

## The 'SEC Speaks' in 2020: Enforcement Adapts to Turbulent Times

Top enforcement officials from the U.S. Securities and Exchange Commission recapped the agency's accomplishments over the past fiscal year and previewed its upcoming enforcement priorities at this year's SEC Speaks conference, held on October 8 and 9, 2020. Despite the virtual format of the presentation, the SEC delivered a clear message: the staff is adapting to the new normal of enforcement amid the COVID-19 pandemic and changing course to address emerging risks to market stability and investor protection. In turn, practitioners should expect ongoing pressure to engage in early and robust cooperation with the SEC's investigations, notwithstanding the added workflow and business pressures brought on by the pandemic.

Among the SEC's regulatory achievements in the last fiscal year was a headline-grabbing *\$4 billion* in financial remedies obtained through the Division of Enforcement (a modest increase over FY 2019). As Chairman Jay Clayton [remarked](#), "the results speak for themselves." While some of the agency's functions have become more difficult to carry out during the pandemic, like onsite inspections by the Office of Compliance Inspections and Examination's (OCIE), others were streamlined. For example, Stephanie Avakian, director of the Division of Enforcement, noted that Wells meetings are occurring at a faster and more efficient pace by using remote technology. In addition to describing the pandemic's impact on day-to-day operations, SEC staff highlighted a number of important recent developments, discussed below.

### Carrying Out Its Mission During a Pandemic

The Division of Enforcement addressed its long-standing priorities of bolstering investigation efficiency, leveraging technology, and protecting retail investors, especially considering the increased potential for insider trading and impairments to financial disclosures due to the pandemic. The staff also spent time discussing modifications to its investigation process as a result of COVID-19 safety protocols.

While the SEC has not released official numbers for fiscal year 2020, the number of enforcement actions will be lower than in prior years. As Chairman Clayton noted, the agency brought over 700 enforcement actions in 2020, which was fewer than in 2019 and 2018. Nonetheless, the SEC's enforcement efforts were more active *after* the onset of the pandemic and its negative impact on the economy. From mid-March 2020 to the end of FY 2020, the division achieved a 7% increase in the number of new investigations opened, and a 68% increase in the number of tips, complaints, and referrals reviewed, compared to the same time period last year. And of the 640 new matters opened, 150 are COVID-19-related. Enforcement Director Avakian mentioned that these investigations were focused on the "microcap space" where the SEC has suspended trading of approximately three dozen issuers based on alleged questionable claims regarding their ability to conduct COVID-19 testing, develop treatments or vaccines, and access personalized protection equipment. The SEC has also filed six COVID-19-related fraud actions.

Acknowledging that investigations into financial fraud and disclosure issues can be lengthy, often averaging three years, Avakian said the enforcement division has focused on streamlining and shortening such investigations. This would be welcome news for issuers who frequently find long investigations to be a drain on time and resources.

## Remote Investigations and Litigation

The enforcement division also described the practical impact the pandemic has had on its investigations. Cooperation and early disclosure by defense attorneys has become more important in the current environment, presumably due to the difficulty of obtaining evidence by remote means. However, enforcement staff issued a caveat that its evaluation of cooperation will continue to largely rely on the analytical framework outlined in the 2001 Seaboard Report. As the SEC noted, the agency's key consideration is whether the cooperation "substantially advances the quality and efficiency" of the investigation.

As an example of the type of cooperation the SEC deems worthy of credit, Associate Director of the Division of Enforcement Anita Bandy pointed to BMW of North America LLC's stance in its [settled action](#) over alleged false and misleading disclosures. Bandy noted that, even during the pandemic, BMW was proactive in its cooperation—producing documents quickly, supplying witnesses on the SEC's timeline, and remediating its sales practices promptly. As a result, the company received a reduced penalty of \$18 million. Of course, Bandy did not quantify the dollar amount of BMW's cooperation reduction.

Given that investigations are document-intensive, the SEC has taken steps to triage and streamline the document request process. Likewise, practitioners should expect to meet those efforts with expedited document productions—even at a time when collecting documents remotely presents added challenges. Deputy Director Marc Berger also addressed the issue of assertions of privilege by defense counsel. Berger said the SEC is carefully reviewing privilege logs and will question privilege assertions. Berger also warned against designating documents as privileged (perhaps due to an overbroad privilege application), but later withdrawing the privilege claim and producing a large volume of documents. Such a scenario can hamper an investigation, particularly if witness interviews have already occurred.

The SEC is taking testimony remotely, with the vast majority of witnesses having agreed to testify via videoconference. In the rare instance that someone chooses to not participate in remote testimony, the SEC will move forward with the investigation and consider the absence of testimony by a witness as a factor in deliberating whether to bring an action, including during the Wells stage. Again, the enforcement division made it clear that its investigations are continuing at a rapid (albeit remote) clip, and it expects those involved in the investigations to match its pace or deal with the consequences. The agency offered no insight as to what its adoption of remote testimony might mean for the future, but we could see a long-term change in how the agency elicits testimony.

The Wells process itself is also occurring on a remote basis, with a significant number of virtual Wells meetings since March. Enforcement Director Avakian emphasized that Wells meetings can meaningfully change the outcome of a case. In a practice tip, Avakian advised defense counsel to be strategic and focus on the issues in a targeted manner. She said while an investigation is sometimes terminated as a result of the advocacy that occurs at a Wells meeting, it is often more realistic for defense counsel to advocate for a reduction in charges.

In litigated cases, the SEC noted that courts have not been particularly warm to defendants' arguments to avoid remote depositions. On this topic, Chief Litigation Counsel Bridget Fitzpatrick pointed to an order from the U.S. District Court for the District of Massachusetts in the case of *SEC v. Commonwealth Equity Services, LLC*. There, the court denied the defendant's request for a protective order and ordered virtual depositions to proceed. Fitzpatrick commented that the order gave a thoughtful overview of best practices for how to conduct remote depositions.

## Whistleblower Program

The SEC's whistleblower program had a [record year](#), highlighting the success that the agency's continued attention has had on the program. Over the last year, the SEC focused and reevaluated their reward process for whistleblowers and implemented changes to make the program more efficient. In FY 2020, the SEC made 39 individual awards to whistleblowers totaling over \$175 million dollars—a 200% increase in the number of awards issued in a single year as compared to their next highest year. This figure represents a third of *all* money rewarded under the program.

Enforcement Director Avakian admonished companies to take whistleblower complaints seriously because whistleblowers often allege that their company failed to adequately respond to their allegations. In the Office of the Whistleblower's [annual report](#) to the U.S. Congress, the SEC noted that 85% of whistleblowers are employees or former employees of a company who first reported the problems internally to the company. Avakian also noted that companies must avoid efforts to determine the identity of the whistleblower and engage in retaliatory actions, as the SEC will bring an action against a company that retaliates against a whistleblower. Given this warning from the SEC, firms should pay careful attention to their internal policies for whistleblower reporting and response procedures. This is especially true in our largely remote work environment where it is no longer an option to walk down to someone's office to report and working from home presents additional compliance challenges.

## Data Analytics

The enforcement division continues its goal to expand and leverage its capacity with data analytics and risk-based tools to identify insider trading schemes and retail frauds in the registered entity space. In the past year, the agency has also dedicated resources to developing data tools in the financial fraud and issuer disclosure space.

In September 2020, the division announced the quarterly earnings per share (EPS) initiative, a risk-based analytics program designed to uncover potential accounting and disclosure violations caused by, among other things, earnings management practices. The program looks for anomalous patterns and considers risk factors and other datapoints to determine if an issuer is an outlier compared to its peers. In September, the SEC filed its [first two cases](#) stemming from the initiative: Fulton Financial Corporation and Interface Inc. In both cases, the SEC alleged accounting misrepresentations based on adjustments that allowed the companies to meet quarterly EPS estimates. The EPS initiative remains ongoing, and the SEC expects it to have a strong deterrent effect on future misconduct.

## SEC Disgorgement Litigation

The U.S. Supreme Court decided [Liu v. SEC](#) in June 2020, thereby solidifying the SEC's ability to seek disgorgement as an equitable remedy in federal court. Although the SEC has been seeking disgorgement in enforcement actions for decades, the agency's ability to do so was called into question in the Supreme Court's 2017 decision in [Kokesh v. SEC](#). In *Kokesh*, the Court held that disgorgement is a penalty subject to a five-year statute of limitations, but indicated in a footnote that its decision did *not* address the broader question of whether courts have authority to order disgorgement in SEC actions.

The Court ultimately upheld the SEC's right to seek disgorgement in *Liu*, but it was not without qualification. Under *Liu*, a district court can award disgorgement if the amount does not exceed the wrongdoers' net profits (after deducting legitimate expenses) and is awarded for the benefit of victims. In light of this guidance, SEC Chief Counsel Joseph Brenner said that the division was spending a lot of time considering what counts as a

"legitimate expense" and provided the SEC's view on this issue.

To show legitimate expenses that can be excluded from net profits, practitioners should support their proposed reduction with appropriate documentation. Defense counsel should also explain what makes the expenses legitimate, such as how the expenses were distinct from the unlawful activity and whether the expenses added value for shareholders. Although ultimately a good decision for the SEC, *Liu's* net profits analysis presents additional hurdles for the agency. Tellingly, Enforcement Director Avakian said the agency will move to seek higher penalties, as opposed to disgorgement, where the applicable statute permits.

## **Disclosure and Accounting Practices**

Aware that firms are facing new and intense pressures, SEC staff warned companies to pay careful attention to their compliance functions. Chief Accountant for the Enforcement Division Matthew Jacques stressed that while the agency does not want to "second guess good faith judgments" it is keeping "a watchful eye" for when good faith is not used in accounting practices. Jacques warned companies not to use the pandemic's impact to cover up past mistakes, or recently discovered mistakes, noting that market decline and economic stress "may reveal past misconduct or result in new misconduct."

Likewise, the Division of Corporation Finance said that it was fielding many questions from registrants asking about how they should approach forward-looking statements considering the present uncertainty and the difficulties many businesses are facing. In response, the agency stressed *consistency*. Companies should ensure that the information provided in a public filing is consistent with the information the company gives to other third parties, like a landlord or lenders. While not mentioned specifically by the SEC, this message of consistency of information in public filings and to lenders is consistent with the agency's investigations related to [Paycheck Protection Program](#) (PPP) loans that have been reported in the press. In a similar vein, the Division of Corporation Finance sent a reminder on insider trading, noting that while companies are in the midst of an event that may trigger a Form 8-K filing, it may not be a good time for "key members" to be trading in the security.

## **Takeaways**

The SEC is meeting the challenge of effective regulation and enforcement in these turbulent times. Throughout the conference, SEC staff referenced lessons learned from the 2008 financial crisis in responding to the market stresses of 2020. In other words, the SEC is battle-tested. Likewise, registrants would be well advised to stay vigilant and allocate appropriate resources to ensure they, too, are addressing emerging risks and compliance concerns in the pandemic era.

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