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2020 Mid-Year Securities Enforcement Update

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I. Introduction: Themes and Notable Developments

A. Impact of the Pandemic on Securities Enforcement

The first half of 2020 will undoubtedly be most remembered for the impact of the pandemic on every aspect of our lives, both personal and professional. To be sure, the pandemic has had a profound effect on the economy and financial markets. As we know from prior crises, financial shocks give rise to a host of regulatory risks for public companies and market participants and lead the SEC to shift its attention to identifying and investigating indicators of potential securities law violations. History teaches us that unprecedented market volatility, fast moving economic events, and dislocations create substantial challenges for compliance, and that there is a significant increase in the risk of an investigation. As the impact of the pandemic continues today, this heightened investigative risk is compounded by unique challenges of remote work arrangements and the diminished ability for direct oversight and interaction.

Similarly, the pandemic had a significant impact on the SEC's enforcement program. Among other things, the pandemic caused the Enforcement Division to recalibrate priorities to address emerging risks, resulted in a number of enforcement actions against parties seeking to take advantage of the crisis, and required an adaptation of the investigative process to a remote work environment. Despite the pandemic, the Commission also continued to institute enforcement actions in its traditional areas of focus that had been in the pipeline since before the quarantine.

1. Enforcement Priorities and Regulatory Risks Arising from the Pandemic

Shortly after the nation implemented quarantine protocols in March, the co-directors of the SEC Enforcement Division took the unusual step of issuing a cautionary statement emphasizing "the importance of maintaining market integrity and following corporate controls and procedures" during this crisis. The SEC cited as examples the heightened risk of insider trading ("in these dynamic circumstances, corporate insiders are regularly learning new material nonpublic information that may hold an even greater value than under normal circumstances") and the need to be mindful of disclosure controls ("protect against the improper dissemination and use of material nonpublic information").[1]

Six weeks later, in a speech in May, Enforcement Co-Director Steven Peikin provided insights on the Division's enforcement priorities in light of the pandemic.[2] In response to the pandemic, the Enforcement Division formed a Coronavirus Steering Committee, comprised of leadership from the Home and Regional Offices, the specialized units, and the Office of Market Intelligence, to identify areas of potential misconduct and coordinate the Division's response to pandemic-related issues. Among the issues receiving heightened regulatory scrutiny are:

- *Insider Trading and Market Manipulation*: The rapid and dramatic impact of the pandemic on the financial performance of companies increases the potential for trading that could be perceived as attributable to material nonpublic information. The Steering Committee is working with the Division's Market Abuse Unit to monitor announcements in industries particularly impacted by the pandemic and to identify potentially suspicious market movements.

- *Accounting Fraud*: As with other financial crises, the pandemic is likely to expose previously undisclosed financial reporting issues, as well as give rise to rapidly evolving financial reporting and disclosure challenges. The Steering Committee is on the lookout for indications of potential disclosure and reporting misconduct. In particular, the Steering Committee is reviewing public filings with an eye toward disclosures that appear out of step with companies in similar industries. The Committee is also looking for accounting that attempts to inaccurately characterize preexisting financial statement issues as coronavirus related.
- *Asset Management*: Asset managers confront unique challenges created by the pandemic, including with respect to valuations, liquidity, disclosures, and the management of potential conflicts among clients and between clients and the manager. The Steering Committee is working with the Division's Asset Management Unit to monitor these issues, including failures to honor redemption requests, which could reveal other underlying asset management issues.
- *Complex Financial Instruments*: As with prior financial crises, the pandemic may reveal risks inherent in various structured investment products. The Steering Committee is working with the Division's Complex Financial Instruments Unit to monitor complex structured products and the marketing of those products to investors.
- *Microcap Fraud*: The Steering Committee is working with the Division's Microcap Fraud Task Force and Office of Market Intelligence, and has suspended trading in the securities of over 30 issuers relating to allegedly false or misleading claims related to the coronavirus.

As we discussed in our prior alerts in March and May on these issues, by understanding the issues that can give rise to regulatory scrutiny, and consulting with counsel on how to navigate unique challenges, issuers and financial institutions can both lower the risk of being in a regulatory spotlight and resolve regulatory inquiries more efficiently.

2. Enforcement Actions Related to the Pandemic

The SEC has brought several enforcement actions against parties allegedly seeking to take advantage of the pandemic. These cases have typically involved allegations that a company, or those trading in a company's securities, have made false or misleading statements about the company's ability to supply scarce protective or testing products in response to the pandemic. It will take much longer to assess whether the crisis leads to enforcement actions based on more nuanced financial reporting, disclosure, or trading conduct.

In late April, the SEC filed an action against a company and its CEO alleging the defendants issued false and misleading press releases about the company's ability to supply large quantities of N95 masks.[3] According to the SEC's complaint, the company issued a press release in February stating that it was in the process of solidifying its mask supply chain, and another press release in March stating that it had a large number of masks on hand. In a subsequent March press release, the company admitted it never had any masks available to sell. The SEC's complaint alleged that the company never had the masks, any orders for them, or any contracts with companies that could supply them.

In May, the SEC filed actions against two different companies for allegedly misleading investors in their press releases concerning COVID-19 product offerings.[4] According to the first complaint, a bioscience company's press release incorrectly stated that the company had begun shipping home finger-prick COVID-19 tests when the tests neither shipped nor were intended for home use. In a second action, the SEC alleged that a company and its CEO issued a misleading press release announcing a multinational public-private partnership to sell thermal scanning equipment to detect individuals with fevers when, in fact, the company had neither an agreement to sell the product nor a government partnership.

In June, the SEC also filed actions alleging market manipulations by parties allegedly using the pandemic as a means to inflate the price of companies' securities. In one action, the SEC alleged that a trader manipulated the stock of a biotechnology company through misleading statements in an online investment forum, including assertions that the company had developed an approved COVID-19 blood test.[5] The complaint also alleged that the defendant spoofed orders on the company's stock to create the appearance of high demand. In a second action against five Canadian citizens, the SEC alleged that the defendants fraudulently inflated microcap companies' stock through misleading statements such as a claim that one of the companies could make medical facemasks and that another had automated kiosks for retail use. The complaint also alleged that the defendants enabled the companies' control persons to anonymously sell company stock and evade registration requirements.[6]

3. Investigative Process in a Remote Work Environment

Despite the pandemic, the Commission's Enforcement program has continued to conduct investigations, albeit with accommodations for the realities of remote work situations.

In his speech in May, Co-Director Peikin noted that the Division staff continued to remain engaged despite the new challenges of a remote work environment. The Division staff was directed to work with defense counsel and others to reach reasonable accommodations concerning document production, testimony, interviews, and counsel meetings, given the challenges of the pandemic, but Mr. Peikin also cautioned that the staff will need to protect potential claims and won't agree to an indefinite hiatus in investigations or litigations. In particular, Mr. Peikin noted that in instances where defense counsel does not agree to tolling agreements, the Division will consider recommending that the Commission commence an enforcement action, despite an incomplete investigative record, and will rely on civil discovery to further support its claims.

B. Supreme Court Ruling on Disgorgement

In June 2020, the Supreme Court in *Liu v. S.E.C.* issued a major decision regarding the scope of the SEC's power to obtain disgorgement of ill-gotten gains in litigated cases.[7] *Liu* did not, as some had hoped, do away with disgorgement in litigated actions entirely. Instead, while leaving lower courts to fill in the precise contours, the Supreme Court articulated three guiding principles for determining the availability and scope of SEC disgorgement: first, disgorgement should benefit "wronged investors" rather than "the public at large"; second, courts may hold parties liable only for their own profits, not others' profits; and third, disgorgement cannot exceed actual gains and must instead be limited to "net profits" after deducting "legitimate expenses."[8]

Liu arose from a 2016 enforcement action alleging misappropriation of millions of dollars of investors' funds under the guise of constructing a cancer-treatment center that would have qualified the investors for EB-5 immigration status. In assessing the district court's award of disgorgement to the SEC, the Supreme Court held that "a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for victims is … permissible under [15 U.S.C.] § 78u(d)(5)," the statute authorizing the SEC to seek equitable relief.[9] The Court provided general guidelines for lower courts to consult in crafting disgorgement awards consistent with this holding.

First, the Court emphasized that disgorgement must be for the benefit of investors, noting that it “must do more than simply benefit the public at large by virtue of depriving a wrongdoer of ill-gotten gains.”[10] In many cases—for example, where there are no apparent investor victims or it is infeasible to distribute the funds to harmed individuals—the SEC deposits disgorged funds with the Treasury. The Court raised doubts about this practice, opining, “It is an open question whether, and to what extent, that practice … satisfies the SEC’s obligation to award relief ‘for the benefit of investors’….”[11]

Second, the Court emphasized “the common-law rule requiring individual liability for wrongful profits,” while noting that “[t]he historic profits remedy … allows some flexibility to impose collective liability.”[12] Thus, while there could potentially be “liability for partners engaged in concerted wrongdoing,” like the married petitioners in *Liu*, joint-and-several liability was “seemingly at odds with the common-law rule.”[13]

Third, the Court explained that disgorgement must not exceed a party’s ill-gotten gains, and, therefore, “courts must deduct legitimate expenses before ordering disgorgement.”[14] In assessing whether expenses were legitimate (and hence deductible), even if incurred in connection with a fraudulent scheme, the Court distinguished legitimate expenses that “have value independent of fueling a fraudulent scheme”—for example, possibly the lease payments and cancer-treatment equipment in *Liu*—from “‘inequitable deductions’ such as for [the alleged fraudsters’] personal services.”[15]

It is unclear how significantly *Liu*’s guidelines will impact SEC enforcement actions going forward. In particular, the Supreme Court left open the question of whether, and under what circumstances, the SEC is permitted to deposit disgorged funds into the Treasury where, as is often the case, it is infeasible to distribute funds to injured investors (if any exist). The SEC may try to sidestep this issue by finding new ways to benefit investors—for example, by depositing disgorgement proceeds into investor protection funds rather than the Treasury. Meanwhile, the Court’s guidance regarding the deductibility of legitimate expenses that “have value independent of fueling a fraudulent scheme” will, in at least some cases, likely result in a broader set of deductible expenses, thereby shrinking the “net profits” eligible for disgorgement.

Even if *Liu* significantly constrains the SEC’s disgorgement authority, the Commission could pivot to minimize its impact. First, it is unclear the extent to which *Liu*’s guiding principles apply to disgorgement in administrative proceedings, where there is express statutory authority for the remedy. The SEC may therefore decide to bring more administrative cases and avoid the judicial forum. Additionally, the SEC may increasingly rely on its statutory authority to pursue civil penalties to make up for any shortfall in disgorgement. As a result, *Liu* may have the effect of altering the mix (but not the amount) of monetary remedies the SEC seeks.

C. Commissioner and Senior Staffing Update

During the first half of 2020, there were a number of leadership changes, several of which reflect the advancement of lawyers with many years of experience in the Division of Enforcement to positions of senior leadership.

As we previewed in our Year-End Enforcement Alert, Commissioner Robert Jackson stepped down in February 2020 to return to teaching at NYU Law School. In June, President Trump nominated Caroline Crenshaw to fill the vacancy. Ms. Crenshaw has worked at the Commission since 2013, most recently as counsel to Commissioner Jackson. Previously, Ms. Crenshaw worked as counsel to former Democratic Commissioner Kara Stein, a position also once held by current Democratic Commissioner Allison Herren Lee. Before joining the Commission, Ms. Crenshaw worked in private practice on investigations defense. Ms. Crenshaw is also a judge advocate in the U.S. Army Judge Advocate General’s Corps. Until Ms. Crenshaw is confirmed, the Commission will operate with four Commissioners: Chairman Jay Clayton, along with

Commissioners Hester Peirce, Elad Roisman, and Lee (currently the only Democrat).

Other changes in the senior staffing of the Commission include:

- In February, Paul Montoya was appointed Associate Regional Director in the SEC's Chicago Office. As Associate Regional Director, Mr. Montaya co-heads the Enforcement program for the Office, along with Associate Regional Director Kathryn Pyszka. Mr. Montoya has worked at the SEC since 1997, including most recently as an Assistant Regional Director in the Chicago office, where he supervised staff in the Asset Management Unit.
- Also in February, Kelly Gibson was appointed Director of the SEC's Philadelphia Office. She was most recently Associate Regional Director in the Philadelphia office, and has worked at the SEC since 2008, including working in the Market Abuse Unit.
- In June, Jennifer Leete was named Associate Director in the SEC's Division of Enforcement. Ms. Leete has worked at the SEC since 1999, most recently as an Assistant Director. She succeeds Antonia Chion who retired in February 2020.

With the election approaching in November, one should expect a number of additional changes over the remainder of the year at senior levels of the Commission. In June, President Trump proposed Chairman Clayton as the U.S. Attorney for the Southern District of New York. However, in view of the events surrounding the nomination, it appears unlikely that the appointment will receive Senate consideration before the election.

D. Whistleblower Awards

The last six months have reflected two distinct trends in the Commission's whistleblower program—an increase in the number of whistleblower complaints, as well as an increase in the number and size of whistleblower awards.

First, as a result of the pandemic, the Commission has noted a marked increase in the number of whistleblower tips. In the two months of quarantine, from mid-March to mid-May, the Enforcement Division triaged more than 4,000 whistleblower tips, a 35% increase over the same period in 2019. As the pandemic continues to impact businesses through the remainder of this year, including by affecting financial reporting, disclosure, and trading, one should expect the increased pace of whistleblower complaints to continue. This puts a premium on companies' ability to demonstrate their response to internal complaints that could presage a whistleblower report to the government.

The second notable trend has been the increased number and size of whistleblower awards in the first half of this year. During the first half of 2020, the SEC awarded a total of nearly $115 million to 15 separate whistleblowers.

Most notably, in June, the SEC announced the single largest whistleblower payment in the program's history—$50 million to an individual who reported what the SEC described as "detailed, firsthand observations" of company misconduct which resulted in an enforcement action that returned funds to harmed investors.[16] In April, the SEC awarded over $27 million, the seventh-largest award in the program's history, to a whistleblower for information that uncovered violations occurring domestically and abroad.[17] Also in April, the SEC awarded over $18 million to a whistleblower who provided information that helped initiate an enforcement action which allowed investors to recover "millions of dollars in losses."[18]

Other significant whistleblower awards granted during the first half of this year include:

- Two awards in January of $277,000 and $45,000 respectively to two whistleblowers in connection with separate fraudulent retail investment schemes.[19]

- An award in February of over $7 million for sustained cooperation that led to a successful enforcement action.[20]
- Four awards in March—a $1.6 million payment for information that revealed securities law violations;[21] $570,000 and $94,000 payments for assistance that resulted in several enforcement actions;[22] and a $450,000 payment for assistance from a compliance professional who first reported internally and waited the required 120 days before reporting to the SEC.[23]
- Two awards in April: one for $2 million for information the SEC deemed “vital” and difficult to uncover without the individual’s cooperation;[24] and a second for nearly $2 million for what the SEC described as “critical evidence of wrongdoing” provided by a whistleblower who suffered hardship as a result of first raising concerns within their organization.[25]
- An award in May of nearly $2 million for information that led to a successful enforcement action and allowed for an asset freeze that prevented disgorgement of ill-gotten investor funds.[26]
- Two awards in June, including a $700,000 payment for information that resulted in asset recovery for investors[27] and a $125,000 payment for information and assistance which helped the SEC and another agency bring enforcement actions against the perpetrator of a fraudulent securities offering.[28]

In total, as of the end of June 2020, the Commission has paid out approximately $501 million to 85 individuals since the whistleblower program began.[29] Because whistleblower awards relate to prior enforcement actions, the recent awards are unrelated to the pandemic. However, the number and size of the recent awards reflect the strong incentives such awards provide to would-be whistleblowers.

II. Public Company Cases

A. Accounting Fraud and Internal Controls

1. Disclosures Cases

In February, the SEC announced a settled order against a global alcohol producer for failing to disclose trends affecting its key performance indicators.[30] The SEC alleged that the producer reported high organic net sales growth and organic operating profit growth without mentioning its pattern of shipping products in excess of distributor demand. According to the settled order, the company allegedly pressured distributors to buy products in excess of demand in order to meet internal sales targets despite declining market conditions, and the resulting increase in shipments enabled the company to meet performance targets and to report higher growth in certain performance indicators. The order also alleged that the company failed to disclose the trends that resulted from shipping products in excess of demand, the positive impact the over-shipping had on sales and profits, and the negative impact that the increase in inventory would have on future growth. The SEC’s order notes that the producer did not report these trends because it did not have adequate procedures in place to consider whether the company needed to disclose them.[31] Without admitting or denying the findings in the SEC’s order, the producer agreed to pay a $5 million civil penalty to settle the action.

In June, the SEC announced a settled action against an insurance company for failing to fully disclose benefits provided to its former CEO.[32] The company allegedly did not report over $5.3 million worth of personal expenses over five years even after the company had been made aware of the inaccuracies. Without admitting or denying the findings, the company consented to the SEC’s cease-and-desist order and to a $900,000 civil penalty.

2. Financial Reporting

In February, the SEC instituted a settled action against a financial institution for allegedly misleading representations concerning the success of its cross-selling business strategy.[33] According to the settled order, the cross-sell metric reflected accounts and services that were unused and unauthorized by customers, and that had been opened through sales practices inconsistent with the company's disclosure of a needs-based selling model. Without admitting or denying the allegations, the firm agreed to cease and desist from future violations and to pay a civil penalty of $500 million for distribution to investors. The settlement was part of a broader resolution with the Department of Justice.

Also in February, the SEC filed an action against a parent company, two of its former executives, and its energy subsidiary for allegedly making misleading statements about the subsidiary's nuclear power plant expansion.[34] According to the complaint, which was filed in federal court in South Carolina, the defendants represented that the company was on track in its plan to build two plants and receive nearly $1 billion in tax credits, even though they knew the company was behind schedule and the plan was eventually abandoned.

3. Cases against Independent Auditors

In May, the SEC instituted settled administrative actions against three former audit partners at an international accounting firm based on allegations that they improperly shared answers to internal training exams and attempted to cover up the misconduct during an internal investigation.[35] The settled order alleged that one former partner requested a second former partner to text him images of exam questions, and during the firm's internal investigation, the first former partner deleted the texts and encouraged the other former partner to follow suit. The third former partner also allegedly shared exams and answers within his team. Without admitting or denying the findings, the former partners agreed to suspensions on appearing or practicing before the SEC as accountants with the right to apply for reinstatement after durations of three years for the first former partner, two for the second, and one for the third.

III. Broker-Dealers

A. Suitability

In February, the SEC instituted a settled action against two subsidiaries of a broker-dealer relating to supervision of investment advisers and registered representatives who recommended certain investments—single-inverse ETFs—to retail investors.[36] The SEC's administrative order alleged that the broker-dealer's policies and training were not reasonably designed to prevent and detect potentially unsuitable recommendations of single-inverse ETFs. Consequently, certain employees allegedly recommended clients buy and hold those securities, despite the risk associated with holding such investments for longer than one day. Without admitting or denying the SEC's findings, the firm agreed to pay a $35 million penalty to be distributed to clients.

B. Trade Execution

In May, the SEC instituted a settled administrative action against an agency broker-dealer for routing certain customer orders in a manner inconsistent with representations in marketing materials as to how customer orders would be routed to market centers for execution.[37] According to the SEC's order, the firm represented that customer orders would be routed to market centers through the firm's smart order router based on execution price and liquidity factors. However, during the relevant period, the firm had entered into arrangements to route orders to unaffiliated broker-dealers (who had more favorable, high-volume pricing arrangements with market centers) to determine routing of the orders to market centers. Without admitting or denying the SEC's allegations, the firm agreed to pay a $5 million penalty. The SEC's order also recognized the firm's cooperation, including retaining an outside expert to analyze the large volume of data related to customer orders and executions.

C. Fees

In May, the SEC instituted a settled action against a broker-dealer based on allegations that the firm provided allegedly misleading information about its "wrap fee" program to customers.[38] "Wrap fee" programs offer accounts in which clients pay an asset-based fee for a bundle of investment advisory and brokerage services, including trade execution services. According to the SEC's order, the firm marketed the program as providing investment advice, trade execution, and other services for a single fee, but it allegedly directed certain wrap fee clients' trades to third-party broker-dealers for execution, which in some instances resulted in clients incurring additional trade execution fees. Without admitting or denying the allegations, the firm agreed to pay a $5 million penalty for distribution to affected clients.

D. Record-Keeping

In the first half of this year, the SEC instituted settled enforcement actions against two separate broker-dealers for deficiencies in trading information—known as "blue sheet" data—that the firms provided to the SEC in response to requests.[39] SEC staff routinely requests blue sheet data from broker-dealers in a variety of investigations or regulatory inquiries. In both of the enforcement actions, the errors in the data that the broker-dealers provided were the result of undetected coding errors in the process for identifying data for production to the SEC. In both actions, the broker-dealer firms consented to violations of the record-keeping provisions of the Securities Exchange Act, Section 17(a)(1) and Rules 17a-4(j) and 17a-25. The firms agreed to pay penalties to the SEC of $3.2 million and $1.55 million, respectively.

Notably, in both settlements, the SEC required the respondent broker-dealer firms to admit to the findings in the settled order, even as both orders acknowledged the firms' remedial actions and cooperation in the investigations; admissions have become a standard practice in blue sheet cases brought by the SEC.

IV. Investment Advisers

A. Risk Management

In January, the SEC instituted partially settled enforcement actions against a New York-based investment advisory firm, the firm's president, and a senior portfolio manager for allegedly misleading representations concerning the management of risk in a mutual fund managed by the advisory firm.[40] The advisory firm and president settled the action; the portfolio manager is contesting the allegations. According to the SEC's order and complaint, during a three-month period, from December 2016 to February 2017, the fund managed by the advisory firm lost approximately 20% of its value when markets moved against the fund's positions. The SEC's settled order against the firm and the president alleged that the advisory firm represented that it maintained risk parameters, but that the firm breached those parameters and did not take corrective action to avoid losses. The SEC's pending complaint against the portfolio manager alleges that he represented to investors that he employed a risk management strategy involving safeguards to prevent losses of more than 8%, but that in fact such safeguards did not limit losses. Without admitting or denying the SEC's findings, the advisory firm and president agreed to implement remedial compliance measures and to pay disgorgement and interest of approximately $9 million and penalties of $1.3 million by the advisory firm and $300,000 by the president.

B. Pre-Release ADRs

In 2020, the SEC has continued its initiative, commenced in 2018, focused on practices related to American Depositary Receipts ("ADRs"). ADRs are U.S. securities that represent foreign shares of a foreign company, and they typically require foreign shares in the same quantity to be held in custody at a depositary bank.[41] "Pre-released" ADRs are a variation that are issued without the deposit of foreign shares. Instead, they require that a customer either already owns the number of shares in equal amounts to the number of shares represented by the ADR or that the broker receiving the shares has an agreement with a depository bank.

In February, the SEC instituted its fifteenth action involving pre-released ADRs. In that settled action, the SEC's order alleged that the broker-dealer improperly borrowed pre-released ADRs from other brokers when it should have known that the brokers did not own the corresponding foreign shares.[42] The order also alleged that the broker-dealer failed to reasonably supervise its securities lending desk personnel concerning the borrowing of pre-released ADRs from these brokers. Without admitting to or denying the allegations, the firm agreed to pay disgorgement and interest of approximately $400,000 and a penalty of approximately $180,000.

C. Share Class Disclosure

In April, the SEC instituted the final three actions the Enforcement Division intends to recommend under the Division's Share Class Selection Disclosure Initiative, a program which provided advisers an opportunity to self-report failures to fully disclose conflicts of interest in selecting mutual fund share classes. Under the program, self-reporting advisers were eligible for standardized settlement terms that included disgorgement of fees, but did not include a penalty.[43] These latest settled orders related to two advisers who self-reported by the deadline and consented to violations of Section 206(2) of the Advisers Act and one who reported shortly after the deadline and consented to violations of Sections 206(2) and 206(4) of the Advisers Act and agreed to pay a $10,000 penalty.

D. Policies and Procedures to Prevent Misuse of MNPI

In May, the SEC instituted a settled administrative action against a Los Angeles-based private equity investment adviser firm based on allegations that the firm failed to implement and enforce policies and procedures reasonably designed to prevent the misuse of material nonpublic information under the particular circumstances in which the firm had a senior employee on the board of a portfolio company while also trading in the public securities of the portfolio company.[44] Notably, the settled order did not allege that the firm engaged in any trading while in possession of material nonpublic information. Even though the firm conducted its trading during the portfolio company's open trading windows, and the firm's compliance department had approved the firm's trades, the SEC's order alleged that the firm did not require its compliance staff to inquire or document sufficiently whether the board representative or other members of the investment team were in possession of material nonpublic information relating to the portfolio company. Without admitting or denying the allegations, the firm agreed to pay a $1 million penalty.

E. Misrepresentation

In May, the SEC filed a complaint and a request for appointment of a receiver against a Florida-based investment advisory firm alleging that the firm improperly inflated revenue data in order to increase asset values and performance metrics.[45] The complaint also alleged that the firm misrepresented monthly returns and investment balances, which, in turn, resulted in the payment of inflated management fees to the firm. The court granted the SEC's request for appointment of a receiver, and the litigation is ongoing.

V. Ratings Agencies

In May, the SEC instituted a settled action against a credit rating agency for allegedly violating two conflict of interest rules—Rule 17g-5(c)(8)(i) and Section 15E(h)(1) of the Securities Exchange Act of 1934—designed to separate credit ratings and analysis from sales and marketing efforts.[46] According to the SEC's settled order, analysts responsible for analyzing and rating the credit of companies also participated in sales and marketing efforts targeted at the same companies the analysts were responsible for rating, creating an impermissible conflict of interest. Additionally, the SEC alleged that the credit rating agency failed to maintain sufficient written policies and procedures to separate the firm's analytical and business development functions. Without admitting or denying the findings, the credit rating agency agreed to pay a $3.5 million penalty and agreed to conduct training and implement changes to its internal controls, policies, and procedures related to the charged provisions.

VI. Cryptocurrency

In the first half of 2020, the Commission continued to bring enforcement actions in the area of cryptocurrency and other digital assets. Some of the enforcement actions were based on alleged failures to comply with the requirement to register an offering of assets deemed to be securities; other actions included allegations of fraud in the offer and sale of digital assets; and one case concerned a celebrity endorsement of an initial coin offering (ICO) without disclosure of compensation received by the celebrity.

A. Registration Cases

In February, the SEC instituted a settled action against a blockchain technology company for conducting an unregistered offering of digital tokens, which the SEC determined to be investment contracts, *i.e.*, securities.[47] Citing to the Supreme Court's decision in *SEC v. W.J. Howey Co.*,[48] as well as the SEC's *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*,[49] the SEC's order alleged that a purchaser of the digital tokens would have had a reasonable expectation of obtaining a future profit based on the company's representations and efforts to build its business, including through its use of the ICO fund proceeds to develop a data marketplace for data sets relating to digital assets. In total, the offering raised approximately $45 million. Without admitting or denying the SEC's findings, the company has agreed to return the funds raised to investors via a claims process, register the tokens as securities, file periodic reports with the SEC, and pay a $500,000 penalty.

In May, the SEC instituted a settled action against a blockchain technology company for conducting an unregistered ICO which raised over $25 million by selling Consumer Activity Tokens to approximately 9,500 investors.[50] During the offering, the company emphasized its expectation that the tokens would increase in value and took steps to make the tokens available for trading on third-party digital asset trading platforms after the ICO. The company planned on using the ICO funds to develop a blockchain-based search platform for targeted consumer advertising. Without admitting or denying the SEC's findings, the company agreed to pay disgorgement and interest of approximately $29 million and a penalty of $400,000. Additionally, the company removed the Consumer Activity Tokens from all digital asset trading platforms and does not plan to continue development of the search platform.

B. Fraud Cases

In January, the SEC commenced an action against two individuals and two businesses, alleging violations of the antifraud and securities registration provisions of the federal securities laws in connection with the sale of digital assets.[51] The complaint alleged that in marketing and selling digital asset securities to raise funds for a blockchain technology they were developing, the defendants misrepresented that the technology was being tested by 20 hedge funds, when in reality they had sent a prototype to 12 hedge funds, none of which used the prototype. Additionally, the complaint alleged that one of the individual defendants used a fake identity when marketing the digital securities to conceal his criminal record. In a parallel action, the U.S. Attorney's Office for the District of New Jersey announced criminal charges against the individual who misrepresented his identity to investors.

In February, the SEC filed an action against an individual alleging violations of the antifraud provisions of the federal securities laws based on misrepresentations about the profits purportedly earned from trading digital assets.[52] The complaint alleged that the defendant misrepresented to investors, comprised mainly of physicians, that he had developed a proprietary algorithm that enabled him to generate extraordinary profits trading cryptocurrencies. Additionally, the complaint alleged that the defendant misrepresented the amount of assets he had under management and used investor funds to pay for personal expenses. In parallel actions, the U.S. Attorney's Office for the Southern District of New York and the Commodity Futures Trading Commission brought criminal and civil actions against the defendant.

In March, the SEC filed an action against three individuals alleging violations of the antifraud and securities registration provisions of the federal securities laws in connection with an ICO. The complaint alleged that the individuals conducted an unregistered ICO—raising more than $4.3 million from more than 150 investors—and made fraudulent representations to investors regarding the risk and value of the digital assets being offered.[53] The complaint also alleged that the individuals never distributed the digital assets to the investors and instead used investor funds to pay personal expenses and funnel proceeds to two other parties.

C. Failure to Disclose Compensation for Endorsement

In February, the SEC instituted a settled action against a celebrity for allegedly violating the anti-touting provisions of the federal securities laws.[54] The celebrity promoted an investment in an ICO but failed to disclose payments he received from the issuer for the endorsements. The endorsements included posts on the celebrity's public social media accounts and a press release. Without admitting or denying the SEC's findings, the celebrity agreed to pay disgorgement of the promotional payments of $157,000 he had received, as well as a $157,000 penalty and agreed not to promote any securities, digital or otherwise, for three years.

VII. Offering Frauds

In the first half of 2020, the SEC continued to bring a substantial number of enforcement actions to enjoin offering frauds, particularly those that targeted retail investors, including seniors.

A. Ponzi-Like Schemes

In January, the SEC filed three cases alleging fraudulent securities offerings that amounted to Ponzi-like schemes. In the first, the SEC alleged that an individual fraudulently raised at least $75 million from more than 500 investors through unregistered securities offerings, promising investors a perpetual guaranteed rate of return on their investments, which he claimed to be channeling into the purchase or creation, marketing, and maintenance of revenue-generating websites.[55] The complaint, which the SEC filed in federal court in Chicago, alleges that, in reality, the defendant used investors' funds to pay investor returns and his own personal expenses, including mortgage payments and private school tuition for his family. The Court granted a temporary restraining order and preliminary injunction, ordered an asset freeze and other emergency relief against the defendant, and appointed a receiver for the defendant's company.[56]

In the second case, the SEC filed an action against two individuals and their companies, alleging that they conducted a fraudulent securities offering that raised almost $5 million from retail investors.[57] The complaint, which the SEC filed in federal court in California, alleges that the defendants solicited investments in a holding company they controlled, purporting that the funds would be used to operate a Washington-licensed recreational marijuana company. Instead, the complaint alleges, the defendants used the investors' funds to support their own lavish lifestyles.

In the third case, the SEC filed an action against a California couple alleging a fraudulent securities offering that raised almost $1 billion from seventeen investors, including major institutional investors, between 2011 and 2018.[58] According to the complaint, which the SEC filed in federal court in Sacramento, the defendants solicited investments from wealthy investors by offering securities in the form of investment contracts through their two solar generator companies. The complaint alleged that the defendants promised investors tax credits, lease payments, and profits from the operation of mobile solar generators but never manufactured the majority of the promised generators and instead used investor funds to pay other investors and for personal expenses. The defendants consented to permanent injunctions, with monetary relief to be determined by the court.

In the first half of 2020, the SEC filed two actions alleging investment frauds that targeted retail investors, including senior citizens. In February, the SEC filed an action against a Florida-based private real estate firm and its CEO and Managing Director, alleging the defendants fraudulently raised more than $170 million from at least 1,100 investors.[59] According to the complaint, the defendants represented to investors that they would receive between 8% and 10% annual interest on their investments, and that their investment would be used to purchase undervalued real estate. The SEC alleges that, in reality, the defendants invested less than half of the funds in properties and used the remainder on personal expenses and to repay investors in another fund. The court granted the SEC's request for emergency relief, including an accounting and the appointment of a receiver over the primary and relief defendants.

In a second case, in May, the SEC filed an action against a California investment adviser alleging he conducted a Ponzi scheme targeting senior citizens in Southern California.[60] The complaint alleges that the defendant raised more than $5.6 million from at least 35 investors by marketing securities in another of his companies and by promising investors between 3% and 10.5% returns on so-called "private annuity contracts." According to the complaint, the defendant did not invest the funds in any securities but rather used the funds to pay promised returns to other investors and to settle investor fraud lawsuits. The court ordered an asset freeze, an accounting, and appointment of a temporary receiver.[61] The U.S. Attorney's Office for the Central District of California also filed a criminal complaint against the defendant.

B. Microcap Stock Fraud

In January, the SEC filed a pair of complaints against six individuals in the U.S., Canada, and Europe alleging fraudulent and unregistered stock offerings in at least 45 microcap companies that raised over $35 million.[62] The complaints allege that the defendants conducted two schemes: one to secretly dump large quantities of microcap stock while fraudulently transferring and hiding the source of funds used to promote the stocks, and another to sell and then manipulatively trade millions of unregistered shares of a microcap stock while artificially inflating its price and dumping the shares into the market. The U.S. Attorney's Office for the Southern District of New York announced parallel criminal charges.

C. Affinity-Based Offering Frauds

In January, the SEC filed a settled action against a Pennsylvania man for allegedly conducting a decade-long fraud, which raised approximately $60 million in investments from Amish and Mennonite community members.[63] According to the SEC's complaint, the defendant, who provided accounting and investment services to fellow Amish and Mennonite community members, solicited investments from his clients and promised to invest the funds in business and real estate loans to other members of the religious community but instead funneled a large percentage of the investments into his personal investment projects, which failed and left him unable to repay investors. The settlement provided for injunctive relief and the return of ill-gotten gains plus prejudgment interest. In February, the defendant also pleaded guilty to criminal charges of conspiracy and fraud brought by the U.S. Attorney's Office for the Eastern District of Pennsylvania.

Also in the first half of 2020, the SEC filed two actions against individuals alleging investment frauds that targeted senior retail investors' retirement funds. In the first action, in March, the SEC filed a complaint alleging that a Russian national, through a number of companies he owned, raised over $26 million from retail investors, many of them older investors looking to invest their retirement savings. According to the complaint, the defendant used internet ads linked to spoofed websites of 24 actual legitimate financial firms to lure investors to invest in fictitious Certificates of Deposit.[64] The U.S. Attorney's Office for the District of New Jersey announced parallel criminal charges.

In the second action, in June, the SEC filed a complaint alleging that a securities broker based in Nashville, Tennessee, defrauded two seniors of nearly $1 million over the course of four years.[65] According to the complaint, after acting as the senior investor's registered representative for more than three decades, the defendant made unauthorized sales of securities from the investor's account and transferred the proceeds of those sales into his own bank account using falsified wire transfer forms. The complaint further alleged that, after the first investor's death in March 2019, the defendant stole funds from another senior's brokerage account in similar fashion. The U.S. Attorney's Office for the Middle District of Tennessee also filed parallel criminal charges.

D. Misuse of Client Funds

In March, the SEC filed charges, and obtained an asset freeze and other emergency relief, against a Florida-based investment adviser and its managing member in connection with an alleged fraudulent unregistered securities offering.[66] The SEC's complaint alleged that the investment adviser made misrepresentations to investors about a purported hedge fund including assurances that investor funds were deposited into a sub-fund, which was purportedly invested in U.S.-listed products and 90% hedged using listed options. According to the complaint, the investment adviser instead directed a significant part of investor funds to a private start-up company owned by a managing member.

In May, the SEC filed an action against the owner of a film distribution company for allegedly violating the antifraud provisions of the federal securities laws.[67] The SEC's complaint alleged that the individual diverted funds he received from an investment management company, which were meant to support his film distribution business, to a sham company and then used the investor funds to pay personal expenses. The SEC is seeking disgorgement, civil penalties, and permanent injunctive relief. In a parallel action, the U.S. Attorney's Office for the Southern District of New York filed criminal charges against the individual.

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Gibson Dunn is one of the nation's leading law firms in representing companies and individuals who face enforcement investigations by the Securities and Exchange Commission, the Department of Justice, the Commodities Futures Trading Commission, the New York and other state attorneys general and regulators, the Public Company Accounting Oversight Board (PCAOB), the Financial Industry Regulatory Authority (FINRA), the New York Stock Exchange, and federal and state banking regulators.

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