Professional Perspective

# SEC Enforcement During Covid-19

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The Securities and Exchange Commission has released guidance about its enforcement priorities since March 2020, and has followed through with numerous enforcement actions arising out of the pandemic, with a particular emphasis on issuers disseminating misleading disclosures relating to Covid-19.

This article discusses increased areas of risk as the Biden administration gets underway, focusing both on what the SEC has said and what it has done since the Covid-19 crisis began, while providing advice on how to mitigate the risks of SEC enforcement in each of these areas.

Looking ahead, general areas of likely SEC enforcement focus include, along with Covid-19- related fraud: public disclosure, financial accounting, Regulation FD compliance, insider trading, and cyber security.

Heightening the risk, the Covid-19 pandemic has increased whistleblower activity, raising the probability that the SEC will learn of misconduct that may arise during the pandemic, or historic conduct that pre-dated the Covid-19 crisis, which had previously gone undetected or unaddressed.

## Foundation for Increased Enforcement

Increased enforcement activity in 2021 is a certainty. As the SEC recognized in its FY 2020 annual report, while the agency did its best to remain active over the last year, investigations were inevitably slowed by the pandemic and accompanying remote working environment. But this will not last forever, particularly with the rollout of Covid-19 vaccines. Further, SEC investigations often take several years to culminate in an enforcement action.

The new presidential administration makes increased enforcement more likely. President Joe Biden has made clear his administration will implement different policies to battle the pandemic, and market observers expect his administration to place a greater emphasis on aggressively enforcing the federal securities laws generally.

In late January 2021, Biden nominated Gary Gensler to lead the SEC--a seasoned market regulator known for his tough tactics based on his prior role as head of the Commodity Futures Trading Commission under President Barack Obama. Then on Feb. 9, 2021, Allison Herren Lee, the acting head of the SEC, restored the authority of senior officers in the SEC's Enforcement Division to issue subpoenas and initiate investigations without higher level approval—a policy first initiated in 2009, which continued through Obama's presidency until being rolled back under President Donald Trump.

## Fraudulent Claims About Public Companies' Covid-19 Solutions

The most obvious enforcement priority is combatting fraud directly related to the Covid-19 crisis. As early as Feb. 4, 2020, the SEC Office of Investor Education and Advocacy issued an investor alert warning about fraudulent claims that a company's products or services will be used to help stop the coronavirus outbreak. The SEC staff's alert highlighted promotional materials aiming to inflate the share price of microcap stocks in "pump-and-dump" schemes, but it noted that such false statements might be made by or about public companies of any size. Following this announcement, the SEC has focused heavily on this category of potential fraud.

On May 12, 2020, while tallying the trading suspensions ordered by the SEC since the onset of the pandemic, the SEC's co-director of the Enforcement Division singled out issuers' claims "relating to access to testing materials, developments of treatments or vaccines, and access to personal protective equipment."

The SEC may suspend trading in any security for up to 10 days when it has reason to doubt the accuracy of information available about that security, and it ordered over 50 suspensions in the five months following its Feb. 4 alert. Most of these orders cited claims made for the company's virus-fighting products or services. The proportion of trading suspensions directly related to the pandemic declined, however, through the summer and fall. Although trading suspensions do not necessarily signal wrongdoing, they certainly indicate SEC concern.

Underscoring the risk, a number of these trading suspensions have already resulted in enforcement actions. For example, on April 28, 2020, the SEC brought its first coronavirus-related fraud action against a corporation that had issued allegedly false press releases claiming that it had negotiated and secured a supply of N95 face masks. *SEC v. Praxsyn et al.*, Case No. 9:20-cv-80706 (S.D. Fla.).

In May, the SEC filed suit against two penny stock companies over allegedly false press releases, claiming that one company had begun manufacturing and shipping home-use Covid-19 tests for the general public, and that the other had developed a joint venture to sell retailers thermal scanning equipment that could detect customers with fevers. *SEC v. Applied BioSciences Corp.*, No. 1:20-cv-03729 (S.D.N.Y. filed May 14, 2020); *SEC v. Turbo Global Partners, Inc. et al.*, No. 8:20-cv-01120 (M.D. Fla. filed May 14, 2020).

SEC enforcement actions in June targeted a pump-and-dump scheme involving allegedly false assertions about a biotech company bringing an "approved" Covid-19 blood test to market, and an allegedly fraudulent scheme to sell corporate control persons' stock in various microcap companies, which in some cases included promotional statements claiming the companies could produce medical-caliber face masks and automated kiosks for retailers. *SEC v. Nielsen*, No. 5:20-cv-03788 (N.D. Cal. filed June 9, 2020); *SEC v. Gomes*, No. 1:20-cv-11092 (D. Mass. filed June 9, 2020).

In September, the Commission charged the president of a biotechnology company with making false and misleading statements about the development and approval of a Covid-19 blood test and in February 2021, brought similar charges against the company. *SEC v. Schena*, No. 5:20-cv-06717 (N.D. Cal. filed September 25, 2020). The SEC then brought charges in a similar case in December against another biotechnology company and its CEO based on false and misleading claims that the company had developed and would soon introduce a finger-prick blood test for Covid-19. *SEC v. Berman et al.*, No. 1:20-cv-10658 (S.D.N.Y. filed December 17, 2020). Fast forward to the present, and claims regarding vaccines and potential Covid-19 treatments are likely to be heavily scrutinized.

Based on the experience of 2020, it is likely enforcement actions based on fraudulent claims will continue throughout the coming year.

## Inadequate Disclosures

Inadequate disclosures in periodic reports, earnings releases, analyst and investor calls, and other statements concerning the impact of Covid-19 on a company is another area of significant risk. The SEC's chairman, the Division of Corporation Finance, and the Office of the Chief Accountant (OCA) all issued statements on the heightened importance of public disclosures in the Covid-19 environment. Corporation Finance announced in March 2020, and has reemphasized periodically into 2021, that it was "monitoring how companies are reporting the effects and risks of COVID-19 on their businesses, financial condition, and results of operations."

In an April 8, 2020 joint statement, SEC Chairman Jay Clayton and Director of the Division of Corporation Finance Hinman advised companies to provide "as much information as is practicable" about their current and future operations and financial positions. They concluded pointedly that "[t]he SEC's commitment to investor protection and market integrity is unwavering, and we are laser-focused on identifying bad actors who would seek to use the current uncertainty to prey on our investors."

Adequate disclosures in the era of Covid-19 must ensure baseline compliance with existing regulations requiring disclosure of material information, but may also entail additional disclosures about the past and present effects of the public health crisis and forward guidance on the company's operations and financial position. The varied and fluid nature of government responses to surges and vaccine rollout, both within the U.S. and around the world, makes the challenge of proper disclosure even more daunting. And while the availability of vaccines provides some hope, uncertainties remain.

Given this uncertainty, the historical information on which public companies generally rely may be less relevant than where they stand today and how they have adjusted, and expect to adjust in the future, their operational and financial affairs to work through the Covid-19 crisis.

As the staff of the SEC's Division of Corporation Finance emphasized, a number of rules and regulations broadly require disclosure about known or reasonably likely effects of and the types of risks presented by Covid-19, even if there is no line item specifically requiring discussion of a particular risk by name.

 

On the bright side, the SEC has offered some assistance in navigating these waters. In particular, guidance from the SEC Corporation Finance staff contains a non-exhaustive list of considerations companies should take into account in crafting Covid-19 related disclosures.

Public company disclosure topics that may be material to investors include:

- The current operating status and future operating plans under Covid-19-related mitigation conditions
- Current liquidity positions and expected financial resource needs
- The impact of Covid-19 on company operations, including impact of actions and policies to protect workers and customer health

If financial assistance received under the CARES Act or similar programs has materially affected, or is reasonably likely to have a material future effect on, the financial condition or results of operations, the affected companies should disclose the nature, amounts, and effects of such assistance. The SEC also offered to engage reporting companies individually in addressing complex issues or offering temporary relief.

The SEC staff repeatedly stated that it does not expect to second-guess good-faith attempts to provide appropriately framed forward-looking information or estimates. That said, this guidance still leaves companies bearing some risk of enforcement actions, particularly if the assumptions behind their public statements prove mistaken. Companies should therefore avoid boilerplate disclosures about potential risks and couple their forward guidance with company-specific operational and financial cautionary statements.

Limiting forward-looking statements and specific estimates to those required by SEC rules offers the best way to cabin legal risk, although it may disappoint investors searching for greater certainty and more detailed information. To further mitigate risk, companies should ensure that their forward-looking statements comply with the safe harbors available under the federal securities laws against private actions and with the common-law "bespeaks caution" doctrine. Under that doctrine, forward-looking statements are not misleading when paired with non-generic cautionary disclosure of specific risks that could materially affect their accuracy. *SEC v. Thompson*, 238 F. Supp. 3d 575, 603 (S.D.N.Y. 2017).

The recent enforcement action against The Cheesecake Factory illustrates these risks. In early December, 2020, the SEC charged The Cheesecake Factory, Inc. with misleading investors about the impacts of the pandemic on the company's business and its financial condition.

In announcing the resolution, the SEC announced: "The action is the SEC's first charging a public company for misleading investors about the financial effects of the pandemic."

With respect to affirmative statements, the SEC targeted the company's SEC filings on March 23 and April 3, 2020, where The Cheesecake Factory stated that its restaurants were "operating sustainably" during the pandemic. The SEC alleged that this statement was false and misleading because, at the time of the disclosures, the company was losing approximately $6 million per week and projecting that it had only 16 weeks of cash remaining.

The SEC further noted that, although the company did not include this information in its SEC filings, it did share this information with potential private equity investors and lenders in connection with an effort to seek additional liquidity. The SEC also targeted certain omissions, specifically, the company's failure to disclose that it had informed its landlords that it would not pay rent in April due to Covid-19 impacts along with its general failure to disclose its decreasing cash reserves in both filings.

Significantly, the SEC did not bring scienter-based or even negligence-based securities fraud charges against The Cheesecake Factory—opting instead to charge violations of reporting provisions—and the fine imposed, $125,000, was relatively modest. This perhaps reflects a reluctance to significantly penalize a company in trying times, but regardless, the SEC clearly brought the case as a statement to all public companies.

Through this action the SEC set its expectations for public company disclosures with respect to adverse financial consequences arising from the pandemic, both in terms of the nature of information required under the federal securities laws, along with the level of detail.

 

The SEC's current emphasis on the heightened need for accurate and current disclosures in the Covid-19 environment, and its preexisting trend toward enforcement actions in the disclosure area, reinforce the need for care and completeness in all public statements and periodic filings.

## Improper Accounting Practices

In addition to its focus on disclosures, the SEC continues to stress the importance of accounting practices. OCA has emphasized the SEC's view that, in "these challenging times, investors and other stakeholders need high-quality financial information more than ever." Consistent with this admonition, we expect an increased focus from the SEC on financial accounting, both during and after the Covid-19 crisis.

### *Accounting Judgments and Estimates*

OCA has identified certain accounting areas where significant judgments and estimates may be necessary due to the fluid conditions created by the pandemic. These include, but are not limited to: fair value and impairment considerations; leases; debt modifications or restructurings; hedging; revenue recognition; income taxes; going concern; subsequent events; and adoption of new accounting standards (e.g., the new credit losses standard). All judgments and estimates must be properly identified and have a reasonable basis.

Here, as elsewhere, public companies are expected to respond by making proper disclosures. Acknowledging the unavoidable uncertainty faced by those making judgments and estimates in the current environment, the SEC has nevertheless emphasized communication and transparency as the solution. Provided that the judgments are disclosed and well-reasoned, OCA will not likely object to them after the fact.

But risks persist. The SEC's pre-pandemic September 2019 administrative proceeding against PPG Industries, Inc. underscores this risk. In *PPG*, the SEC found that a senior accounting officer and subordinates delayed recognition of, or misclassified, certain known expenses and liabilities, such as a healthcare reserve accrual and a compensation expense accrual, and improperly classified adjustments to income to improve apparent income from continuing operations.

The same month, the SEC brought an administrative proceeding against The Bancorp, Inc. for materially understating a measure of the aggregate probable loss in its loan portfolio. The SEC faulted the bank for failing to assign appropriate risk ratings to certain loans, which kept it from properly recognizing as impaired both individual loans and groups of loans with similar risk characteristics, as required by GAAP. The bank eventually restated its financial statements and was ordered to pay a civil penalty of $1.4 million.

Although the risk of enforcement over improper accounting judgments has grown during the pandemic, OCA has emphasized its record of consulting with public companies and auditors to resolve complex and novel reporting concerns during the first two quarters of 2020. Proactive consultation could therefore significantly mitigate such risks.

### *Improper Deviations from GAAP*

Another enforcement target will likely be deviations from GAAP and use of non-GAAP metrics to improve the company's apparent financial performance.

Division of Corporation Finance guidance addresses the appropriate use of non-GAAP measures to adjust for or explain the impact of Covid-19 in earnings estimates and other financial results in advance of finalizing the required financial reporting.

Companies presenting non-GAAP financial measures or performance metrics to explain the impact of Covid-19 should provide a clear definition of the metric or measure, explain how it helps investors assess the impact of the pandemic on the company's financial position, and include a statement indicating how management uses the measure or metric.

Other considerations include reconciling non-GAAP measures to preliminary or reasonably estimable GAAP results; reconciling to GAAP results for required financial statements–e.g., 10-K or 10-Q–and limiting non-GAAP measures in public presentations to those measures used to report financial results to the board of directors.

While there are often good reasons to apply non-GAAP methods, and indeed GAAP measures might be unavailable for the relevant reporting period because of delays imposed by pandemic-related adjustments, Corporation Finance specifically warned against using non-GAAP measures for the sole purpose of presenting a more favorable view of the company.

The Division has also reminded companies presenting metrics related to Covid-19, or changing the method by which they calculate a metric as a result of the virus, to comply with the SEC Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A Guidance), effective Feb. 25, 2020. The MD&A Guidance requires companies changing a method of calculating a metric to disclose all of the following:

- Any differences in the way the metric is calculated or presented compared to the previous period
- The reasons for the change
- The effects on the amounts and information disclosed both currently and previously
- Any other differences in methodology or results that would reasonably be expected to be relevant to understanding the company's prospects or performance

Companies disregarding this guidance may be at risk of enforcement action. A prominent example from the recent past involved Hertz Global Holdings. In late 2018, the SEC assessed Hertz a civil penalty of $16 million after determining, among other things, that the company improperly changed its accounting methodology—in a manner incompatible with GAAP—for subrogation recovery of funds from car renters or insurers following damage to its vehicles.

The SEC found that, under pressure to meet certain targets, Hertz adjusted its approach to calculating its subrogation allowance or collections to be written off in a manner not in accordance with GAAP. Significantly, according to the SEC, these changes all "had a favorable impact on the company's financial statements."

## Other Enforcement Priorities

Other areas of SEC enforcement focus include Regulation FD, insider trading, and cyber-security. The Enforcement Division has stressed the importance of market integrity since the beginning of the pandemic. In a March 23, 2020, statement, the co-directors of the Enforcement Division stated that, in the current environment, material nonpublic information may hold even greater value than usual and remain nonpublic for longer periods, especially if a company delays earnings reports or other required SEC filings due to Covid-19. For publicly traded companies, they emphasized the importance of having appropriate internal controls to protect against the improper dissemination and use of material nonpublic information.

The co-directors focused not only on preventing insider trading but also on compliance with Regulation FD, which prohibits public companies from making selective disclosures, including inadvertent selective disclosures, of material nonpublic information in certain circumstances. The SEC Division of Corporation Finance guidance similarly referenced Regulation FD and reminded public companies to avoid selective disclosures by disseminating information broadly to the public.

The protection of material nonpublic information relating to the distribution of government funds related to the pandemic is particularly important. For example, allegations in late July 2020 of insider trading by the chief executive of Eastman Kodak prompted the SEC to open an investigation into the company. The investigation was prompted by suspicious timing of stock-option grants provided to company executives the day before the public disclosure that Kodak had been awarded a $765 million federal loan to produce pharmaceutical ingredients under the Defense Production Act. The announcement of the SEC investigation and Congressional scrutiny into the award of the loan caused the government to halt the loan to the company and resulted in significant negative impact on Kodak's stock price.

The allegations also prompted Kodak to appoint a special committee to conduct an internal investigation. The committee's investigation concluded that Kodak did not violate any securities laws, but recommended changes to Kodak's internal controls policies and structures. These recommendations included hiring new personnel in its legal department, updating policies regarding insider trading, enhancing "the rigor of its insider-trading processes to ensure all relevant personnel are aware of the policies," and ensuring that these policies "apply equally to both Kodak officers and employees that are deemed insiders and to members of the board."

Despite the internal investigation's findings, the company troubles may not be over. On Nov. 11, 2020, the company disclosed that five former executives "were able to collect millions of dollars by selling stock options they did not own" in July 2020. The company discovered that deficiencies in its controls failed to prevent the unauthorized issuance of 300,000 previously forfeited stock options. According to news reports, the SEC and the inspector general of the U.S. International Development Finance Corporation continue to investigate the company, although the latter reportedly found no wrongdoing as of December 2020.

In this environment, it is essential that companies reexamine their existing policies and procedures designed to prevent the misuse of material nonpublic information and do so as the pandemic continues—what the former SEC chair referred to as "good corporate hygiene." The SEC has made clear that enforcement of insider trading prohibitions will be a priority for the foreseeable future.

The SEC and its Enforcement Division also issued guidance on public companies' regulatory compliance obligations concerning cyberattacks. Public companies and certain issuers are obligated under Exchange Act §13(b)(2)(B) to "maintain internal accounting controls that reasonably safeguard company, and ultimately, investor assets from cyber-related frauds."

But public companies in a remote-work posture face increased risk of cyberattacks and other forms of cyber risks. For example, employees working from home may be more susceptible to phishing attacks and many companies may not have the infrastructure or procedures in place to ensure that company information is transmitted through secure channels, such as a company VPN, by employees working remotely. This makes the company's information only as secure as its employees' individual networks, creating a significant, and for many companies, unexpected cybersecurity risk. Without question, the current environment presents increased risk.

## Increased Incentives for Whistleblowing

The changes to the work environment brought on by Covid-19 have already had significant impacts on companies' exposure to whistleblower complaints. The Enforcement Division reported that between mid-March and the end of the 2020 fiscal year, it received approximately 16,000 tips, complaints, and referrals—about a 71% increase over the same period in the previous year. SEC Division of Enforcement, 2020 Annual Report at 19. This increase is likely the result of several factors.

First, the SEC has taken dramatic steps to incentivize whistleblowing in the form of large award payments to whistleblowers and direct statements encouraging employees and investors to report misconduct. In April 2020 alone, the SEC announced over $52 million in whistleblower awards followed by its largest ever award of approximately $114 million to a single whistleblower in October 2020, providing a massive incentive for individuals with allegations of misconduct to come forward. The SEC also repeatedly issued statements actively encouraging investors, a group not traditionally associated with whistleblowing, to report misconduct to regulators.

Second, the law provides incentives and protections to employees laid off after reporting information to the SEC. Retaliation protections for whistleblowers are greater for those reporting externally to regulatory bodies than for individuals reporting internally. *See Digital Reality Trust, Inc. v. Somers*, 138 S. Ct. 767 (2018). The economic disruption caused by Covid-19 and the resulting increase in unemployment could incentivize potentially impacted employees to report externally with a view toward benefiting from these protections. Similarly, while the prospect of continued employment may have created a disincentive for certain employees to report externally to the SEC, the increased risk to future employment may remove that deterrent.

Third, the remote work environment in which many companies find themselves creates unexpected risks that employees will decide to report alleged misconduct externally rather than internally. The work-from-home environment can disrupt internal reporting channels like anonymous hotlines, and it could delay response times to internal complaints and reports—prompting employees to take alternative actions.

While the risks associated with SEC whistleblowers are not new, the Covid-19 environment has certainly increased these risks. As a result, companies must be vigilant in ensuring internal reporting mechanisms, along with response protocols, training, and documentation, remain active and accessible.

## Conclusion

The Covid-19 crisis has had far-reaching and unexpected impacts on public companies in the U.S. But as discussed above, beyond the risk to operations and financial performance, significant regulatory risks exist—risks that will only increase under the new Biden administration. As a result, it is imperative for public companies to redouble their focus on compliance with applicable laws and regulations during, and often in spite of, the extraordinary circumstances.

 