ThompsonKnight

Client Alert *November 13, 2019*

HIGHLIGHTS FROM THE SEC DIVISION OF ENFORCEMENT'S FISCAL YEAR 2019 ANNUAL REPORT

On November 6, 2019, the United States Securities and Exchange Commission's Division of Enforcement (the "Division") published its Annual Report for Fiscal Year 2019 (October 1, 2018 to September 30, 2019), available here (the "Report").[1] Again this year, the Division reported its results in the context of advancing "five core principles": (1) retail investor protection, (2) individual accountability, (3) keeping pace with technological change, (4) imposing remedies that most effectively further enforcement goals, and (5) constantly assessing the allocation of resources.

Of 862 total enforcement actions filed in FY19, 526 were "standalone," 210 were follow-on administrative proceedings, and 126 were limited-scope actions to deregister public companies for failing to timely file public reports with the Commission (see Exhibit A). Notably, the Division's Share Class Selective Disclosure Initiative accounted for approximately 18% of its standalone filings. Those actions, and the accelerated completion of other actions involving self-reporting and cooperation, buoyed results for a year that included a 35-day government shutdown and, according to Division Co-Directors Stephanie Avakian and Steve Peikin, "significant headwinds" stemming from the Supreme Court's decisions in *Kokesh v. SEC*, 137 S. Ct. 1635 (2017) and *Lucia v. SEC*, 138 S. Ct. 2044 (2018).[2]

CONTINUED FOCUS ON RETAIL INVESTORS

Keeping with Chairman Jay Clayton's mission, the Division continued its emphasis on protecting retail investors and noted the success of its Share Class Selective Disclosure Initiative. Since its inception in February 2018, the Initiative has resulted in 95 enforcement actions and more than $135 million being returned to affected investors.[3] In these cases, the Division recommended standardized settlement terms for advisory firms that self-reported their failure to disclose conflicts of interest in selecting fee-paying mutual fund share classes for clients, despite the availability of no-cost or lower-cost share classes in the same fund. The Division describes the Initiative as an extraordinary success and noted that its scale and speed of returning funds to harmed investors is "otherwise unachievable" through individual enforcement alone.[4]

Throughout FY19, the Division continued to pursue fraudulent securities offerings and violations by broker-dealers, investment advisers, and others who brought harm to retail investors. In its Report, the

[1] U.S. Securities and Exchange Commission, *Div. of Enforcement Annual Report* (Nov. 6, 2019).

[2] *Kokesh* held that the Commission's claims for disgorgement are subject to a five-year statute of limitations. *Lucia* held that appointment of SEC Administrative Law Judges is subject to the Appointments Clause of the U.S. Constitution.

[3] *Annual Report*, at 2.

[4] *Id.*

Division also notes the important interplay between prevention and enforcement, highlighting two new objectives for the Retail Strategy Task Force it formed in 2018: a Teachers' Initiative and a Military Service Members' Initiative,[5] each focused on increasing investor knowledge and education, while also guarding against investment fraud.[6]

HOLDING ISSUERS, FINANCIAL INSTITUTIONS, GATEKEEPERS, AND INDIVIDUALS ACCOUNTABLE

The Division also continued its efforts to root out misconduct at both the issuer and financial institution levels (including audit firms), noting that "accurate financial and other disclosures are the bedrock of our capital markets."[7] Several public companies were at the center of the Division's focus for a wide array of alleged conduct, including fraud, misleading risk factor disclosures, and deficient disclosure controls. Notable companies subject to enforcement actions in FY19 include Facebook Inc., Nissan, and Hertz Global Holdings Inc.[8]

In FY19, the Commission filed enforcement actions against a number of audit firms, and the Report notes the critical gatekeeping role they play in the markets (see Exhibit B). Of particular note, KPMG was ordered to pay a $50 million civil penalty in a settled action based on violations of PCAOB Rule 3500T, requiring audit firms to "maintain integrity in the performance of a professional service." In its order, the Commission found, and KPMG admitted to, "significant misconduct across the entire organization" that included theft of confidential PCAOB inspection information and a widespread internal test-cheating scandal involving numerous KPMG audit professionals.[9] Likewise, PricewaterhouseCoopers, LLP was ordered to pay $7.9 million in monetary remedies for violating auditor independence rules by providing prohibited non-audit services to a public issuer during an audit engagement of the issuer as well as for its improper professional conduct in failing to properly disclose to audit committees of multiple issuers that it was performing non-audit services for those issuers.[10]

The Report also reminds readers that the Division's enforcement reach extends to the individual bad actors at fault in these violations, which is evidenced by the fact that 69% of the Commission's standalone actions involved charges against one or more individuals. True to its goal of specific and general deterrence within the corporate structure, the Commission charged individuals throughout the corporate hierarchy, including C-suite actors and gatekeepers.

CYBER MISCONDUCT AND DIGITAL ASSETS

The Division continued its efforts throughout FY19 to detect and confront wrongdoing by issuers and other participants operating in the digital asset space, including through the Cyber Unit it formed in

[5] *Id.* at 11.

[6] *Id.*

[7] *Id.* at 2.

[8] *Id.* at 3.

[9] *Id.* at 4.

[10] *Id.* at 5.

2017 "to combat cyber-related threats by focusing Enforcement resources and expertise on, among others things, violations involving distributed ledger technology, cyber intrusions, and hacking to obtain material, nonpublic information."[11]

The Report notes that in FY19, the Division "matured and expanded" these enforcement efforts. While continuing to pursue and punish those who intentionally violate the law, the Commission also brought actions under the securities laws requiring registration of securities offerings and exchanges, regulating broker-dealers, and prohibiting improper promotion, also known as "touting," of Initial Coin Offerings, or "ICOs". Such actions underscore a continuing refrain from the Commission that it will continue to regulate in this area. As it expands the scope and breadth of its enforcement reach involving digital assets, the agency is demonstrating a willingness to commit resources—including funding, staff, and analytics—to keep pace with an evolving industry and technological change.

Importantly, the Report notes that in FY19 the Commission settled with three digital asset issuers, which included "resolutions designed to bring issuers into prospective compliance with the securities laws" that "provide issuers a path to compliance with registration requirements."[12] Chairman Clayton also discussed a "path to compliance" in an April 2019 speech, stating further that "[t]his path includes appropriate disclosures to investors so they can make a more informed decision as to whether to seek reimbursement or continue to hold their tokens."[13] These sentiments, and the settled enforcement actions, not only dovetail with the Division's encouragement of self-reporting and cooperation, but also offer some guidance to industry participants about the issues they should consider, and the analysis they should undertake, when working in or around investments involving digital assets.

STRATEGIES TO IMPROVE THE EFFICIENCY AND PACE OF INVESTIGATIONS

A recurring theme in the Report, and a stated goal for FY20, is the Division's emphasis on accelerating the pace of its investigations, guided by the Division's belief that "cases have the greatest impact when they are filed as close in time to the conduct as possible."[14]

On average in FY19, a Division investigation lasted approximately two years between case opening and the filing of an action. The Division is focused on reducing the length of investigations and expects to see its best results on this front in financial fraud and issuer disclosure cases, which in FY19 took an average of 37 months from opening to filing. Notably, these statistics do not address investigations that are ultimately closed without any recommended enforcement action.

[11] Press Release 2017-176, SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors (Sept. 25, 2017), *available at* https://www.sec.gov/news/press-release/2017-176.

[12] *Annual Report*, at 12, 6, respectively.

[13] Jay Clayton, Chairman, Sec. and Exch. Comm'n, Management's Discussion and Analysis of the SEC: Remarks at the "SEC Speaks" Conference (Apr. 8, 2019), *available at* https://www.sec.gov/news/speech/speech-clayton-040819.

[14] *Annual Report*, at 7.

The Division continues to encourage cooperation, not only to reduce the duration of an investigation, but also for crediting meaningful efforts by companies and individuals. In FY19, the Commission continued to acknowledge cooperation by, for instance, reducing or even forgoing civil penalties in cases against PPG and Comscore.[15] While there is not a bright line test for establishing meaningful cooperation, practitioners, companies, and individuals continue to look to the Commission's statements in press releases and public orders as well as its 2001 Seaboard Report. That report provided a framework for considering companies' cooperation through, for instance, self-policing, self-reporting, and remediation.[16] Going forward, the Division says it is "endeavoring to find additional ways to message what companies and individuals have done to merit the cooperation credit they received."[17]

Both a September 2019 settled action against PPG Industries, Inc. and the Division's Share Class Selective Disclosure Initiative indicate that the potential for receiving cooperation credit (and reducing the duration of an investigation) increases for companies and individuals who not only cooperate during an investigation but also self-report and remediate.[18] Of course, the decision of whether, when, and how to self-report possible violations of the securities laws involves careful factual and legal analysis.[19]

Further, Division staff continue to refer matters to criminal authorities at both the state and federal level and collaborate on parallel investigations, especially those involving recidivists, Ponzi schemes, insider trading, and those who demonstrate an intent to defraud. In October 2019, more than 300 individuals representing the Commission, Department of Justice, FBI, and other agencies gathered at a Commission-hosted Criminal Coordination Conference to discuss best practices and strategies. The conference is an example of how the SEC and its colleagues in criminal enforcement, including those overseas, will continue to combine efforts and resources—including analytics and other tools—not only to detect and pursue securities fraud, but also to locate, apprehend, and hold individual wrongdoers accountable.

---

[15] *Id.* at 8.

[16] *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) ("Seaboard Report"), *available at* http://www.sec.gov/litigation/investreport/34-44969.htm.

[17] *Annual Report,* at 8. In addition to incentivizing companies' cooperation, the Commission's Whistleblower Program has led to significant SEC enforcement actions covering a wide array of violations and resulting in more than $2 billion in monetary remedies. Since the program's inception in 2011, the Commission has awarded 66 whistleblowers approximately $387 million. The Division reports that it received thousands of tips and a record number of whistleblower claims in FY19 and is now working to "streamline and substantially accelerate the evaluation of claims for whistleblower awards," and it expects "substantial improvement" in FY20. *Id.*

[18] *In re PPG Industries, Inc.*, Exchange Act Release No. 10,701 (Sept. 26, 2019), https://www.sec.gov/litigation/admin/2019/33-10701.pdf. "In this settled action, the Commission concluded that PPG improperly recorded expense accruals and misclassified income, which led to the company reporting inflated income results for two years." *Annual Report,* at 3.

[19] For more information on the legal implications of such actions, please contact one of the attorneys listed at the end of this document.

MONETARY REMEDIES

Overall, the Commission obtained more monetary remedies in FY19—$4.349 billion—than it did in FY18, though civil penalty sums were down slightly from last year (see Exhibit C).

One important factor spurring the Division to accelerate the pace of its investigations is the Supreme Court's June 2017 decision in *Kokesh v. SEC* that Commission claims for disgorgement are subject to a five-year statute of limitations.[20] Given that securities violations often involve complex facts and circumstances and can be particularly difficult to detect and prove, especially when bad conduct is intentionally concealed, *Kokesh* has presented a unique challenge to the Division to identify, investigate, and file actions timely enough to secure one of the Commission's strongest remedies. It should be noted, however, that legislation has been introduced to establish a statutory limitations period for the Commission and effectively undo *Kokesh*.

While the Division works to accelerate its investigative pace in FY20, the Commission's authority to obtain disgorgement stands to be further impacted. On November 1, 2019, the Supreme Court agreed to consider the Commission's very authority to seek disgorgement in *Liu v. SEC*.[21]

CONCLUSION AND LOOKING AHEAD

Moving into FY20, we expect these trends to continue and will watch for new developments in the courts and any new trends and priorities that emerge from the Commission now that it has returned to a full slate of five Commissioners (the Division has been hiring new staff after a more than two-year hiring freeze) as well as any trends that emerge with the approaching election.

If you have any questions about the information contained in this Client Alert, please contact the Thompson & Knight attorney with whom you regularly work or the attorneys listed below for more information.

CONTACTS:

Timothy R. McCormick
214.969.1103
Timothy.McCormick@tklaw.com

William L. Banowsky
214.969.1231
Bill.Banowsky@tklaw.com

Richard B. Roper
214.969.1210
Richard.Roper@tklaw.com

Michael W. Stockham
214.969.2515
Michael.Stockham@tklaw.com

Jessica B. Magee
214.969.1375
Jessica.Magee@tklaw.com

[20] 137 S. Ct. 1635 (2017).

[21] 754 F. App'x 505, 507 (9th Cir. 2018), *cert. granted sub nom.* Liu v. SEC, No. 18-1501, 2019 WL 5659111 (U.S. Nov. 1, 2019).

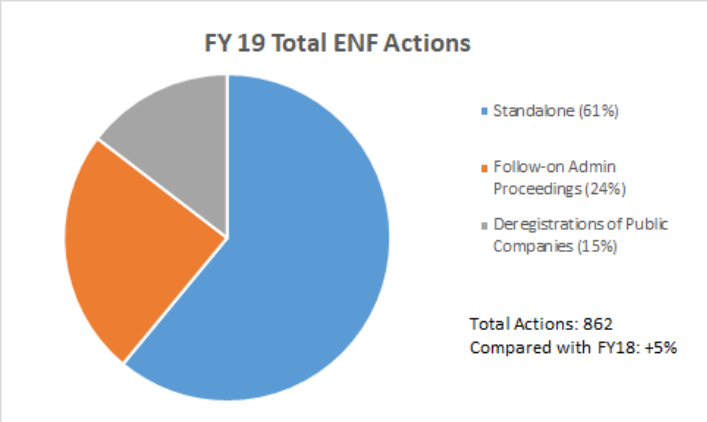

Exhibit A: Total Enforcement Actions Filed in FY19

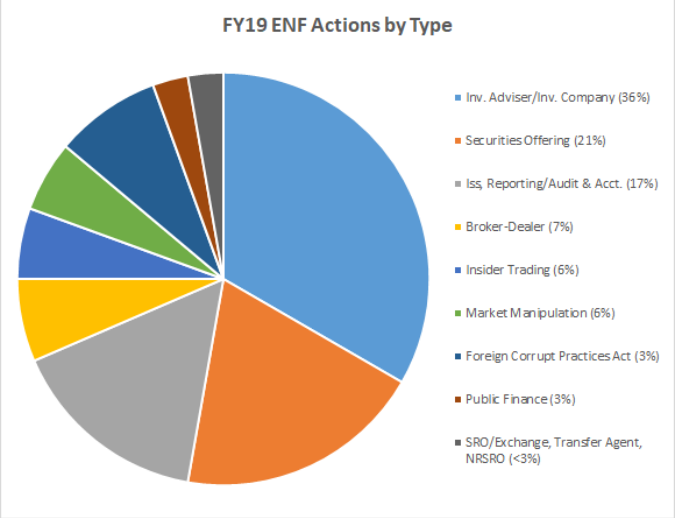

Exhibit B: FY19 Enforcement Actions by Type

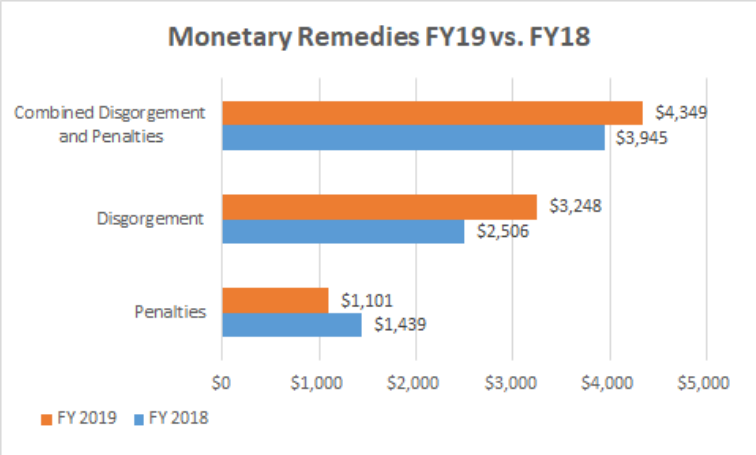

Exhibit C: Monetary Remedies – FY19 vs. FY18