

# Daily Journal

www.dailyjournal.com

FRIDAY, DECEMBER 18, 2020

PERSPECTIVE

## SEC Overcomes COVID-related Challenges and Declares Successful Enforcement Year

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In 2020, the Securities and Exchange Commission's Enforcement Division achieved what Director Stephanie Avakian described as "extraordinary results" in the face of the unexpected and unprecedented challenges posed by the global coronavirus pandemic. Although the 715 enforcement cases filed in FY2020 are a marked decrease from the previous year, the SEC collected a new record of \$3.589 billion in disgorgement, representing a roughly 10% increase from FY2019. By contrast, the SEC distributed only \$602 million to harmed investors in FY2020, barely exceeding half of that returned to harmed investors in the prior fiscal year.

Looking ahead to 2021, SEC Enforcement Division practices are set to shift considerably with the incoming Biden administration. Though rumors continue to swirl regarding who specifically President-elect Joe Biden may tap as chair of the SEC, the expectation is that this individual will likely have a prosecutorial background, marking a pronounced swing of the pendulum back towards stricter enforcement practices. The new "tone at the top" from Biden's chosen chair — whoever that may be — is likely to echo the regulation-centric priorities of the Commission under the Obama administration and former Chair Mary Jo White. This shift in enforcement priorities is expected to lead to a renewed increase in enforcement actions brought, and to continue the increase in penalties assessed and disgorgement awarded in 2017, 2018 and 2019.

Nevertheless, a more aggressive SEC could face a significant obstacle in implementing its new enforcement priorities: a more conservative federal court system in which President Donald Trump has appointed nearly 200 federal judges plus three Supreme Court justices. In the Su-

preme Court, this turnover may only reinforce the status quo. The SEC has suffered a string of defeats over the last few years, as overwhelming, bipartisan majorities of Justices have rebuked the SEC's efforts to exceed its express statutory or constitutional authority to pursue disgorgement beyond the applicable five-year statute of limitations (*Kokesh v. SEC*, unanimous decision), to appoint administrative law judges (*Lucia v. SEC*, 7-2 decision), and, most recently, to seek inequitable disgorgement awards untethered to investor harms (*Liu v. SEC*, 8-1 decision). The first insight into this friction will likely come from the interpretation of SEC disgorgement limitations promulgated in *Liu*,

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where the SEC's desire for greater disgorgement awards may conflict with courts' application of this opinion. In its FY2020 Enforcement Report, the Commission notes that depending on how lower courts apply *Liu's* limitations on disgorgement, the SEC may be left with no choice but to recommend higher statutory penalties in lieu of disgorgement.

#### Navigating a COVID-19 Environment

As the Enforcement Division succinctly noted in its annual report, "the real story of 2020 was COVID-19." Indeed, by late March, the Enforcement Division established a "Coronavirus Steering Committee" to coordinate investigative and regulatory efforts into COVID-19's impacts on the financial markets, including scams targeting retail investors and misuse of material nonpublic information to take advantage of market volatility. Like many of us, the Enforcement Division staff began working remotely in March and continues to do so today. Although the initial transition

was a struggle that caused a multi-week disruption to productivity, the Enforcement Division learned to operate in these conditions. Despite FY2020's many disruptions, between mid-March and fiscal year-end the Enforcement Division recommended 36 trading suspensions and 492 enforcement cases; opened 640 inquiries and investigations (over 150 of which related to COVID-19 issues); and triaged over 16,000 tips, complaints, and referrals — all while reducing the median investigation time to 21.6 months (the quickest rate in the past five years).

The first enforcement action against a public company focusing on COVID-19 disclosures recent-

2020 disclosures, the SEC's approach to COVID-19 also signals the SEC's views on future black swan events.

#### Whistleblower Program's Record-Breaking Year

The SEC's Office of the Whistleblower had another banner year in 2020, awarding approximately \$175 million to 39 individuals, the largest amounts in the past 10 years and an almost 300% increase from 2019. As a result, the Enforcement Division anticipates receiving substantially more tips moving forward, and, in recognition of the fact that the Enforcement Division investigates a very small percentage of the tips received, the SEC is working to accelerate the evaluation of claims. Clearly, the whistleblower program remains a critical part of the SEC's enforcement program, allowing it to investigate and file more enforcement actions and obtain higher financial remedies. Given the stated success of the whistleblower program and 2020 results, we should expect to see increased whistleblower activity in 2021 and even more records shattered.

The SEC also continued its efforts to enforce Rule 21-F, which generally prohibits impeding the efforts of whistleblowers. The Commission filed an action in federal court in New York alleging that defendants entered into a settlement agreement with investors to resolve litigation by the investors in violation of Rule 21-F. The settlement agreement in the underlying case expressly prohibited the investors from speaking with the SEC about their claims, and the defendants allegedly sued the investors for breach of the agreement. The SEC case is pending.

#### International Enforcement

In FY2020 the SEC continued to flex its regulatory muscle against foreign companies seeking access to U.S. capital markets. For example, the SEC entered into an \$18 million settlement with German automaker BMW AG to resolve an enforcement ac-

ly crossed the finish line. The SEC announced a settlement with The Cheesecake Factory, Inc. earlier this month related to public statements in March and April about the pandemic's impact on the company's operations and financial condition. Despite the company's contemporaneous disclosures about changes to the company's business model and withdrawal of prior guidance, the SEC alleged that statements that the company was "operating sustainably" were materially misleading because internal documents showed that "the company was losing \$6 million in cash per week and ... projected that it had only 16 weeks of cash remaining" and the company had already "informed its landlords that it would not pay rent in April due to the impacts that COVID-19 inflicted on its business."

It remains to be seen whether The Cheesecake Factory settlement is a harbinger of cases to come. Even if only a small number of these cases is brought by the SEC, issuers would be wise to review them carefully. As important as it is for companies'

tion related to purportedly misleading statements the company made about its sales volumes while offering corporate bonds to U.S. investors through a U.S. financing subsidiary. BMW AG allegedly inflated its retail sales by having its North American subsidiary maintain a reserve of unreported sales it could use to satisfy internal sales targets and paying dealers to designate unsold cars as “demonstrators” or “loaners” to inflate the number of sales. Enforcement Division Director Avakian, noted that companies that seek access to U.S. capital markets “have an obligation to provide accurate information to investors.”

As another example of the SEC’s focus on regulating foreign companies’ access to U.S. investment capital, the Enforcement Division brought enforcement actions related to “pre-releases” of American Depository Receipts. ADRs are essentially certificates sold by U.S. banks that correspond to shares of foreign companies, which the banks have purchased and are holding, which allow American investors to invest in companies listed exclusively on foreign exchanges without incurring high fees or needing to exchange currency. Ensuring market integrity in pre-releases of ADRs has been a focus of the Commission over the past two years. This initiative, which has now ended, resulted in over a dozen actions totaling more than \$432 million in disgorgement and penalties.

Looking ahead to next year, a top priority for the SEC (and potential source of friction for U.S. foreign relations) may very well be increasing the quality of financial disclosures from Chinese companies listed on U.S. markets. Recent legislation passed by Congress (but not yet signed into law) requires many foreign companies to: (i) accede to increased Public Company Accounting Oversight Board oversight over the auditors reviewing these companies’ financial statements; and (ii) provide more detailed disclosures about foreign governments’ ownership of these companies. Should any such company fail to do so over several years, this legislation requires the Commission to prohibit trading of that company’s securities in the Unit-

ed States. This expected regulatory initiative is in line with the SEC’s stated goals to ensure that foreign companies seeking to raise capital in the U.S. provide adequate disclosures to investors when doing so.

#### **Disclosure Trends: Renewed Focus on Environmental, Social and Governance Issues**

The SEC will be one of the most important federal agencies for advancing environmental, social and governance priorities, particularly with regard to climate change and board diversity. Public disclosures regarding climate-related policies, including climate risk disclosure, can be expected to take shape under a Democrat-controlled SEC, consistent with President-elect Biden’s campaign commitment to require publicly traded companies to disclose climate risk and greenhouse gas emissions in their operations and supply chains. Democratic Commissioners Allison Herren Lee and Caroline Crenshaw have expressed support. Commissioner Lee has called climate change a “systemic risk to financial markets” and called for standardized disclosures by financial institutions regarding climate change. More broadly, we also expect to see a greater push particularly from the investor community for SEC-required disclosures, akin to what is required already in financial accounting in order for investors to better compare and evaluate companies’ environmental, social and governance performance.

Unless control in the Senate slips away from the Republicans, legislation such as the Diversity in Corporate Leadership Act is unlikely to get real traction. However, the SEC may advance some initiatives such as revisiting public disclosure of board diversity. Currently, pursuant to guidance issued by the SEC in February 2019 under Item 401(e) of Regulation S-K, to the extent the board considered self-identifying diversity characteristics, the SEC “would expect that the company’s discussion required by Item 401 would include, but not necessarily be limited to, identifying those characteristics and how they were considered.” However, as SEC Commissioner Lee has remarked, companies have been left to determine whether diversity information

is material. The new SEC chair could make board diversity a higher priority by pushing to amend Reg S-K to require data and reporting regarding gender and racial diversity on corporate boards, as well as new Nasdaq rules that require listed companies to disclose diversity statistics and have at least two diverse directors on its board.

#### **The New, Expanded “Insider Trading”**

Although the number of insider trading cases dipped during the SEC’s fiscal 2019 and 2020, continuing a downward trend that began in the Obama administration, 2020 may best be remembered for “insider trading” cases that did not allege insider trading.

In one such case against a private equity firm, the Commission alleged that the firm invested several hundred million dollars in a public company, allowing it to appoint a senior employee to the company’s board. The SEC alleged that the private equity firm obtained potential material nonpublic information about the company, specifically through the firm’s representative on the company’s board. After receiving this information, the private equity firm allegedly purchased more than 1 million shares of the company’s common stock, which was 17% of the publicly available shares. Although the SEC did not allege insider trading, the Commission found fault with the firm’s failure to require its compliance staff, prior to approving the trades, to sufficiently inquire and document whether the board representative and others possessed material nonpublic information relating to the portfolio company. The firm paid a \$1 million penalty to settle the matter.

In another 2020 case — this time involving a public company — the SEC assessed a \$20 million penalty based on allegations that the company’s internal accounting controls were inadequate to determine whether the company was in possession of material nonpublic information at the time of a company share buy-back. The case drew an unusual public dissent by two Commissioners who noted, “Make no mistake: Insider trading by public companies engaged in share

repurchases is unacceptable, and we support all appropriate actions — including charges under Rule 10b-5 — when companies use material non-public information to take advantage of their shareholders. ... But the tools we use must be fit for the task. And in this case, we believe [internal accounting controls rules are] not the appropriate tool.”

Looking forward, expect the Biden administration’s SEC to renew scrutiny of so-called 10b5-1 plans under which public company insiders can lawfully sell shares according to a pre-determined schedule. More than 10 years ago, an academic study questioning the statistically abnormal returns for 10b5-1 trading was followed by warnings from the SEC’s Enforcement Division, and, ultimately, an enforcement action involving 5 million options sold pursuant to the Rule 10b5-1 plan, resulting in proceeds of over \$139 million. Now, in a case of regulatory déjà vu, a 2020 academic study suggests that executives make prearranged sales of company stock more frequently on days when their companies announce positive news than on days when negative news is announced. Expect regulatory action to follow in 2021.

#### **Conclusion**

The Enforcement Division had a successful year in FY2020, advancing several initiatives and obtaining more penalties and disgorgement awards. With President-elect Biden’s potential appointment of a more prosecutorial-minded chair and an increased ability to manage COVID-19-related challenges, we expect FY2021 to result in more aggressive SEC enforcement.

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