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A Strong Year For SEC Enforcement

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(November 6, 2018, 4:32 PM EST)

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On Nov. 2, 2018, the U.S. Securities and Exchange Commission's Division of Enforcement released its 2018 annual report, which presents and assesses the division's accomplishments during the 2018 fiscal year.[1] The statistics, as well as the narrative discussion in the report, reveal an active division focused on pursuing cases impacting retail investors, such as investment adviser fraud, as well as actions directed at the impact of emerging technological changes on the securities market, such as cryptocurrencies and cybersecurity. While the penalty and disgorgement numbers were similar to last year, this was primarily because of the massive settlement with Petrobras, under the terms of which the SEC will credit all but $85 million to account for settlements in related actions by the U.S. Department of Justice, a class of investors, and Brazilian regulators. The significant reduction in monetary remedies absent Petrobras suggests that the SEC's shift in focus with respect to the types of cases brought has had a tangible impact on enforcement remedies.

Describing FY 2018 as a "great success" in their message accompanying the report, Co-Directors of Enforcement Stephanie Avakian and Steve Peikin de-emphasized the importance of quantitative metrics (such as raw number of cases filed or penalties levied), focusing instead on qualitative metrics, such as "the nature, quality, and effects" of the division's enforcement program as a better measure of success. Avakian and Peikin reiterated the five principles, originally announced in the FY 2017 report, that guide the division's assessment of its performance: "(1) focus on retail investors; (2) focus on individual accountability; (3) keep pace with technological change; (4) impose remedies that most effectively further enforcement goals; and (5) constantly assess the allocation of our resources." With this framework in mind, set forth below are observations based on the data and information provided in the report.

FY 2018: Strong Year for Enforcement

Despite early predictions that enforcement numbers would likely trend down under Chairman Jay Clayton, the report's statistics leave little doubt that enforcement remains a robust part of the commission agenda. FY 2018 saw an increase in the number of enforcement actions, with the commission bringing 821 actions as compared to 754 in FY 2017. Of those 821 actions, 490 were " stand-alone" actions brought in federal court or as administrative proceedings, 201 were "follow-on" proceedings, and 121 were proceedings to deregister public companies that were delinquent with commission filings.

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A significant percentage of the division's 490 stand-alone cases involved securities offerings (approximately 25 percent), investment advisers/investment company issues (approximately 22 percent), and issuer reporting/accounting and auditing (approximately 16 percent). Other significant areas of enforcement activity were broker-dealer misconduct (13 percent), insider trading (10 percent) and market manipulation (7 percent). The number of Foreign Corrupt Practices Act cases remained the same as in FY 2017 with 13 cases. The most significant year-over-year increase came in the area of investment advisers/investment company actions (108 in FY 2018 compared to 82 in FY 2017) and securities offerings (121 in FY 2018 compared to 94 in FY 2017).

Focus on Retail Investors

The division continues to focus on retail investors, as reflected by the fact that half of the 490 stand-alone enforcement actions brought in FY 2018 involved allegations or findings of wrongdoing that harmed retail investors. The report highlights the work of the division's Retail Strategy Task Force, which was formed in FY 2018, for playing a critical role in using data analytics to establish lead-generation initiatives. In addition, the report notes the key role played by larger-scale initiatives, such as the Share Class Selection Disclosure Initiative, or SCSDI, launched earlier this year to encourage advisers to self-report their alleged failures to disclose financial conflicts of interest related to the receipt of 12b-1 fees. Initiatives such as the SCSDI allow the division to identify, address and remediate violations more quickly and more efficiently than pursuing cases on an individual basis.

Policing Cyber Misconduct

Cyber-related misconduct continues to be a key focus area for the commission. In FY 2018, the division brought 20 stand-alone cases involving initial coin offerings and digital assets. According to the report, the division's Cyber Unit, which was formed at the end of FY 2017, has been instrumental in identifying and bringing a range of cases, from an action against an investment adviser for inadequate cybersecurity policies and procedures[2] to an action against a public company for the accuracy of cyber-related disclosures.[3] The report also stated that the division has 225 cyber-related investigations ongoing. As such, we can expect FY 2019 to see even more significant developments in this space.

Holding Individuals Accountable

The division continues to focus on individual accountability and the results for FY 2018 bear that out. Of the 490 stand-alone actions brought in FY 2018, 72 percent involved charges against one or more individuals, including high-profile senior executives, a congressman and a professional athlete — a similar number to prior years. The division litigated five cases in FY 2018 which, although similar to the number in FY 2017, is down from the number of trials from just a couple of years ago. Perhaps predicting some criticism on this point, the report points to the impact of Lucia v. SEC,[4] a case in which the U.S. Supreme Court held earlier this year that the appointment of the SEC's administrative law judges violated the U.S. Constitution's appointments clause, and to the substantial litigation resources that will be required to address the decision in FY 2019.

Penalties Higher, Disgorgement Lower, Though Results Heavily Dependent on One Case

In terms of penalties and disgorgement, FY 2018 saw an increase in the amount of penalties obtained ($1.439 billion) and a slight decrease in the amount of disgorgement ($2.506 billion). Importantly, the most significant driver of these numbers was the Petrobras settlement, in which the company agreed to pay $933 million in disgorgement and an $853 million penalty. All but $85 million of those amounts will be deemed satisfied if Petrobras, within one year, makes payments in the related actions involving the DOJ, a class action settlement fund and Brazilian authorities. Therefore, backing out all but $85 million of the Petrobras penalty amount reveals a significantly lower penalty figure for FY 2018 — approximately $671 million, which is dramatically less than the $1.27 billion for FY 2017 and the $1.175 billion for FY 2016.

The significant reduction in the penalty amounts appears largely attributable to the types of cases brought by the commission, including a decrease in cases against financial institutions and fewer market manipulation and issuer reporting/accounting and auditing actions.[5] There may also be an element of change in the approach of the commissioners to the use of penalties more generally in resolving enforcement actions. As for the lower disgorgement number, the Kokesh v. SEC[6] decision, in which the Supreme Court held that disgorgement is subject to a five-year statute of limitations, was called out as materially impacting the commission's ability to obtain disgorgement. The commission estimates that the Kokesh decision may result in the commission foregoing approximately $900 million in disgorgement. The emphasis on returning funds to harmed investors remains a priority for the commission. In FY 2018, the division distributed $794 million to harmed investors, down from the $1.073 billion for FY 2017. Of course, such distributions reflect monetary remedies imposed in prior years and distributed through fair funds.

Novel Tools

In addition to more traditional forms of relief such as penalties and disgorgement, the division also focused its attention on other tailored remedies to advance its enforcement goals, including equitable relief in the form of specific undertakings. FY 2018 saw the division employ these types of undertakings in high-profile settlements involving Theranos Inc.[7] and Tesla Inc.[8] In the case of Theranos, the undertaking sought to address potential misuse by now-former CEO Elizabeth Holmes of her controlling interest in the company by requiring her to relinquish voting control over the company and mandated that she not profit from her ownership stake until $750 million was returned to other Theranos investors. In the case of Tesla, the commission's undertaking addressed the risks posed by the lack of sufficient oversight and controls over CEO Elon Musk's communication practices by requiring, among other things, that Tesla employ an experienced securities counsel to advise on disclosure issues, add two independent directors to the board, establish a committee of independent directors, and adopt mandatory controls to oversee the CEO's public communications. We expect the commission to continue to reserve the use of these sorts of undertakings to limited situations where tailored remedies are necessitated by the particular facts of the case.

Impact of Resource Constraints

The commission continues to labor under the constraints imposed by an agencywide hiring freeze that has been in place since late 2016. The report notes that the number of positions at the division, including the number of contractors supporting the division's investigations, is down by 10 percent from FY 2016 to FY 2018.

The FY 2018 annual report provides useful insight into the priorities guiding the Division of Enforcement under Clayton. A key area to watch over the next year will be the division’s continued role in addressing the risks posed by rapid changes occurring in the technology area, including cyber and cryptocurrency-related issues, and their impact on the securities markets. We also expect the division to continue its focus on investment managers, as well as other market participants with direct touches on retail investors.

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[1] https://www.sec.gov/files/enforcement-annual-report-2018.pdf.

[2] https://www.sec.gov/news/press-release/2018-22.

[3] https://www.sec.gov/news/press-release/2018-71.

[4] 138 S. Ct. 2044 (2018).

[5] The New York Times, in commenting on enforcement results, noted that the significant decline in penalties is primarily attributable to a decreased focus by the SEC on financial institutions as well as a significant decline (40 percent) in actions against large public companies. See Trump Administration Spares Corporate Wrongdoers Billions in Penalties, New York Times (Nov. 3, 2018) (https://www.nytimes.com/2018/11/03/us/trump-sec-doj-corporate-penalties.html).

[6] 137 S. Ct. 1635 (2017).

[7] https://www.sec.gov/news/press-release/2018-41.

[8] https://www.sec.gov/news/press-release/2018-226.