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Legal Update

SEC Enforcement Annual Report FY2020: Key Takeaways and Trends

On November 2, 2020, the U.S. Securities and Exchange Commission ("SEC") Division of Enforcement staff published its annual enforcement report for fiscal year 2020.[1] This has been an unprecedented year, including for the SEC's Division of Enforcement. SEC Chairman Jay Clayton noted that the report highlights "enforcement's extraordinary efforts" amidst the challenges of the COVID-19 pandemic. Despite this, the SEC reported a 17% decrease in enforcement cases, but an increase in the amount of penalties those cases generated.

In this Legal Update, we provide our key takeaways, that include a continuing emphasis on investment advisers and broker-dealers, whistleblowers and individual accountability, trends for SEC enforcement in FY2020 and insights into what we may expect to see from the Division of Enforcement in the future, as well as the impact of the global pandemic on the SEC's enforcement efforts.

Highlights

1. *Seventeen percent decrease in enforcement cases, bigger penalties per case*: The SEC brought 715 enforcement cases in FY2020, but these cases resulted in approximately $4.68 billion in disgorgement and penalties – a record amount for the SEC. In contrast, in FY2019 the SEC brought 862 enforcement cases, resulting in only $4.3 billion in disgorgement and penalties. The chart below provides a comparison of the amount of SEC enforcement activity in recent years.

Enforcement Actions Filed in Fiscal Year 2015 to 2020						
	FY 2020	**FY 2019**	**FY 2018**	**FY 2017**	**FY 2016**	**FY 2015**
Standalone Enforcement Actions	405	526	490	446	548	508
Follow-On Admin Proceedings	180	210	210	196	195	167
Delinquent Filings	130	126	121	112	125	132
Total Actions	**715**	**862**	**821**	**754**	**868**	**807**

Source: Division of Enforcement, *2020 Annual Report* (Nov. 2, 2020).

Although there was a record-breaking amount of penalties in FY2020, it is unclear whether investors are seeing the benefits of the SEC's "big game" approach to enforcement. In FY2019, the SEC returned approximately $1.2 billion to harmed investors, but in FY2020, the SEC only returned roughly $600 million to harmed investors. Depending on the results of the recent presidential election, we expect that enforcement priorities may change going forward, which could impact the number and types of cases brought by the SEC.

2. *Registered Financial Professionals*: The conduct of investment advisers and broker-dealers, particularly as it applies to retail investors, continues to be an enforcement priority. Although investment adviser/investment company enforcement is down since the conclusion of the SEC's Share Class Selection Disclosure Initiative, it continues at the approximate levels seen prior to the launch of that initiative.[2] Similarly, the number of enforcement actions against broker-dealers remained relatively steady from FY2019. Finally, of specific note, proper disclosure by such entities remains a key focus for SEC enforcement, particularly with respect to conflicts of interest. Some noteworthy enforcement actions also focused on the following violations:
    - *Market Integrity*: Improper handling of "pre-released" American Depositary Receipts.
    - *Disclosure*: Providing misleading information to clients in retail wrap fee programs regarding trade execution services and transaction costs as well as failing to disclose conflicts arising from sources of investment adviser compensation.
    - *Regulation SHO*: Failing to correctly net positions and mark long and short sales in violation of Regulation SHO.
    - *Compliance*: Repeated failure to recognize red flags and file suspicious activity reports for U.S. microcap securities trades executed on behalf of customers as well as inadequate controls concerning the use and protection of material nonpublic information.
    - *Technical Rules/Shorting*: Violating the short tender rule in a partial tender offer.
    - *Regulatory Requirements*: Failing to provide complete and accurate blue sheet trading data.
    - *Record Retention*: Failing to preserve business related text messages exchanged on the personal devices of registered representatives.
3. *COVID-19 Response*: Risks related to the COVID-19 pandemic are among the highest immediate priorities for SEC enforcement. The Division of Enforcement established the Coronavirus Steering Committee in order to coordinate its efforts with respect to the uncertainties and risks posed by the pandemic environment. This increased level of organization was required, in part, to deal with the extensive increase in whistleblowers, tips, complaints and referrals. FY2020 saw the receipt of 23,650 tips, complaints, and referrals, a substantial increase over the 16,850 received in FY2019, a significant portion of which are attributable to COVID-19 related issues. Many conditions caused by the pandemic, such as the widespread transition to remote work and increased market volatility, have attracted scrutiny from the Division of Enforcement.[3] By the end of FY2020, the Division of Enforcement had opened more than 150 COVID-19 related inquiries or investigations, many of which remain ongoing. The SEC views all manner of securities fraud related to the pandemic as particularly egregious. We expect the SEC to aggressively investigate allegations of fraud with regard to the stimulus programs and, where appropriate, pursue enforcement action. Financial

institutions that participated in the stimulus programs should be prepared for significantly heightened scrutiny.

4. *Whistleblower Program*: The whistleblower program continued to be a high priority for the SEC in FY2020, and whistleblower complaints had a record-breaking year. In FY2020, the SEC received approximately 6,800 more tips, complaints and referrals than in FY2019. The SEC also paid a greater amount of money in whistleblower awards and rewarded more individual whistleblowers than in any prior fiscal year.[4] The SEC granted the largest single whistleblower award in SEC history, awarding approximately $114 million to one whistleblower in October 2020, which Chairman Jay Clayton referred to as "testament to the Commission's commitment to award whistleblowers who provide the agency with high-quality information."[5] The SEC has stressed the importance of its whistleblower program in achieving positive results in enforcement. Importantly, in September 2020, the SEC amended its whistleblower program in an effort to further encourage whistleblowers to assist the SEC in rooting out misconduct.[6] We expect that the whistleblower program will remain an essential part of the SEC's enforcement efforts, continuing to incentivize whistleblowers by granting large awards for providing substantial assistance to SEC enforcement staff.[7]

5. *Individual Accountability*: The SEC has continued to focus on individual accountability for enforcement, continuing to emphasize its current belief that holding individuals accountable is one of the strongest methods of achieving deterrence. In FY2020, 72% of the SEC's standalone actions involved charges against one or more individuals; this percentage is roughly in line with the results of the last several fiscal years and up from 69% in FY2019.

In addition to our key takeaways, the SEC Division of Enforcement reaffirmed its focus on several traditional enforcement priorities, including issuer disclosures, reporting/accounting violations, insider trading and other abusive trading practices, and operational goals, such as decreasing the time it takes to conduct an investigation and improving the efficiency of its implementation of SEC resources.

FY2020 also hosted landmark court decisions that impact SEC enforcement remedies as progeny of *Kokesh v. SEC* are adjudicated.[8] In June 2020, the Supreme Court in *Liu v. SEC* affirmed the authority of courts to order disgorgement through their power to order "equitable relief" under Section 21(d)(5) of the Securities Exchange Act of 1934.[9] Although not addressed in the annual report, the Third Circuit also found in June 2020 that the SEC's request for an "obey the law" injunction against future violations of the federal securities laws and its request for a bar an individual from participating in the penny stock industry was properly issued and not a penalty.[10] These court challenges have the potential to fundamentally change the way the SEC Division of Enforcement handles enforcement remedies, and further challenges are expected to make their way through the judiciary.

Particularly in light of the additional challenges presented by doing business in a pandemic environment, firms should be aware of risks associated with their operations and how the SEC's enforcement trends could bring additional regulatory scrutiny going forward.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

Marlon Q. Paz
+1 202 263 3044
mpaz@mayerbrown.com

Richard M. Rosenfeld
+1 202 263 3130
rrosenfeld@mayerbrown.com

Matthew Rossi
+1 202 263 3374
mrossi@mayerbrown.com

Daniel L. Stein
+1 212 506 2646
dstein@mayerbrown.com

Kyle P. Swan
+1 202 263 3072
kswan@mayerbrown.com

Endnotes

[1] SEC, Division of Enforcement, *2020 Annual Report* (Nov. 2, 2020), *available at* https://www.sec.gov/files/enforcement-annual-report-2020.pdf.

[2] The SEC's Share Class Selection Disclosure Initiative was responsible for a significant portion of the Division of Enforcement's activity in the investment adviser space. From March 11, 2019 through September 30, 2019, the SEC issued orders against 95 advisers that chose to participate in the initiative.

[3] *See* SEC, Public Statement, *Statement from Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, Regarding Market Integrity* (Mar. 23, 2020), *available at* https://www.sec.gov/news/public-statement/statement-enforcement-co-directors-market-integrity.

[4] The SEC awarded a record $175 million to 39 whistleblowers in FY2020.

[5] SEC, Press Release, *SEC Issues Record $114 Million Whistleblower Award* (Oct. 22, 2020), *available at* https://www.sec.gov/news/press-release/2020-266.

[6] For a more detailed description of the amendments to the SEC's whistleblower program, please read the Mayer Brown Legal Update available here.

[7] FY2021 is already off to a strong start for whistleblower awards. On November 5, 2020, the SEC announced two separate whistleblower awards: an award of over $3.6 million and another award of $750,000 for assistance provided to SEC enforcement staff.

[8] *Kokesh v. SEC*, 37 S. Ct. 1635 (2017).

[9] *Liu v. SEC*, 140 S. Ct. 1936 (2020).

[10] *SEC v. Gentile*, 939 F.3d 549 (3d Cir. 2019).