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A Harbinger Of More Aggressive SEC Settlements

Law360, New York (August 23, 2013, 12:17 PM ET) -- The U.S. Securities and Exchange Commission recently announced that Philip A. Falcone, a New York-based hedge fund advisor, and the hedge fund he managed, Harbinger Capital Partners LLC, have agreed to settle allegations of misappropriation of client assets, market manipulation and client betrayal.

The settlement requires Falcone and Harbinger Capital to pay more than $18 million in penalties and, in the case of Falcone, to be banned from the securities industry for at least five years. Most notably, however, the settlement also required Harbinger Capital and Falcone to admit wrongdoing, a dramatic break from the SEC's traditional practice of allowing defendants to settle suits without admitting or denying liability.

The settlement is seemingly the product of tough negotiations. Falcone and Harbinger Capital earlier reached an agreement-in-principle with the Enforcement Division to resolve the investigation, but it was rejected by the commission. It is highly unusual for the commission to reject settlements that have been negotiated by the Enforcement Division. In this case, however, it appears that the commission did so at least in part because of its determination to require admissions of wrongdoing in certain matters going forward.

Background of SEC Action against Falcone and Harbinger Capital

The case arose out of a civil enforcement action filed by the SEC in June 2012 against Falcone, Harbinger Capital and Harbinger Capital's former Chief Operating Officer Peter A. Jenson. The complaint charged Falcone and Harbinger Capital with violating Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 and Sections 206(1), 206(2), 206(4) and 206(4)-8 of the Advisors Act. Falcone also was charged as a control person under Section 20(a) of the Exchange Act; Jenson was charged with aiding and abetting Falcone and Harbinger Capital's alleged violations.

Specifically, the SEC alleged that Falcone improperly used $113 million in fund assets to pay his personal taxes, secretly favored certain customer redemption requests at the expense of other investors and conducted an improper "short squeeze" in bonds issued by a Canadian manufacturing company.

In their settlement papers, which were filed in the U.S. District Court for the Southern District of New York, defendants Falcone, Harbinger Capital and other parties admitted to a detailed set of facts illustrating multiple acts of misconduct that harmed investors and interfered with the normal functioning of the securities markets. In its press release announcing the settlement agreement, the SEC highlighted the defendants' admissions to the following facts as the basis for the settlement agreement:

- Falcone improperly borrowed $113.2 million from the Harbinger Capital Partners Special Situations Fund (SSF) at an interest rate lower than SSF was paying to borrow money, to pay his personal tax obligation, at a time when Falcone had barred other SSF investors from making redemptions, and did not disclose the loan to investors for approximately five months.

- Falcone and Harbinger granted favorable redemption and liquidity terms to certain large investors in HCP Fund I and did not disclose certain of these arrangements to the fund's board of directors and the other fund investors.

- During the summer of 2006, Falcone heard rumors that a financial services firm was shorting the bonds of the Canadian manufacturer and encouraging its customers to do the same.

- In September and October 2006, Falcone retaliated against the financial services firm for shorting the bonds by causing the Harbinger funds to purchase all of the remaining outstanding bonds in the open market.

- Falcone and the other defendants then demanded that the financial services firm settle its outstanding transactions in the bonds and deliver the bonds that it owed. Defendants did not disclose at the time that it would be virtually impossible for the financial services firm to acquire any bonds to deliver, as nearly the entire supply was locked up in the Harbinger funds' custodial account and the Harbinger funds were not offering them for sale.

- Due to Falcone's and the other defendants' improper interference with the normal interplay of supply and demand in the bonds, the bonds more than doubled in price during this period.

The district court still must approve the settlement, which asks the court to enter a final consent judgment that (1) enjoins Falcone from acting or associating with any broker, dealer, investment advisor, municipal securities dealer, municipal advisor, transfer agent or nationally recognized statistical rating organization; (2) orders the appointment of an Independent Monitor; (3) orders the defendants to pay disgorgement in the amount of $6,507,574 plus prejudgment interest in the amount of $1,013,140; and (4) orders the defendants to pay civil penalties in the amount of $10,500,000 under provisions of the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisors Act. The settlement agreement does not prevent Falcone from serving as a director or officer of a public company, including his publicly traded company Harbinger Group Inc.

Significance of the Settlement

This settlement is significant because it is the first to implement an aggressive new policy outlined earlier this year by the SEC's new chairperson, Mary Jo White, by which the SEC will seek admissions of wrongdoing in certain settlement agreements, overturning the SEC's long-standing policy of allowing defendants to "neither admit nor deny" wrongdoing.

This settlement also sets a precedent that could potentially impact the outcomes of other SEC investigations involving banks, hedge funds and other financial institutions and individuals. (Virtually all prior cases filed by the SEC against major financial institutions have been settled without any admission of wrongdoing.)

Consequently, this settlement likely portends a new enforcement climate in which settlements are more costly and the collateral consequences are more severe. On the other hand, defendants may refuse to settle cases if they are required to admit wrongdoing because admissions may subject them to civil suits brought by shareholders and others; defendants' refusal to settle may stretch thin the SEC's resources and possibly lead to more trials and fewer enforcement actions overall.

Applicability of SEC's Policy Change to Future Cases

In light of the SEC's new policy of requiring an admission of wrongdoing as part of certain settlements, companies and individuals should be aware of the impact of the policy on future cases as follows:

- Companies and individuals should proceed with extreme caution before admitting any wrongdoing and entering into a settlement agreement with the SEC. Like a plea agreement, an admission of wrongdoing could be used by the Department of Justice or civil plaintiffs in parallel civil litigation, resulting in serious financial harm to the defendant. Moreover, an admission of wrongdoing could potentially jeopardize a defendant's insurance coverage, as many insurance policies exclude coverage where a finding of intentional misconduct or fraud has been made.

- Companies should implement comprehensive policies and procedures to address compliance with securities laws. Such policies must be continuously communicated and rigorously enforced at all levels of the organization.

- Companies will often conclude that cooperation with an SEC investigation is in their best interest. Robust corporate policies and proof of their enforcement may help to limit the extent of an SEC investigation by showing that no misconduct occurred or that any misconduct was limited in scope. Cooperation could potentially also encourage resolution of an SEC investigation through a deferred prosecution agreement or a nonprosecution agreement.

- Companies and individuals facing an SEC investigation should consider the business and reputational reasons that may weigh against entering into a settlement agreement, especially where admission of wrongdoing is required. In some situations, litigation through trial rather than settlement may be the best strategy.

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