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Securities and Exchange Commission Year in Review: Enforcement Actions and Issues from 2018

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It is that time of year again. As we usher in a new year, looking ahead to the issues and changes likely to affect those in the securities industry and financial markets, it is important to pause for a moment and look back on the key highlights and trends from 2018. Of course, we all know that past performance is no guarantee of future results, but when it comes to prognosticating about the direction of federal securities regulation, in particular that of the Securities and Exchange Commission's (SEC) Enforcement Division, past performance is a pretty good indicator of where things are likely headed.

In one sense, 2018 was a year of turbulence and change. The surprise election of Donald Trump in November 2016 continued to be felt, with ideological polarization impacting virtually every facet of life—from what we consider "real news" (or "fake news," as the case may be) to how we interact on social media. Indeed, some of the polarization has even managed to infiltrate the halls of many of the federal government's regulatory agencies. On the other hand, however, 2018 was a year of relative prosperity, with a growing economy and relatively stable markets. And despite the drama that emanated from agencies like the Environmental Protection Agency and the Consumer Financial Protection Bureau, the SEC managed to stay out of the spotlight and carry out its mission in a mostly apolitical manner.

Now more than 18 months into Jay Clayton's tenure as Chairman, the SEC's priorities have come into clear focus. At a high level, those priorities demonstrate a general continuity with the priorities of his predecessor Mary Jo White. There are differences, to be sure, but those differences are relatively minor—certainly nothing like the differences that have emerged as a result of the changing of the guard at other federal agencies. Clayton's SEC is focused on five key areas: (1) protecting retail investors, (2) holding individuals accountable, (3) keeping pace with technological change, (4) imposing remedies that further enforcement goals, and (5) allocating resources effectively.[1]

This article looks back at SEC Enforcement activity over the past fiscal year and provides some insight as to where the SEC is likely to focus next. In the process, the article assesses how these five principles are animating enforcement priorities in a number of key areas, while at the same time examining how external forces are impeding progress towards the SEC's goals. Specifically, the article addresses: (1) leadership changes at the SEC, (2) external challenges to the SEC's regulatory authority, and

(3) the SEC's continued focus on a number of key areas (that is, cybersecurity and regulation of digital assets, insider trading, the Whistleblower Program, and claims against investment advisers and investment companies).

Leadership Changes Galore: Three New SEC Commissioners Confirmed

One of the most important developments that occurred in 2018 may have been the swearing in of new SEC leadership. When Jay Clayton took over as Chair of the SEC in May 2017, only two of the remaining four Commission seats were filled, one by Kara Stein and the other by Michael Piwowar. The other two seats had been empty since 2015. Although President Obama nominated two individuals to fill those seats, Hester Peirce (a Republican) and Lisa Fairfax (a Democrat), certain Democratic senators blocked their nominations as a means of obtaining leverage in a larger political fight concerning the Supreme Court's *Citizens United* decision,[2] and the seats remained empty throughout the balance of President Obama's term.

Seven months after Clayton was sworn in, President Trump finally got around to filling the empty seats, nominating Peirce (the former Obama nominee) and Robert Jackson, a 41-year old Democrat and legal scholar. Both were sworn in as commissioners in January 2018.[3] Commissioner Peirce came to the SEC from the Mercatus Center at George Mason University, a free-market oriented think tank, where she served as Senior Research Fellow and Director of the Financial Markets Working Group.[4] Commissioner Jackson was a law school professor at both NYU School of Law and Columbia Law School and previously served as a senior policy advisor at the US Department of Treasury.[5]

With the confirmation of Peirce and Jackson, all five SEC seats were occupied for the first time in several years. Having a full slate of commissioners was short-lived, however, as Commissioner Piwowar announced his resignation in May 2018.[6] To fill Piwowar's seat, President Trump nominated Elad L. Roisman, a 37-year-old lawyer for the Senate Banking Committee, who was confirmed by the Senate in September.[7]

It is too early to tell how the new Commissioners will shape policy going forward. Despite the fact that President Trump has now appointed four of the five current Commissioners—and will soon appoint a fifth when Commissioner Stein's tenure ends—internal checks and balances prevent the SEC from becoming overly partisan; no more than three Commissioners may be from the same political party. Nevertheless, the de-regulatory bent of the three Republican Commissioners does hold the potential to shape policy over the coming years, particularly in areas such as opening up private markets to more individual investors and scaling back requirements on smaller companies.[8]

As discussed below, at least one major issue has seen the Commissioners split along political lines (that is, proposal to cap whistleblower awards), but those splits are not unusual. Thus far, Commissioner Clayton's leadership has not departed significantly from that of his predecessors, and the five key principles outlined by SEC Enforcement—the most central being the focus on retail investors—do not signal a wholesale departure from the recent objectives of the SEC. This issue merits some attention over the coming year, but at least for the moment, significant changes seem unlikely.

Internal Goals Meet External Roadblocks: Supreme Court Restricts SEC Authority

Chairman Clayton's ability to execute on the SEC's five key goals has encountered some fairly significant external challenges, in particular from the Supreme Court, and these challenges continued to play out over the course of the past year. First, a 2017 decision, *Kokesh v. SEC*, has restricted the ability of the SEC to seek disgorgement for fraudulent activity more than five years old, and a 2018 decision, *Lucia v. SEC*, has cast doubt on the constitutionality of decisions rendered by administrative law judges (ALJs).

Kokesh v. SEC: SEC Disgorgement Penalties Subject to Statute of Limitations

The SEC's ability to punish alleged wrongdoers for harm to retail investors suffered a significant setback with the Supreme Court's recent decision in *Kokesh v. SEC*.[9] In a unanimous decision authored by Justice Sotomayor, the Court held that 28 U.S.C. § 2462—which imposes a five-year limitations period to any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise"—applies to claims for disgorgement imposed by the SEC for violations of federal securities laws.[10] This ruling has curtailed the SEC's ability to seek disgorgement for conduct more than five years old and, by some estimations, has already prevented the SEC from obtaining more than $800 million in disgorgement.[11]

To understand how this situation arose, it is helpful to examine the underlying federal district court case that led to the Supreme Court's decision. After a jury verdict in the SEC's favor, the district court set about imposing penalties. The court ruled that the five-year limitations period at 28 U.S.C. § 2462 precluded any monetary penalties for misappropriation that occurred prior to October 27, 2004 (that is, five years before the complaint), but it ruled that disgorgement is not a "penalty" within the meaning of the statute and, thus, awarded the SEC all $34.9 million of misappropriated funds.

On appeal, the Tenth Circuit affirmed, holding that disgorgement is neither a "penalty" nor a "forfeiture" and thus not within the ambit of the statute of limitations.[12] Just three months before the Tenth Circuit published its opinion, however, the Eleventh Circuit came to a different conclusion, holding in *SEC v. Graham* that "disgorgement" fell within the ordinary meaning of "forfeiture," and that the SEC's claim for disgorgement was time-barred under 28 U.S.C. § 2462.[13]

The Supreme Court granted cert in *Kokesh* to resolve the circuit split. The SEC argued that disgorgement is not punitive but "remedial" in that it "lessen[s] the effects of a violation" by "restor[ing] the status quo."[14] The Court largely rejected this argument, however, observing that disgorgement often does not simply restore the status quo, but rather "leaves the defendant worse off." For example, the Court noted that insider traders are often ordered to disgorge not only their unlawful gains, but also the benefit that accrues to *third parties* whose gains can be attributed to the wrongdoer's conduct. Similarly, the Court pointed out that tippers are often required to disgorge profits gained by tippees, and that district courts often ignore the expenses incurred by a wrongdoer in generating ill-gotten gains. For all of these reasons, the Court held that disgorgement is often punitive rather than remedial.

Although decided in 2017, the ramifications of the Court's decision have come into clearer focus over the past year, and the picture that has emerged is not a pleasant one for a SEC focused on making restitution to Main Street investors who have suffered losses at the hands of alleged securities law violators. Indeed, Chairman Clayton has personally lobbied Congress to expand the SEC's power in light of the Supreme Court's holding in *Kokesh*.[15] In Chairman Clayton's view, the decision essentially rewards well-concealed frauds that go undetected while the limitations period expires, and Congress should override the decision by giving the SEC narrowly tailored authority to pursue disgorgement in cases where a well-concealed and elaborate fraud would otherwise be time-barred.[16]

Chairman Clayton's efforts to procure a legislative fix to the implications of the *Kokesh* decision have thus far been unsuccessful. Whether this issue will rise to the top of what is likely to be an active and contentious legislative agenda in the coming year remains to be seen. In the meantime, the SEC Staff will be under more pressure than ever to act promptly in investigating and bringing potential enforcement actions.

Lucia v. SEC: Supreme Court Rules SEC ALJs Unconstitutional

Frequently, the SEC delegates the task of enforcing our nation's securities laws to an ALJ, appointed by SEC Staff members, who presides over cases and imposes penalties against alleged wrongdoers.[17] During the first half of FY 2018, administrative proceedings accounted for 80 percent of new SEC enforcement actions against public companies.[18] The SEC's extensive use of ALJs over the last few years is the result, in part, of the SEC's expanded powers under the Dodd-Frank Act.

In June 2018, however, the Supreme Court held that the SEC's use of ALJs was unconstitutional. For reasons discussed below, the fallout from this decision may not be as significant as it would seem. But the decision is still a major setback and the questions that remain from the Supreme Court's narrow decision are likely to vex the Enforcement Division in the coming years.

The SEC's bout at the Supreme Court over the constitutionality of their ALJs has been a long time in the making. Respondents to SEC administrative proceedings have been challenging ALJ decisions for years in federal court, arguing either that ALJs are impermissibly insulated from presidential removal, or that ALJs were not appointed in accordance with the Appointments Clause of Article II of the US Constitution.[19] Many of these cases were dismissed on jurisdictional grounds until the DC Circuit in *Raymond J. Lucia Cos. v. SEC*[20] held that SEC ALJs are "employees" of the federal government not subject to the Appointments Clause.[21] Just four months later, the Tenth Circuit reached the opposite conclusion, holding that SEC ALJs are "officers" of the federal government, and therefore were unconstitutionally appointed to their posts.[22] In 2018, the Supreme Court granted certiorari to resolve this circuit split.

The SEC had initially instituted administrative proceedings against Mr. Lucia for misleading prospective clients in a retirement savings strategy scheme. ALJ Cameron Elliot presided over the case and concluded that Mr. Lucia had violated the Investment Advisers Act.[23] Lucia appealed to the SEC, and then to the Court of Appeals for the DC Circuit. According to Lucia, the judgment against him was issued by an "Officer[] of the United States" whose appointment failed to comply with the requirements of the Appointments Clause of the Constitution.[24] Indeed, ALJ Elliot had been appointed by SEC Staff members, not the President, "Courts of Law," or "Heads of Departments," as the Constitution would require if ALJ Elliot were deemed an officer of the United States.[25]

The Supreme Court framed the issue as "whether the Commission's ALJs are 'Officers of the United States' or simply employees of the Federal Government."[26] The Court's basic framework for deciding whether a particular official can be considered an "Officer of the United States" is to determine whether that official held a "continuing and permanent" position[27] and whether that official "exercis[ed] significant authority pursuant to the laws of the United States."[28] Practically, the Supreme Court's framework boils down to whether the official in question is more similar to "civil surgeons," which were found to be just mere employees, or members of the Federal Election Commission, which were found to be Officers of the United States.[29] Justice Kagan delivered the opinion of the Court, holding that ALJ Elliot, along with all of his colleagues who had been appointed by SEC Staff members, were "Officers of the United States," and thus subject to the mandates of the Appointments Clause. For Justice Kagan and the majority, *Lucia* represented a straightforward application of one of the Court's prior decisions, *Freytag v. Commissioner*.[30]

In *Freytag*, the Supreme Court held that the "special trial judges" of the United States Tax Court were "Officers of the United States." Just like the judges at issue in *Freytag*, SEC ALJs "receive a career appointment"[31] and exercise "significant discretion" in carrying out their adjudicative functions.[32] To be sure, Justice Kagan highlighted four powers that both the *Freytag* judges and the SEC judges wield at their disposal: (1) they "take testimony," meaning that they receive evidence, examine witnesses, and take pre-hearing depositions; (2) they "conduct trials" by administering oaths, ruling on motions, and regulating the course of a hearing; (3) they rule on the admissibility of evidence; and (4) they "have the power to enforce compliance with discovery orders."[33] Therefore, in order to cure the constitutional error that occurred in Lucia's administrative proceeding, the Supreme Court awarded Lucia a new hearing in front of a constitutionally appointed judge.[34]

The Supreme Court resolved the circuit split, but in doing so, raised more questions than answers. To begin with, *Lucia* only decided the Appointments Clause issue, failing to reach whether the removal procedures for SEC ALJs are unconstitutional. As it stands now, the Administrative Procedure Act permits ALJs to be removed only for "good cause" found by the Merit Systems Protection Board.[35] The members of the Board can be removed by the President for "inefficiency, neglect of duty, or malfeasance in office."[36] Now that the SEC's ALJs have been found to be "officers" within the meaning of the Appointments Clause, they may be unconstitutionally insulated from presidential removal because there exists a two-tier system for their removal.[37]

In his dissent, Justice Breyer stressed that the majority's decision could have far-reaching consequences, potentially "transforming administrative law judges from independent adjudicators into dependent decisionmakers, serving at the pleasure of the Commission."[38] Thus, *Lucia* could eventually convert the ALJ position into a partisan officer, whose decision-making could depend on which political party is in control of the White House. Respondents in SEC administrative proceedings will likely continue to bring this challenge to the removal procedures.

In addition, *Lucia* fails to resolve whether SEC ALJ appointment by the head of the SEC is constitutional because the Court declined to decide whether an ALJ is a "principal" or "inferior" officer.[39] If ALJs are considered "principal" officers for purposes of the Appointments Clause, only the President of the United States, with the advice and consent of the Senate, would be able to appoint them.[40] On the other hand, if ALJs are considered "inferior" officers, the head of a department, such as the SEC, could appoint them without Senate confirmation.[41]

The Supreme Court declined to reach the issue because both the SEC and Lucia acknowledged that SEC ALJs are "inferior" officers, but such a determination may not be so simple. *Edmond v. United States* defined "inferior officers" as "officers whose work is directed and supervised at some level by others who were appointed by presidential nomination with the advice and consent of the Senate."[42] While SEC ALJs issue decisions that may be subject to SEC review, Justice Kagan supported her holding in *Lucia* by arguing that the SEC's ALJs play a more autonomous role than the special trial judges at issue in *Freytag* because the SEC "can decide against reviewing an ALJ decision at all."[43] Moving forward, Respondents to administrative proceedings could seize this language to argue that an unfavorable ALJ ruling against them is unconstitutional because that ALJ should be categorized as a "principal officer" within the meaning of the Appointments Clause due to the ALJ's occasional unfettered discretion.

Legal commentators are at odds with regards to the practical implications of *Lucia*'s decision. Some are of the view that *Lucia* permits any party with current administrative proceedings in front of an SEC ALJ who has challenged their constitutionality to demand a new hearing. Others believe that Justice Kagan's narrow holding should not affect the status quo.[44] After a temporary halt to all ALJ proceedings, SEC lawyers in August confirmed that the agency had reaffirmed the appointments of the same ALJs who had been hearing cases prior to the *Lucia* decision.[45]

The SEC announced that it would give all cases pending before their ALJs the opportunity for a new hearing, but most of the outcomes are likely not in doubt.[46] So it should be business as usual moving forward for the SEC's Enforcement Division, particularly given its clear preference for administrative proceedings (even in the midst of the uncertainty presented by *Lucia*). However, for the foreseeable future, we can expect more, not less, challenges to SEC ALJ rulings in the federal district courts.

Cybersecurity Enforcement at the Forefront

If 2017 was a call to action on the cybersecurity enforcement front, 2018 was a year full of enforcement activity in response. Throughout 2017, Avakian and Peikin, in their role as co-directors of the SEC Enforcement Division, repeatedly emphasized that cybersecurity would be a top Division priority. This culminated in the September 2017 creation of the Cyber Unit within the enforcement division.

If 2018—the Cyber Unit's first full year in existence—is a preview of what is to come, the SEC will be at the forefront of cyber-related enforcement for many years. In particular, the Division focused on three primary areas of enforcement: (1) stopping unregistered and/or fraudulent trading of digital assets, including initial coin offerings (ICOs); (2) the safeguarding of customer information by registered entities; and (3) public company disclosures and controls.

Digital Assets/Initial Coin Offerings

This past year brought a little bit of old and a little bit of new in the world of SEC digital asset enforcement. As the Division ramped up its cyber-related enforcement efforts in 2017, it focused on unlawful sales of unregistered digital assets as well as misrepresentations in the sale of such assets. This was again a focus area in 2018. For example, the SEC halted an ICO run by Dallas-based AriseBank that claimed to be the world's first "decentralized bank."[47] AriseBank allegedly used common tactics, including social media and a celebrity endorsement to raise what it claims to be $600 million of their $1 billion goal in just two months.[48] AriseBank and its co-founders offered investment in their cryptocurrency by depicting AriseBank as the first decentralized bank using more than 700 virtual currencies.[49] It also falsely stated that it purchased an FDIC-insured bank, which allowed it to offer customers FDIC-insured accounts.[50] In response to this scheme, the SEC sought for the first time the appointment of a receiver in connection with an ICO fraud.[51]

The SEC has also halted fraudulent ICO schemes that have misrepresented connections with well-known entities, including being affiliated or sanctioned by the SEC itself. In May 2018, for example, the SEC obtained a court order halting an ICO run by a self-described "blockchain evangelist."[52] Titanium Blockchain Infrastructure Services, Inc. allegedly lied about business relationships with the Federal Reserve, PayPal, Verizon, Boeing and The Walt Disney Company, among others.[53] The website also contained fabricated testimonials from corporate customers. Once again, the SEC obtained the appointment of a receiver to oversee the $21 million that the ICO raised from investors.[54]

In a similar, but even more brazen, scheme, Blockvest LLC claimed that its ICO and its affiliates received regulatory approval from various agencies, including the SEC. Blockvest allegedly used the SEC seal without permission and falsely claimed that its crypto fund was "licensed and regulated."[55] Blockvest's founder also promoted the ICO with a fake agency he created called the "Blockchain Exchange Commission," and used a graphic similar to the SEC's seal and the same address as SEC headquarters.[56] Just a few weeks later, the SEC suspended trading in securities of American Retail Group, Inc. due to alleged false claims about SEC regulation and registration. The company issued two press releases claiming that it had partnered with an SEC-qualified custodian for use with cryptocurrency transactions that would be "under SEC Regulations," and that the company was conducting a token offering that was "officially registered in accordance [with] SEC requirements."[57]

Given the continued proliferation of schemes claiming approval or affiliation with the SEC or other regulators, the SEC has provided specific warnings about such claims. In announcing its complaint against Blockvest, for example, Robert Cohen, Chief of the Enforcement Division's Cyber Unit said that the "SEC does not endorse investment products and investors should be highly skeptical of any claims suggesting otherwise."[58] On the same day it announced the Blockvest complaint, the SEC also issued an investor alert warning investors to watch out for false claims about SEC and CFTC endorsements used to promote digital asset investments.[59]

In addition to these enforcement actions related to making false claims in the sale of digital assets, the SEC has also warned of selling such assets without complying with the federal securities laws, in particular by failing to register with the SEC. For example, in 2017, the SEC issued an investigative report, known as the DAO Report, which concluded that that issuers of distributed ledger or blockchain technology-based securities must register offers and sales of such securities unless a valid exemption applies.[60] In 2018, the SEC brought the first case charging unregistered broker-dealers for selling digital tokens following this report. The SEC charged a self-described "ICO Superstore" and its owners with promoting the company's website as a way to purchase digital tokens during ICOs and also to engage in secondary trading.[61] These activities required them to register as broker-dealers, which they all failed to do. In announcing the charges and settlement, Avakian encouraged "those developing digital asset trading businesses to contact the SEC staff … for assistance in analyzing registration and other securities law requirements."[62]

In addition to charging ICO operators for failure to register as broker-dealers, the Division also brought its first case based on findings that a digital token trading platform, EtherDelta, operated as an unregistered national securities exchange.[63] EtherDelta operated as an online platform for secondary market trading of ERC20 tokens, which is a type of blockchain-based token commonly issued in ICOs. EtherDelta provided a marketplace to bring together buyers and sellers of digital asset securities. It provided an order book, a website that displayed orders and a "smart contract" used to process trades. The SEC found that EtherDelta's users executed more than 3.6 million orders for tokens that qualified as securities. Because EtherDelta's platform offered trading of securities, it was required to register as an exchange or operate pursuant to an exemption, which it failed to do.[64] In another related action, Marc Berger, Director of the SEC's New York Regional Office, made the SEC's position on digital token trading platforms clear: "Platforms that engage in the activity of a national securities exchange, regardless of whether the activity involves digital assets, tokens, or coins, must register with the SEC or operate pursuant to an exemption. We will continue to focus on these types of platforms to protect investors and ensure compliance with the securities laws."[65]

In an enforcement action combining both the failure to register and falsely claiming SEC approval, the SEC charged a hedge fund manager for operating as an unregistered investment company. Crypto Asset Management LP offered an unregistered hedge fund that it marketed as the "first regulated crypto asset fund in the United States."[66] The fund also claimed that it was regulated by the SEC and had filed a registration statement with the SEC. However, by engaging in a non-exempt public offering and investing more than 40 percent of the fund's assets in digital asset securities, CAM caused the fund to operate as an unregistered investment company.[67]

In addition to pursuing enforcement actions, the SEC has also focused on educating market participants. For example, on November 16, 2018, the Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets collectively issued a statement recapping the SEC's ICO-related enforcement actions.[68] Among other things, the statement highlighted two recent enforcement actions brought against ICO issuers for failing to register the offerings. In each case, the SEC imposed a $250,000 penalty, but also provided that the issuers could continue to operate so long as they registered their tokens as securities pursuant to the Securities Exchange Act of 1934 and agreed to file periodic reports with the SEC for at least one year.[69] The SEC used the statement and enforcement actions to highlight both the need to register at the outset of an ICO, but also that that "there is a path to compliance with the federal securities laws going forward, even where issuers have conducted an illegal unregistered offering of digital asset securities."[70]

Outside of the enforcement context, the SEC's Office of Investor Education and Advocacy unveiled a mock ICO website—HoweyCoins.com—to educate investors. The site, which was launched in May 2018, touts a coin investment opportunity in the travel industry and comes complete with many of the enticements common to the very offerings that the SEC is attempting to police, including a white paper with a complex but vague explanation of the opportunity, promises of guaranteed returns, and a countdown clock showing that time is running out on an opportunity for a 15 percent bonus. The site also claims that the coins are registered with the US government and will trade on an SEC-compliant exchange. Members of the Office of Investor Education and Advocacy double as HoweyCoins promoters and the site also includes celebrity testimonials that are common in initial coin offerings. While the site certainly looks and feels real, any opportunity to invest ends as soon as a user clicks on the "Buy Coins Now" link. At that point, the user is led to investor education tools and tips from the SEC and other financial regulators.

Safeguarding Customer Information by Investment Advisers and Broker-Dealers

In addition to enforcement related to digital assets, the SEC has repeatedly emphasized the importance of safeguarding customer information. In September 2018, the SEC showed just how seriously it takes cybersecurity policies and procedures when it fined a broker-dealer and investment adviser $1 million related to the failure of such policies regarding a cyber intrusion that compromised personal information of thousands of customers.[71] Specifically, the SEC charged Voya Financial Advisors Inc. with violating both the Safeguards Rule and Identity Theft Red Flags Rule.

The Safeguards Rule, which is Rule 30(a) of Regulation S-P[72] requires every broker-dealer and investment adviser registered with the SEC to adopt written policies and procedures that address safeguards for the protection of customer records and information.[73] The Identity Theft Red Flags Rule, which is Rule 201 of Regulation S-ID,[74] requires broker-dealers and investment advisers registered with the SEC to develop and implement a written Identify Theft Prevention Program that is designed to detect, prevent, and mitigate identity theft in connection with the opening of certain covered accounts.[75]

In addition to its own employees, VFA uses contractor representatives who work in their own offices throughout the United States.[76] Cyber intruders impersonated these contractors over six days in 2016 by calling VFA's support line and requesting that contractors' passwords be reset. The intruders used the new passwords to access the contractors' accounts and gain access to personal information of 5,600 VFA customers.[77] They then used this information to create new online customer profiles and obtain access to account documents for three customers. The intrusion continued for several days, and VFA's security staff failed to take action such as blocking the intruders' IP addresses or freezing the compromised representatives' work sessions.[78] Additionally, even after a contractor representative notified VFA of the fraudulent reset of his password and VFA's customer service call center received several calls from suspicious numbers impersonating either that representative or his customers, customer service still provided account-level information.[79]

The SEC found that the VFA failed to terminate the intruders' access due to weaknesses in its cybersecurity procedures, some of which had been previously exposed during prior fraudulent activity.[80] VFA also failed to apply its cybersecurity procedures to the systems used by its contractors.[81] This marked the first SEC enforcement action charging violations of the Identity Theft Red Flags Rule. It is important to note that while VFA had a written Identity Theft Prevention Program pursuant to the rule, it did not review or update the program in response to changes in risks to its customers or provide adequate training to its employees. Additionally, the Identity Theft Prevention program did not contain the necessary procedures to respond to identity theft red flags, such as the ones detected by VFA during the intrusion.[82]

Public Company Disclosures

Just as the SEC has made the protection of customer data a priority in 2018, it has also focused on public company disclosures of cyber breaches. In February 2018, the SEC attempted for the second time (the first effort was in 2011) to provide guidance on when an issuer should disclose a data breach.[83] The SEC's guidance focused on the materiality of a particular cyber risk or breach. The SEC emphasized in the guidance that this standard applies not only to actual cyber events or breaches but also to the material risk of a cyber-event. The SEC also stressed that the need to make a disclosure must be analyzed on a case-by-case basis, depending on the nature, extent and potential magnitude of the risk or breach. In assessing whether disclosure is required, a company should consider the range of harm that an incident could cause, including to a company's reputation, financial performance, and customer or vendor relationships, along with the possibility of litigation or regulatory actions. The obligation to disclose is not limited to periodic reports such as 10-Ks or 10-Qs; it can also include current reports in an 8-K or 6-K. While the SEC made very clear that disclosure of material cyber events is mandatory, it also highlighted that a company should not make detailed disclosures that might compromise its cybersecurity efforts or provide a "roadmap" for those seeking to penetrate a company's security systems.[84]

The guidance also touched on insider trading and made clear that material, non-public information regarding cyber events should be treated no differently than any other material, non-public information. Officers, directors and other executives cannot trade on such information, and companies should have policies and procedures in place to guard against them doing so and also to help ensure the company makes timely disclosure of such information.[85]

Soon after issuing this guidance, the SEC brought an enforcement action against Altaba (formerly known as Yahoo!) and assessed a $35 million penalty based on its failure to disclose a massive data breach in which hackers obtained personal data relating to hundreds of millions of user accounts.[86] Within days of a 2014 intrusion, Yahoo's information security team knew that hackers had stolen personal data of millions of customers that Yahoo internally referred to as the company's "crown jewels."[87] While the breach was reported to senior management and the legal department, Yahoo failed to adequately investigate the circumstances of the breach or consider whether it needed to be disclosed to investors. It in fact was not disclosed to the public until more than two years later when Yahoo was in the process of closing the acquisition of its operating business by Verizon. During these two years, Yahoo's SEC filings stated that it faced the risk of data breaches, but never disclosed that a large breach had occurred. Notably, notwithstanding the SEC's insider trading warning addressed above, the SEC did not charge any Yahoo insiders regarding the data breach. In announcing the penalty, co-director of Enforcement Peikin said that the SEC does not "second-guess good faith exercises of judgment about cyber-incident disclosure. But we also have cautioned that a company's response to such an event could be so lacking that an enforcement action would be warranted."[88]

Continuing its focus on data breach disclosures, the SEC issued a report in October 2018 regarding the need for public companies to consider cyber threats when implementing internal accounting controls.[89] The report stemmed from the Division's investigation of nine public companies that were victims of cyber fraud, specifically email phishing schemes, and collectively lost more than $100 million, including two companies that lost more than $30 million and a third that lost more than $45 million. The Division ultimately did not bring charges against any of the companies, but used the investigation to highlight the need for internal controls and urged public companies to calibrate their accounting controls to the current risk environment. Just as the SEC issued a warning regarding cyber event disclosures before bringing an enforcement action, this report is no doubt intended to put issuers on notice that an enforcement action could follow if appropriate controls are not put in place.[90]

Insider Trading Remains an Area of Intense Focus

As in years past, deterrence of insider trading remained a key focus of the Enforcement Division, with insider trading actions comprising ten percent of all enforcement actions filed by the SEC in 2018. After a slight dip in the number of insider trading cases brought in 2017, the Enforcement Division brought 51 such cases in 2018 (a 24 percent increase), with federal courts beating out administrative courts as the preferred venue by a nearly three-to-one margin.[91] The mix of cases demonstrated a broad-based approach in which the SEC pursued claims targeting a wide range of alleged conduct and individuals.

The increase in insider trading cases is noteworthy in light of reductions in Enforcement Division personnel. Despite a two-year hiring freeze, the Division has been able to increase its enforcement activity in the area of insider trading, largely through reliance on the SEC Market Abuse Unit's Analysis and Detection Center, which uses increasingly sophisticated data analytics tools to pore over increasingly large collections of trading data. These analytics tools have enabled the SEC to identify individual traders with a history of fortuitous trades and focus its attention on those individuals and entities. In other words, the SEC is doing more with less.

Illustrative of the cases brought based on the Market Abuse Unit's data analysis is *SEC v. Yao Li*. According to the SEC, Li, Vice President of Technology at a Silicon Valley fiber optics company, regularly learned critical, nonpublic information about the company's financial performance well before its quarterly earnings reports.[92] Over the course of two years, Li allegedly traded shares in the company's stock (typically selling or short selling shares) in advance of at least three disappointing earnings announcements by the company.[93] Rather than trade the shares in his own account, Li allegedly placed trades in accounts in his wife's name, or accounts that he held jointly with his wife and that were not monitored by the company.[94] Li ultimately settled the claim.[95] Although he made nearly $200,000 in profits by trading on inside information, his total liability to the SEC was well more than double that: $196,203 in disgorgement, prejudgment interest of $23,062, and a $196,203 penalty.[96]

The SEC also continued to pursue enforcement of the securities laws against alleged tippers. In a case that received a tremendous amount of media attention, the SEC brought an enforcement action against US Congressman Chris Collins.[97] The SEC alleges that Representative Collins, an independent board member of an Australian biopharmaceutical company, received disappointing news about the company's multiple sclerosis drug while attending an event at the White House.[98] Collins then allegedly conveyed the bad news to his son, who in turn conveyed the news to his girlfriend's father.[99] Although Representative Collins did not trade any shares of the company, the other recipients of the news allegedly did—both on the Australian exchange and in over-the-counter pink sheet transactions in the US.[100] In addition to the SEC enforcement action, all three individuals have also been charged criminally.[101]

While insider trading cases may not be as directly tied to the SEC's retail investor initiative as other types of claims (for example, those against investment advisers and broker dealers), it is still an area of intense focus and will likely remain so for years to come.

Changes to the Whistleblower Program?

The SEC's Whistleblower Program continues to be a critical source of investigatory leads, and given the pressure posed by the Supreme Court's *Kokesh* decision to uncover and pursue cases within the five-year limitations period, it is arguably more important than ever. From the program's inception through the end of fiscal year 2017, the SEC has received more than 22,000 whistleblower tips, and original information provided by whistleblowers has led to enforcement actions in which the SEC has obtained more than $1.4 billion in financial remedies, including more than $740 million in disgorgement and interest, much of which has been returned to harmed investors.[102] To date, the SEC has awarded more than $326 million to 59 individual whistleblowers.[103] By any objective measure, these are impressive figures.

Fiscal year 2018 was no less impressive. In fact, of the Whistleblower Program's 10 largest awards to date, four were made over the past year: (1) a $15 million award in September (eighth largest); (2) a $33 million award in March (third largest); (3) a $39 million award in September (second largest); and (4) a $50 million award in March (largest ever, though split between two whistleblowers). Incredibly, of the $326 million awarded to whistleblowers since the Program began, more than 42 percent of that figure is accounted for by the four largest awards of 2018.

In the midst of this banner year for whistleblowers, the SEC proposed a number of amendments to the Program rules, including one that, if enacted, could reduce awards to whistleblowers in cases where the total recovery exceeds $100 million. The current rule provides that a whistleblower who provides original information that leads to a recovery of at least $1 million can receive between 10 percent and 30 percent of the recovery, without an upper limit on recovery.[104] The proposed amendment would authorize the SEC to adjust the award percentage so that it would yield a payout that does not exceed an amount "reasonably necessary to reward the whistleblower and to incentivize other similarly situated whistleblowers."[105] In practical terms, this means that the SEC would have the authority to reduce large awards like those made in 2018, though the amendment provides that in no event would a whistleblower's award be adjusted below $30 million.[106] The proposed amendment is intended to "make sure that the SEC is a responsible steward of the public trust while continuing to provide strong whistleblower incentives."[107]

Not all Commissioners are pleased with the proposal. Commissioners Jackson and Stein issued public statements dissenting from the prosed amendments. Commissioner Jackson argued that the proposal "risks harming investors by adding two things to this exceptionally successful program that don't belong in the world of whistleblowers: uncertainty and politics."[108] Because only one percent of whistleblower tips actually lead to awards, Jackson believes that large awards serve a valuable purpose in incentivizing risk averse employees to come forward with information of potential wrongdoing.[109] Commissioner Stein agreed, arguing that giving the Commission the authority to reduce an award that it feels is "too big" will weaken the Program and questioning whether the SEC even has the authority to decrease awards. In support of this latter point, Commissioner Stein pointed to the whistleblower statute itself, in which Congress "specifically told the Commission that [it] could 'not take into consideration the balance of the Fund' in determining the amount of an award."[110]

The comments received during the public comment period demonstrate that the proposal to reduce whistleblower awards is deeply unpopular.[111]

Among those who took the time to write in with comments was US Senator Charles Grassley, who like Commissioners Jackson and Stein, came out in opposition to the amendment. Senator Grassley observed that the SEC's Office of Inspector General (OIG) evaluated award levels in 2013 and concluded—based on two empirical studies addressing how monetary award levels address whistleblower behavior—that the award levels were reasonable and should not change.[112] Moreover, picking up on a theme sounded by Commissioner Stein, Grassley pointed out that the whistleblower statutes specifically direct the SEC not to take into account the dollar balance in the Investor Protection Fund when determining the size of a whistleblower award, thus indicating an intention not to alter awards in light of extraneous considerations.

Given the divide on the SEC and the unpopularity of this proposed amendment, it would appear that its enactment is far from certain. If the dissenters are correct, that uncertainty may, by itself, begin to quell the flow of incoming tips, and the absence of tips may create even more difficulty in uncovering and pursuing well-concealed frauds within the applicable five-year statute of frauds. It will be interesting to see how this issue plays out in the coming year.

Investment Advisers in the Crosshairs

The SEC's focus on protecting the retail investor has led to a sharp increase in the number of enforcement actions brought against investment advisers and investment companies. Compared to 2017, when the SEC brought 82 such actions, 2018 saw 108 enforcement actions against investment advisers and investment companies, which comprised 22 percent of all SEC actions.[113]

In contrast to insider trading cases, which tend to be brought in federal court, the vast majority of cases against investment advisers and investment companies (81 percent) were brought as administrative proceedings.[114] The reason for this is that the sanctions available to SEC Staff in administrative proceedings are well-suited to enforcement of securities law against investment advisers, including cease and desist orders, suspension or revocation of investment advisor registrations, censures, and bars from association with the securities industry—in addition to civil monetary penalties and disgorgement.

As usual, the cases against investment advisers broke down into several major categories, including (1) steering clients into inappropriate, risky investments, (2) failing to disclose commissions and other conflicts of interest, (3) failing to disclose fees, and (4) operating alleged Ponzi schemes. Over the past year, however, the SEC added to the list by pursuing at least three so-called "cherry-picking" schemes, in which trades are made in omnibus accounts and then allocated to specific accounts, with the best-performing trades allocated to preferred accounts.[115]

The SEC's focus on "cherry-picking" schemes is not new. Indeed, much of the current focus on this area stems from an initiative begun in 2015, when SEC economists, working with Enforcement Division investigators, began mining trading data to identify instances of advisers disproportionately allocating profitable trades to favored accounts.[116] In a speech at the Symposium for Federal Judges on the Economics of Corporate & Securities Law, Commissioner Michael Piwowar touted the SEC's recent enforcement activity directed towards stamping out cherry-picking, and the particular role played by economists.[117] Piwowar pointed out SEC economists—a group to which he once belonged—use sophisticated econometric and statistical tools to identify investment advisers who are allocating trades unfairly.[118] Piwowar noted that in one recent case, *In the Matter of Valor Capital Asset Management, LLC*, the SEC's econometric and statistical analysis showed that there was less than a one-in-a-trillion chance that the disproportionate allocation of favorable trades to the investment adviser's personal accounts was due to chance.[119]

But filing enforcement actions was only one aspect of the Enforcement Division's approach to protecting retail investors. It also pursued strategic initiatives focused on remedying alleged wrongs based on investment advisers' self-reporting of violations.[120] One such initiative concerned alleged disclosure failures relating to 12b-1 fees—that is, marketing and distribution fees often charged by one or more share classes of a mutual fund. The SEC has long brought enforcement actions against investment advisers who invest their clients' assets in higher-cost share classes when a lower-cost share class for the same fund is available; indeed, since 2013, the SEC has brought at least 15 such actions,[121] including one that resulted this year in a $12 million settlement.[122] Moreover, the SEC's Office of Compliance Inspections and Examinations has also prioritized this area, publishing a risk alert in 2016 highlighting the risks around marketing and distribution fees.[123]

Despite this focus, co-Director Avakian has noted that the SEC continues to see failures in share class disclosures.[124] Frustrated with the time commitment required to pursue these cases, over 22 months on average, the Enforcement Division launched the Share Class Disclosure Initiative, a voluntary program whereby investment advisers can self-report their failures to disclose their financial conflicts of interest relating to compensation they received in the form of 12b-1 fees.[125] Although self-reports would be required to disgorge any undisclosed fees (to be returned to investors), the Enforcement Division would recommend to the SEC that it waive any penalties.[126] The SEC has not disclosed the number of self-reports it received over the past year, but in a speech given just prior to the end of the fiscal year, co-Director Avakian said that the number was "substantial," and that the success of the initiative would allow the SEC to return money to investors on a broader scale, and more quickly than if pursued through traditional enforcement measures.[127]

Municipal Securities Remain a Point of Focus

The SEC's focus on the retail investor has led to continued scrutiny of the municipal securities market. Retail investors have significant exposure to municipal securities. Indeed, as of December 31, 2015, 41 percent of municipal bonds were owned by individual investors, and 29 percent were owned through mutual funds and other pooled investment vehicles.[128] Although the SEC's focus on this space began several years ago under the leadership of SEC Chair Mary Jo White, the renewed focus on the retail investor has breathed new life into this area.

The SEC's regulation of the municipal securities market is less direct than its regulation of the equity market because municipal securities are exempt from federal securities registration and reporting requirements that apply to other publicly offered securities.[129] However, the SEC can nevertheless reach this space through its regulation of broker-dealers and municipal securities dealers, as well as its power to enforce anti-fraud provisions of the securities laws.[130] And over the past several years, the SEC has been quite active, including through the institution in 2014 of the Municipalities Continuing Disclosure Cooperation (MCDC) Initiative, a self-disclosure initiative targeting material misstatements and omissions in municipal bond offering documents.[131] As a result of the MCDC Initiative, the SEC brought 143 municipal securities-related enforcement actions in 2015 and 2016.[132]

The SEC ended the MCDC Initiative in 2016, but it continues to bring enforcement actions against issuers and others involved in the municipal securities market. Indeed, the SEC brought several enforcement actions in this area during 2018, including actions against:

1. the former mayor of Markham, Illinois, who allegedly engaged in a pay-to-play scheme by soliciting and receiving a bribe from a construction contractor,[133]
2. a municipal adviser that allegedly overcharged the City of Rolling Fork, Mississippi for advisory services and failed to disclose certain related party payments,[134]

3. a municipal adviser that misrepresented its experience and failed to disclose conflicts of interest to a South Texas school district,[135]
4. two firms and 18 individuals allegedly involved in a scheme to divert new-issue municipal bonds to broker-dealers at the expense of retail investors by posing as retail investors, then "flipping" the bonds to broker-dealers for a fee,[136] and
5. an unregistered municipal adviser and its principal for failing to register and for failing to disclose material facts about their registration to a California school district.[137]

In addition, the SEC obtained lifetime bars prohibiting three town officials in Ramapo, NY, from participating in municipal bond offerings.[138] This concluded a litigation commenced by the SEC in 2016 charging the officials with falsifying the books of the town's primary operating fund to hide losses from bond investors.[139]

Conclusion

As the SEC embarks upon another year of securities regulation and enforcement—its 85th for those keeping score—its enforcement goals are clear. The core of Chairman Clayton's enforcement agenda is protection of the Main Street investor. This principle permeated the Enforcement Division's activities in 2018, as evidenced by increases in the number of actions against investment advisers, the targeting of cryptocurrency and ICO schemes, a tightening up of cyber protections, and a continued focus on insider trading claims. To protect the retail investor, Clayton's SEC has shifted its enforcement focus away from institutions, including the large Wall Street firms that prior administrations have targeted for alleged abuses, and has sought to hold individual wrongdoers accountable for their actions, theorizing that a focus on individuals will act as a greater deterrent to other potential wrongdoers.

Having so clearly defined the SEC's goals at the outset of his tenure, there is little reason to expect deviation from this course in the coming years. While a full slate of Commissioners may provide Chairman Clayton with the opportunity to ease regulation in certain areas, those efforts are unlikely to reach enforcement. The continuity between the enforcement efforts of past administrations and the current administration reflect a general consensus that the SEC's enforcement efforts are reasonable, necessary, and effective. As such, major changes are unlikely.

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