who commits such a violation, if such other person is subject to his supervision. . . ."

Cohen is barred from "being associated in a supervisory capacity with any broker, dealer, or investment adviser until December 31, 2017." The ban will be extended for two years in the event of a future final judgment against Cohen or a Cohen Entity for violation of a federal securities

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law, or a future final judgment against a Cohen Entity employee for a scienter-based federal securities law violation. Cohen must also comply with the undertakings described below.

Undertakings

Cohen must, within 30 days of the Order, retain an independent consultant to (1) conduct a review of all Cohen Entities for compliance with federal securities laws and (2) recommend policies and procedures to improve such compliance. The consultant must report to the relevant Cohen Entity and to the SEC every six months. Cohen has 60 days to adopt each recommendation by the consultant, but may challenge and suggest alternatives to any requirement he considers to be "unnecessary, inappropriate, or unduly burdensome." He must, however, abide by the consultant's final decision. As is customary, the consultant and its affiliates are prohibited from being employed by Cohen or his affiliates for two years after the engagement ends.

In addition, Cohen has agreed to investigate any "profitable (including loss avoidance) trade" identified by the SEC; to consent to any proposed onsite examination by SEC staff of any of Cohen's registered or unregistered firms; and to produce employees for deposition on 21 days' notice.

The undertakings described above will remain in effect until the end of 2017. However, if the SEC brings a new enforcement action against Cohen or a Cohen Entity for conduct that occurred after August 1, 2013, and that was not reported by Cohen or a Cohen Entity, the undertakings may remain in effect beyond December 31, 2017.

The settlement is a victory for the SEC in the sense that Cohen has been effectively barred from managing outside money for the next two years and his family office, Point72 Asset Management, L.P. (Point72) and its affiliates, will be supervised by a compliance monitor and are subject to examination by the SEC. On the other hand, Cohen obtained the settlement without acknowledging wrongdoing and without a fine; moreover, he may be eligible to manage outside money in as little as two years.

"Bad Actor" No-Action Relief

The JOBS Act eliminated the long-standing ban on general solicitation and advertising in private placements of securities (Rule 502(c) of Regulation D) for offerings that comply with new Rule 506(c). See "Katten Seminar Provides Hedge Fund Managers With a Roadmap for JOBS Act Compliance" (Nov. 8, 2013). At the same time, new Rule 506(d) disqualifies an issuer from relying on Rule 506(b) or (c) if the issuer or certain other designated persons are deemed to be "bad actors" by reason of a conviction, order or judgment arising out of certain securities laws violations. See "SEC Provides Guidance on When the Bad Actor Rule Disqualifies Hedge Fund Managers From Generally Soliciting or Advertising" (Mar. 7, 2014); and "How Can Hedge Fund Managers Negotiate the Structuring, Operational and Due Diligence Challenges Posed by the Bad Actor Disqualification Provisions of Rule 506(d)?" (Oct. 11, 2013).

Rule 506(d)(2) permits the SEC to waive bad actor disqualification "upon a showing of good cause and . . . if the Commission determines that it is not necessary under the circumstances. . . ."

Of relevance to the Order, a "bad actor" may include a beneficial owner of 20% or more of an issuer's outstanding voting equity securities, calculated on the basis of voting power. Cohen's

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family office, Point72, was concerned that certain of its portfolio companies might face bad actor disqualification by reason of entry of the Order against Cohen. Point72, or the funds it manages, may own more than 20% of the voting securities of issuers that wish to rely on Rule 506, and Cohen is deemed to have beneficial ownership of any securities over which Point72 has voting or dispositive power. Consequently, if Cohen were deemed a bad actor, such issuers would be disqualified from relying on Rule 506(b) or (c) for private placements of their securities.

Therefore, Point72 requested, and received, no-action relief from the SEC to the effect that the following issuers (Issuers) are not subject to bad actor disqualification:

> [Issuers] with respect to which Mr. Cohen is as of the date hereof, directly or indirectly, the beneficial owner of 20% or more of the outstanding voting securities, calculated on the basis of voting power, excluding (i) any Cohen Entity, (ii) any pooled investment funds managed by a Cohen Entity, (iii) any issuer of which Mr. Cohen is the beneficial owner of 50% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power, and (iv) any issuer of which Mr. Cohen serves as a director or officer.

In support of its request, Point72 argued that:

- Cohen's alleged violation arose under the Advisers Act, rather than in connection with an offering or sale of securities. It involved a single employee and took place in 2008.
- Cohen and his firms have already taken, and will take, "substantial remedial steps" to address the alleged violation.
- The Cohen Entities will be subject to a compliance monitor.
- None of the Issuers were involved in the alleged misconduct.
- Approximately 15 Issuers would be adversely affected by "bad actor" disqualification because they routinely rely on Rule 506 in raising capital.

Based on the representations made in Point72's request letter, and on the condition that Cohen and the Cohen Entities comply with the Order, the SEC has indicated that the Issuers will not be subject to disqualification under Rule 506(d) and may continue to rely on Rule 506(b) and (c) for private placements.

To read the SEC settlement order, click here.

To read the related no-action letter and request, click here.

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