SEC Enforcement Co-Director Provides Update on Priorities During Pandemic: Takeaways for Issuers, Investment Advisers and Investment Companies

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Following up on previous guidance, Steven Peikin, Co-Director of the SEC Division of Enforcement ("Enforcement"), provided updated detail on Enforcement's response to the COVID-19 pandemic in a virtual keynote address last month at the Securities Enforcement Forum West 2020. (We discussed Enforcement's prior statements here and here.) In his remarks, Peikin affirmed that Enforcement will continue to prioritize COVID-19-related fraud – in particular, microcap fraud, insider trading and market manipulation, and false or misleading issuer disclosures. Peikin also reported that investment advisers, investment companies, and broker-dealers are within Enforcement's sights in connection with redemption and sales and marketing practices related to the pandemic. Moreover, while acknowledging that the crisis "has had – and will continue to have – a substantial impact" on Enforcement's operations, the Co-Director made clear that the Division intends to press ahead across all of its priority areas, whether COVID-19-related or not.

Key Risk Areas

In order to ensure a "well-coordinated response" to the pandemic and carry out Enforcement's priorities, Peikin and his Co-Director Stephanie Avakian established a Coronavirus Steering Committee in late March. The Committee, which is comprised of approximately two dozen managers from across the Division, aims to "proactively identify and monitor areas of potential misconduct, ensure appropriate allocation of [Enforcement's] resources, avoid duplication of efforts, coordinate responses as appropriate with other state and federal agencies," and ensure overall consistency in Enforcement's approach. According to Peikin, the Committee has focused on the following key risk areas:

Microcap Fraud. Pointing to Hurricane Katrina and the Ebola crisis as examples, Peikin noted that microcap fraudsters typically make "specious claims of treatments, disaster-response capabilities, and the like," and that Enforcement has observed "an explosion of similar activity" in recent months. Accordingly, the Steering Committee has been working with Enforcement's Microcap Fraud Task Force and Office of Market Intelligence to triage matters for possible trading suspensions against microcap issuers.

Enforcement has relied heavily on its broad authority to seek trading suspensions against such issuers since the onset of the pandemic, having obtained more than 30 suspensions to date based on what it viewed as questionable representations about, for example, availability of testing materials, development of treatments and vaccines, and access to personal protective equipment. Peikin further reported that the staff is conducting the investigations following those suspensions on an "extremely expedited basis."

Insider Trading and Market Manipulation. Consistent with Enforcement's previous statements, Peikin emphasized that the volatility of financial markets during the pandemic, coupled with a "regular stream of potentially market-moving announcements" by issuers, have increased opportunities for insider trading and market manipulation. The Steering Committee has therefore been working with the Division's Market Abuse Unit to monitor trading activity around announcements in industries particularly impacted by COVID-19 and other "suspicious market movements."

Issuer Disclosure. Also consistent with previous Enforcement guidance, the Co-Director noted the increased likelihood that financial stresses in the current economic climate may tempt issuers to make materially false or misleading disclosures concerning the impact of the downturn on their businesses or may expose accounting or disclosure-related violations that pre-date the pandemic. Enforcement is therefore taking a risk-based approach to scrutinizing issuer disclosures and financial reporting, concentrating on structural risks such as excessive debt or leverage and liquidity disruptions that may be red flags of such misconduct.

In addition, Peikin reported that the Steering Committee is focusing on issuers in industries particularly impacted by the downturn through a systematic review of their public filings, with the goal of identifying disclosures that appear to be "significantly out of step" with those of other issuers in the same industry. Enforcement also plans to scrutinize disclosures, valuations, and impairments that may be attempting to disguise previously undisclosed weaknesses as coronavirus-related.

Investment Adviser and Broker-Dealer Misconduct. Peikin noted that the Committee, working with Enforcement's Asset Management Unit, is keeping a watch for failures by private funds and investment companies to honor redemption requests as a potential indicator of underlying misconduct. The Committee is also working with the Complex Financial Instruments Unit to monitor the performance of structured products in an effort to spot improper marketing and sale of those products to retail investors.

Enforcement Matters To Proceed Despite Obstacles

The Co-Director also sent an explicit message that investigations and enforcement actions – including both matters focused on COVID-19 as well as those falling within previously existing Enforcement priorities – will go forward despite the logistical obstacles posed by the pandemic, including the fact that Enforcement staff have been working remotely since March. To bolster the point, Peikin reported that since mid-March, the staff has processed more than 4,000 Tips, Complaints, and Referrals – a 35 percent increase from last year – and has opened hundreds of new investigations, both COVID-19-related and not.

While Enforcement is cognizant that witnesses, custodians, and defense counsel "are all confronting many of the same difficulties" as the Enforcement staff, Peikin noted that the Division "cannot effectively shut down our program by agreeing to a blanket hiatus in investigations or litigation." Accordingly, while staff have been "directed to work with counsel and others to reach reasonable accommodations" where possible, Enforcement will not "permit the crisis to be used as a cover for gamesmanship."

Relatedly, the Co-Director observed that Enforcement is "keenly focused" on matters with approaching statute of limitations deadlines that risk the loss of the SEC's ability to seek penalties or disgorgement. Hence, in cases where defense counsel refuses to enter into a tolling agreement and the staff views the investigative record as adequate to support an enforcement action, Enforcement will consider recommending that the Commission authorize an action and, where necessary, will seek to supplement the record through discovery in litigation.

Takeaways for Issuers and Registrants

Given the Division's focus on both COVID-19-related fraud and pre-existing misconduct, issuers and regulated entities would be well advised to take the following steps, as appropriate:

- Issuers should remain attentive to their internal controls with respect to disclosure and financial reporting, including regular review and testing to ensure that they effectively address the specific pandemic-related risks identified by Enforcement to date. In addition, their compliance training should alert relevant employees explicitly to potential pressures to downplay the pandemic's effects and flatter financial performance. These steps will be critical not only in order to avoid making potentially problematic disclosures, but also to preserve the possibility of obtaining credit from the SEC and/or U.S. Department of Justice for the effectiveness of the issuer's compliance program in cases where either agency concludes that a disclosure was materially false or misleading.
- Issuers who fall into one or both of the categories that Enforcement associates with heightened risk – i.e., those with debt, leverage, or liquidity issues and those in industries especially hard-hit by the pandemic, such as transportation, hospitality, auto parts and equipment, or oil and gas – should anticipate the possibility of Enforcement attention, and hence, be especially prepared to substantiate their disclosures and to demonstrate the effectiveness of their internal controls as set forth above.
- As we have noted previously, issuers and regulated entities should review their policies and procedures and codes of ethics to ensure that they address insider trading and manipulation specifically, and extend to all categories of individuals with access to material non-public information, including, but not limited to, officers, directors, employees, consultants, and other outside professionals. They should also consider supplementing these with written guidance and training on the current risks of insider trading and manipulation as articulated by Enforcement.
- Registered broker-dealers and investment advisers should expect increased scrutiny of the sale and marketing of complex financial products to retail investors by the SEC's Office of Compliance Inspections and Examinations as well as Enforcement. This issue has been a focus of enforcement activity by the Complex Financial Instruments Unit in recent years, and per the Co-Director's remarks, will remain so. Broker-dealers and advisers therefore should be ready to demonstrate that their recommendations of those

products to retail investors were consistent with their respective obligations under the securities laws. They should also be prepared to show the reasonable design and effectiveness of their policies and procedures with respect to this issue or quickly address any potential shortcomings therein.

- Investment advisers should also be attentive to disclosures concerning valuation of assets and risk management, which have been recent priorities of the Asset Management and Complex Financial Instruments Units. The fallout from the pandemic may well intensify their interest in these areas over the coming months.
- Given Enforcement's focus on investor redemptions, private funds should be careful not to impede redemption requests in a manner inconsistent with the documents governing the advisory relationship or their representations to investors. Investment companies should be similarly vigilant with respect to their redemption obligations under the Investment Company Act.

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Foley Hoag has formed a firm-wide, multi-disciplinary task force dedicated to client matters related to the novel coronavirus (COVID-19). For more guidance on your COVID-19 issues, visit our Resource Page or contact your Foley Hoag attorney.
