SEC SPEAKS 2020: ENFORCEMENT AND EXAMINATION HIGHLIGHTS

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Investigations, Enforcement, and White Collar Alert

By: Meghan E. Flinn, Hayley Trahan-Liptak, Stephen G. Topetzes, Chelsie D. Rimel, Scott G. Ofrias

On October 8 and 9, the Securities and Exchange Commission (SEC or Commission) held its annual "SEC Speaks" program in partnership with the Practicing Law Institute, this year in a virtual format and after a several-month postponement due to COVID-19. Over the course of the conference, SEC Commissioners and senior members of the Commission staff addressed developments and trends, priorities for the upcoming fiscal year, and the impact of COVID-19 on the Commission's activities.

This alert summarizes the enforcement- and examination-related remarks and highlights the key takeaways for SEC-regulated entities and individuals as the Commission continues to press ahead with its initiatives in the midst of a global pandemic.

Key Takeaways

- The Commission has quickly implemented and adapted to new practices to advance its initiatives while COVID-19 persists. Examination and enforcement staff are increasingly adept at conducting their work remotely, and, in all aspects of the Commission's work, it appears that the next year will be "virtual" business as usual.
- At the same time, the SEC is identifying and pursuing securities violations arising from the market variability created by the pandemic. In particular, the Division of Enforcement is monitoring for investment scams and misrepresentations in financial statement disclosures, and examiners are focused on financial stress triggered by the fluctuating economy.
- Issues relating to the SEC's authority to order disgorgement continue to occupy the staff as *Liu* plays out in the lower courts. Going forward, it will be important for defense counsel to show the work involved with disputing and countering a disgorgement amount proposed by the staff in negotiations.
- Though at no point during the two-day panel did the Commission engage in a substantive discussion of its widely debated amendments,[1] the Whistleblower Program can be expected to serve as an ongoing source for investigations and enforcement actions in the coming year.
- The SEC's commitment to diversity and inclusion is a constant theme worth noting. In her remarks, Commissioner Crenshaw spoke highly of the SEC's commitment to diversity and advised that closing gender gaps and racial diversity should be treated by organizations like other business objectives: make a plan, create metrics to measure progress, mentor colleagues, and recognize growth.

I. EXAMINATION PRIORITIES

On the first day of the program, speakers from the Office of Compliance Inspections and Examinations (OCIE) provided their observations from 2020 thus far, highlighting a number of areas of concern that have arisen as a result of the COVID-19 pandemic. Drawing in part from these COVID-19 related concerns, the speakers also offered a glimpse at planned 2021 examination priorities.

OCIE released 2020 examination priorities in January. The speakers noted that the COVID-19 pandemic highlighted additional compliance risks for the exam staff that led to new areas of focus. Generally, these risks stemmed from two pandemic-related effects: market volatility and remote-work arrangements. With respect to market-volatility, the areas of emphasis include proper protection of investor assets, including collecting funds and monitoring disbursements given market volatility and a heightened possibility for fraudulent offerings due to false or misleading claims. The speakers also addressed risks stemming from changing workplace environments, including ensuring proper supervision and oversight of personnel; the maintenance of business continuity plans that allow for remote operation and supervision; and protection of personally identifiable information in a remote environment. In his opening remarks, Commissioner Elad Roisman noted that through changing circumstances and challenging work environments, the staff has successfully carried on the SEC's mission, in spite of the volatility associated with this year.

Looking ahead to 2021, the speakers identified several topics that are likely to be examination priorities, particularly given the changing economic environment and logistics of coping with a continuing global pandemic. First, speakers noted a likely focus on liquidity events resulting from an economic downturn, citing the potential tumult in the real estate market, for instance. Fluctuating valuations of securities caused by rapid growth and drops in the market may be a focus of exams. Second, speakers emphasized that ensuring policies and procedures are in place that lead to proper supervision of employees is likely to be a concern in examinations. Finally, speakers discussed the July creation of the Emerging Risk Examination Team (ERET) within OCIE, which is tasked with providing specialized support to examination teams where a crisis event may occur. As the COVID-19 pandemic continues, OCIE expects the ERET, along with its usual resources, to continue to address the changing compliance landscape.

II. ACCOUNTING ISSUES

In a panel led by Sagar S. Teotia, the SEC's Chief Accountant, senior accountants from the Divisions of Enforcement, Corporate Finance, and Investment Management discussed accounting updates and issues encountered in the past year.

A main discussion point was the effect of COVID-19 on accounting procedures. The Office of the Chief Accountant received a large volume of questions related to COVID-19 and the speakers emphasized the Office's dedication to providing high-quality financial information. Mr. Teotia focused on the staff's collaborative efforts with domestic and international entities alike to increase transparency in a global market affected by the pandemic.

The Chief Accountant for the Division of Enforcement, Matthew S. Jacques, highlighted the Division's work to become more efficient in its investigations. Rather than examining a large swath of information, the Division is conducting smaller, targeted inquiries. Mr. Jacques also warned that recent market declines and stress may reveal past misconduct or encourage new misconduct. He explained that it is still too early to distinguish these patterns but the Division is on high alert and actively searching for misconduct. Mr. Jacques concluded his

remarks with a discussion of best practices. In particular, given the technical nature of accounting investigations, Mr. Jacques highlighted the importance of including knowledgeable professionals in discussions with the SEC in order to expedite and elucidate the investigatory process.

Keeping with the theme of guidance with respect to the era of COVID-19, the Chief Accountant for the Division of Investment Management, Alison Staloch, discussed the Division's update of Frequently Asked Questions related to the custody rule and issues with board meetings and electronic signatures to fit the needs of remote work. She also introduced the revival of the "Dear CFO" letters, which are comment letters designed to inform companies and their accountants regarding financial reporting, auditing, and other accounting matters. This year marked the first letter issued in nearly 20 years; the last letter was published in 2001.

Finally, the Chief Accountant for the Division of Corporate Finance, Craig C. Olinger, discussed the new rules on guarantor reporting which were enacted in March 2020. These rules amended financial disclosure requirements applicable to registered debt offerings that include credit enhancements, such as subsidiary guarantees. The amendments were enacted to increase the likelihood that issuers will conduct registered debt offerings. The changes are not effective until January 2021, but Mr. Olinger explained that some voluntary compliance has already occurred.

III. JUDICIAL AND LEGISLATIVE DEVELOPMENTS

The Office of the General Counsel hosted a panel discussing major case developments over the past year. Led by General Counsel Robert Stebbins, the panel, consisting of SEC litigators with firsthand experience of each case, explained the rulings and their potential implications.

Liu v. SEC

The panelists began by discussing the Supreme Court's decision in *SEC v. Liu*,[2] which they view as favorable for the SEC. The *Liu* case traces back to a fraud investigation concerning the EB-5 Immigrant Investment Program, which resulted in a disgorgement penalty of nearly $27 million.

Senior litigation counsel first gave a brief background on an earlier case, *Kokesh v. SEC*,[3] where the Supreme Court ruled against the SEC, determining that disgorgement is subject to the five-year limitations period.[4] A footnote in the *Kokesh* opinion, however, left open the question of whether the SEC even had the authority to order disgorgement.

Turning to that question in *Liu*, the Supreme Court determined that disgorgement was permissible as an equitable remedy, but that the amount must be limited to the wrongdoers' net profits and be awarded to the victims. The Court remanded the case to the district court for a determination on whether the disgorgement amount in *Liu* was fair based on these principles.

The speakers identified three takeaways from the *Liu* decision.[5] The first concerns the disbursement of disgorged sums. Per the *Liu* decision, disgorgement must be for the benefit of investors. One panelist stated that, where possible, the Commission will continue to identify victims who may be compensated through disgorged amounts, but nevertheless submitted that, in the SEC's view, funding the Treasury with the disgorgement penalty may still be justified in certain circumstances, such as when the victims cannot be identified. Second, the staff observed that, recognizing the Supreme Court's apparent concern with the broad scope of joint and several liability for disgorgement, the Commission will only permit joint and several liability if the parties participated in a "concerted

wrongdoing."[6] Third, as relates to net profits and expenses, the panelists explained that the Supreme Court held that the Commission must deduct business expenses before disgorgement so long as those expenses are legitimate. The panel stated the Commission will continue to seek disgorgement on a consistent basis and will follow these principles. The discussion did not explore significantly the types of expenses or other considerations that might be relevant to determining net profits based upon the facts of an individual case, and those issues will continue to be a focus for registrants and others.

Gentile v. SEC

Several panelists then addressed *Gentile v. SEC*, a Third Circuit decision that speaks to another issue relating to *Kokesh*, the Commission's authority to obtain injunctions.[7] *Gentile* concerned two pump and dump schemes to manipulate penny stocks, which resulted in millions of dollars in ill-gotten gains for the respondent, who was arrested in 2012. When his cooperation agreement fell through in 2016, he announced he was starting a brokerage firm in the Bahamas. The SEC sought an injunction to stop this new business venture.

As the panel explained, the district court determined that, in light of *Kokesh*, an injunction was a penalty subject to the five-year statute of limitations and was therefore barred. The speakers noted that the Third Circuit vacated the district court's opinion, determining the SEC injunction was consistent with congressional intent of preventing harm by forestalling future violations. In discussing the Third Circuit's rationale, the panelists emphasized the court's conclusion that Congress authorized the Commission to seek injunctions to deter and protect the public and that the injunction sought by the Commission was intended to prevent future misconduct, not penalize the wrongdoer for his prior violations.

Regulation Best Interest (Reg BI)

A senior litigation counsel also addressed one of the Commission's newest regulations, Regulation Best Interest (Reg BI). Commissioner Caroline Crenshaw, the newest member of the Commission, also made a point to stress the importance of this regulation in her remarks and its potential to ensure retail investors are protected from misaligned advisors.

The panelists explained that Reg BI enhances and codifies the standards of conduct for broker-dealers, requiring that broker-dealers act in the best interest of retail customers. The speakers outlined four obligations established by Reg BI: (1) Disclosure – broker-dealers must provide either before or at the time of investment a full and fair disclosure of material facts about the investment and any conflicts of interest; (2) Care – broker-dealers must act with reasonable diligence, care, and skill; (3) Conflicts of Interest – broker-dealers must establish and maintain enforcement procedures reasonably designed to identify and mitigate conflicts of interest; and (4) Compliance – broker-dealers must have written policies reasonably designed to stay in compliance with this regulation.

The speakers then highlighted a recent victory in a case that challenged the validity of the SEC's authority in adopting Reg BI.[8] The petitioners argued that Reg BI was arbitrary and capricious and that the Commission exceeded its rulemaking authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Second Circuit rejected these arguments and ruled in favor of the SEC, upholding Reg BI.

Rule 30e-2

The panel then shed light on the recent judicial review of SEC Rule 30e-3. According to the panel, SEC Rule 30e-3 modernized the delivery of financial reports by allowing funds to deliver them electronically rather than by mail. A consumer advocacy group and representatives of the paper industry brought an action against the SEC,

arguing the rule is arbitrary and capricious because it prioritizes cost savings over delivery preferences.[9] In contrast, the panel explained, the SEC argued that the decision to modernize fund disclosure is appropriate and sufficiently tailored to protect the investor.

The court agreed with the SEC and determined that neither the paper company nor the consumer advocacy group had standing. The paper-industry representatives asserted interests beyond those that are regulated by the SEC, and the consumer advocacy group failed to identify any actual injury.

Exchange Fees (NASDAQ / NYSE)

The SEC concluded the panel by highlighting two decisions that were adverse to the Commission relating to exchange fees. The first case settled a 14-year legal dispute concerning fee increases on U.S. stock exchanges. The panelists explained that the SEC rejected the fee increases charged by exchanges for market data. The U.S. Court of Appeals for the D.C. Circuit determined that the SEC cannot suspend or challenge fee increases if they do not act within 60 days after the exchange files a notice indicating a change in price.[10] The second case concerned a two-year pilot program announced by the SEC to examine the fees and rebates structure that U.S. exchanges implement. The Commission argued that the pilot program was structured to promote liquidity and competition. As the panelists explained, the D.C. Circuit disagreed, vacated the pilot program, and determined that the SEC lacked the authority to adopt it.[11] The panelists further explained that, according to the court, the SEC does, however, have the authority to run a pilot program to collect data to see if there is an issue.

IV. ENFORCEMENT INITIATIVES

In his opening remarks, SEC Chairman Jay Clayton praised the Enforcement Division for its productive year, having brought over 700 actions and increased remedies by 10 percent. At the same time, Commissioner Roisman cautioned against “regulation by enforcement” and emphasized that compliance, rather than enforcement, should be the primary objective. With that backdrop, a panel from the Division of Enforcement recapped the Division's work over the past year—including adaptations made to remain effective and efficient in a telework environment—and offered practical considerations and insight for the defense bar.

Enforcement in the Era of COVID-19

The panel discussed ways in which the Division has modified its techniques and leveraged technology to proceed with investigations virtually without interruption in the era of COVID-19. Associate Director Anita Bandy noted that, to assist with triaging potential witnesses, the Division has more frequently invited proffers at the early stages of an investigation. She added that, for the most part, remote testimony has been seamless. Director Stephanie Avakian further stated that, since March, the Division has held numerous Wells meetings by video and found them to be just as effective as in-person meetings. On the litigation side, Chief Litigation Counsel Bridget Fitzpatrick confirmed that the SEC is proceeding with depositions on a virtual basis in accordance with court orders, and has even completed a virtual bench trial. She pointed to a recent district court order that helpfully outlines remote deposition protocols, including “best practices” for video testimony.[12]

The panel also highlighted the Division's COVID-19-related enforcement efforts. Ms. Avakian stated that the Division has opened more than 150 investigations in connection with COVID-19 issues, and she underscored the trading suspensions and enforcement actions arising from apparent COVID-19 investment scams. Deputy Director Marc Berger explained that, going forward, the Division will be focusing on financial disclosures, such as

performance and valuations, and the extent to which those figures may be used to disguise weaknesses derived from the pandemic.

Implications of *SEC v. Liu*

Chief Counsel Joseph Brenner addressed the Division's perspective on disgorgement in light of *Liu*. Mr. Brenner explained that, since the decision, communications with defense counsel have focused on the court's directive that legitimate business expenses must be deducted from the disgorgement amount. He suggested that counsel advocating for deductions be prepared to explain what makes the expenses legitimate *(i.e.*, describe the value add for investors), how the expenses are tied to profits earned from the fraud, and how the expenses should be computed. Mr. Brenner emphasized that a negotiation regarding disgorgement is most constructive if defense counsel can analyze the disgorgement amount up front and share that analysis with the enforcement staff.

Ms. Fitzpatrick added that, in the litigation context, defense counsel should expect the Commission's trial attorneys to actively pursue discovery regarding the issues remanded in *Liu*, including the nature of any business expenses, in an effort to make a complete record with respect to claims of disgorgement.

Noteworthy Cases

The Division of Enforcement panelists primarily discussed two areas of enforcement focus over the past year. First, Ms. Avakian elaborated on cases involving financial fraud and issuer disclosure, which tend to be complicated and time-intensive given the volume of documents and witnesses involved. As a result, the Division has endeavored to streamline and accelerate these investigations by increased staffing, early substantive engagement, and imposing a tighter post-investigation schedule for all parties. Ms. Bandy then discussed the first cases brought under the division's Earnings Per Share Initiative, which aims to use risk-based data analytics to identify potential accounting and disclosure violations reflected in the reporting of quarterly earnings per share.[13] She also cautioned that the Division will be closely monitoring COVID-19-related effects on financial accounting and disclosures, taking cues from principles applied following the 2008 financial crisis.[14] In particular, the Division will consider whether the financial disclosures reflect information that is out of line with industry peers.

Second, in the retail space, Mr. Berger noted that the Division is focused on misconduct arising in interactions between investment professionals and retail investors. For example, a recent failure-to-supervise case alleged that registered representatives did not fully understand the risks associated with certain complex ETF products and, as a result, recommended the products to unsuitable investors, including senior citizens and retirees. In another case, a firm had failed to disclose conflicts of interest presented in retirement plans offered to teachers. Additionally, Mr. Berger stated, Ponzi schemes and offering frauds targeting retail investors continue to be a concern, particularly where the scheme victimizes members of an identifiable group or community.

Whistleblower Program

Commissioner Crenshaw highlighted the success and importance of the Commission's Whistleblower Program, which had a record-breaking year. According to Ms. Avakian, the awards represent one-third of the money awarded in the history of the program. Furthermore, whistleblower tips prompted 202 enforcement actions, resulting in $765 million in financial remedies. Both Commissioner Crenshaw and Ms. Avakian pointed to the recent amendments to the rules governing the Whistleblower Program, which are intended to increase the efficiency with which awards to whistleblowers are processed and the transparency of the program.

Practical Considerations: Cooperation Credit and Attorney-Client Privilege

Ms. Bandy spoke to the Division's ongoing efforts to credit cooperation appropriately, explaining that cooperation is largely still evaluated under the factors announced in the "Seaboard Report" issued by the SEC in 2001.[15] The seminal consideration is whether the cooperation substantially enhanced the quality and efficiency of the investigation. In a recent case, for example, the respondent was forthcoming and proactive and, notwithstanding the complexity of the matter and the difficulties presented by collecting evidence internationally during the pandemic, worked to produce quickly documents and witnesses such that the investigation was resolved within ten months. As a result of this cooperation and other substantial remediation efforts, the Commission imposed a reduced penalty.[16]

Mr. Berger also offered insight regarding the Division's consideration of claims of attorney-client privilege. He cautioned that entities should be mindful of privilege designations and expect follow-up questions from the staff on privilege logs. He also flagged concerns related to the staff's receipt of a substantial supplemental production following a second-level privilege review and explained that receiving a large, belated production can interfere with the investigation.

FOOTNOTES

[1] For more insight regarding these amendments (and the industry's mixed reactions), we direct you to a recent episode of our firm's podcast, Voluntary Disclosure, available here.

[2] 140 S. Ct. 1936 (2020). Our recent alert discusses the implications of the *Liu* holding: *Liu v. SEC: The Supreme Court Limits the SEC's Disgorgement Power and Sets the Stage for Future Legal Battles* (June 24, 2020), available here.

[3] 137 S. Ct. 1635 (2017).

[4] 28 U.S.C. § 2462.

[5] The panel mentioned that, in light of Liu, several cases have been remanded back to the district court for a determination on the fairness of the disgorgement penalty.

[6] *See Liu*, 137 S. Ct. at 1949 ("The common law did, however, permit liability for partners engaged in concerted wrongdoing . . . the Court need not wade into all the circumstances where an equitable profits remedy might be punitive when applied to multiple individuals.").

[7] 939 F.3d 549 (3d Cir. 2019).

[8] XY Planning Network v. SEC, 963 F.3d 244 (2d Cir. 2020).

[9] Twin Rivers Paper Co., LLC v. SEC, 934 F.3d 607 (D.C. Cir. 2019).

[10] NASDAQ v. SEC, 961 F.3d 421, 423 (D.C. Cir. 2020) ("[A] provision of the [Dodd-Frank Act] deprives us of jurisdiction to review the Commission's decision not to suspend a fee rule within 60 days under Section 19(b)(3)(C) of the Exchange Act.")

[11] NYSE v. SEC, 962 F.3d 541, 546 (D.C. Cir. 2020) ("Nothing in the Commission's rulemaking authority authorizes it to promulgate a 'one-off' regulation like Rule 610T merely to secure information that *might* indicate to the SEC whether there is a problem worthy of regulation.").

[12] *See* SEC v. Commonwealth Equity Servs., LLC, Order Allowing Depositions by Remote Means and Establishing Remote Deposition Protocols, No. 1:19-cv-11655, ECF No. 46 (Sept. 16, 2020).

[13] *See* In the Matter of Fulton Fin. Corp., Admin. Proc. File No. 3-20084 (Sept. 28, 2020); In the Matter of Interface Inc., Admin. Proc. File No. 3-20085 (Sept. 28, 2020).

[14] A recent alert by our firm discusses in detail how the SEC's response to the 2008 financial crisis can offer insights as to the SEC's expected reaction to fraud and securities violations arising from the COVID-19 pandemic. *See COVID-19: Still Open for Business, and Business is Booming: What Companies Should Expect from the SEC in the Time of COVID-19* (June 2, 2020), available here.

[15] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Release No. 34-44969 (Oct. 23, 2001), available here.

[16] *See* In the Matter of Bayerische Motoren Werke Aktiengesellschaft, Admin. Proc. File No. 3-20060 (Sept. 24, 2020).

KEY CONTACTS

MEGHAN E. FLINN
PARTNER

WASHINGTON DC
+1.202.778.9458
MEGHAN.FLINN@KLGATES.COM

HAYLEY TRAHAN-LIPTAK
PARTNER

BOSTON
+1.617.951.9148
HAYLEY.TRAHAN-LIPTAK@KLGATES.COM

CHELSIE D. RIMEL
ASSOCIATE

WASHINGTON DC
+1.202.778.9157
CHELSIE.RIMEL@KLGATES.COM

STEPHEN G. TOPETZES
PARTNER

WASHINGTON DC
+1.202.778.9328
STEPHEN.TOPETZES@KLGATES.COM

