How the SEC Enforcement Division Responds to a Crisis

March 25, 2020

As markets react to the spread of the coronavirus (COVID-19), the SEC has expressed its intent to respond proactively to the impact the crisis has had on capital formation, secondary trading, and investors. Risks can become heightened during a market downturn, and we expect that the Enforcement Division will concentrate resources on certain types of investigations, including potential: (1) material misrepresentations and omissions about the impact of the coronavirus on public companies and investment products; (2) trading based on material nonpublic information about changes in the financial performance of public companies; (3) errors in the operation of trading platforms being stressed by high trading volume and volatility; (4) misuse of investor assets, and (5) frauds seeking to take advantage of investor anxiety. In the coming weeks and months, public companies should be vigilant regarding their disclosure practices and management of material, nonpublic information, and industry professionals similarly should be cautious when describing the impact of the pandemic on their investment services and products.

COVID-19 has had a sudden and dramatic impact on our personal and professional lives. The U.S. securities markets have experienced a similar effect. The Dow Jones Industrial Average lost more than 25% of its value in ten trading days as investors struggled to understand the long-term economic consequences of the pandemic, and 1,000 point swings have become almost routine.

The SEC is affected as well. A majority of SEC staff began teleworking on March 10, and the agency has "transitioned to a full telework posture with limited exceptions."[1] The SEC now must balance the health and safety of its staff with its stated mission of facilitating capital markets, overseeing fair and orderly trading, and protecting investors.

SEC staff have mobilized previously in response to crises. Some crises originate in the financial sector, such as the broad 2007-2008 financial crisis and the more specific 2010 Flash Crash. Others originate outside the financial sector but quickly impact the markets, such as 9/11 and COVID-19. Sometimes a crisis poses a threat to the SEC's own operations, financial condition, or reputation, such as the 2019 government shutdown, the hacking of the SEC's EDGAR system, and the Madoff Ponzi scheme. As with prior events, we believe the SEC will be motivated to find opportunities to show that it is responding to the current crisis.

Because the Enforcement Division primarily acts through investigations and case filings, it is important to consider the types of cases that will receive its heightened scrutiny. Based our experience, as well as a recent statement by the Enforcement Co-Directors, we believe the Enforcement staff will be particularly alert to the following issues.

[1] *SEC Coronavirus (COVID-19) Response* (**https://www.sec.gov/sec-coronavirus-covid-19-response).**

1. Material Misrepresentations, Omissions, and Disclosure Violations

After a market crisis, the SEC often brings cases involving misleading descriptions of investment risk. This can impact both public companies and investment professionals.

Public Companies.

For public companies, the Enforcement staff may focus on the accuracy of disclosures about the impact of the pandemic on their businesses. We have observed an increase in voluntary filings on Form 8-K, which might indicate an effort to err on the side of disclosure. As discussed during the first **Davis Polk Daily Coronavirus Conference Call,** public companies should be careful when communicating with the market about the impact of the coronavirus. As investors search for information about the financial impact of the pandemic, companies' public statements might receive heightened scrutiny. Companies also should consider whether any statement, such as disclosure of a modest number of layoffs, might create a duty to update if conditions change.

The SEC also may focus on possible instances of selective disclosure, especially when prior guidance may no longer be reliable and as analysts seek new or updated guidance from company executives. To the extent that companies are making statements about layoffs or other business developments that they normally would not consider material, they might consider communicating the information to the market in a Regulation FD-compliant communication. Finally, the SEC might also look for indications of questionable accounting practices being used to mask unexpected revenue shortfalls.

Securities Industry Professionals.

For industry professionals, the SEC's approach may be informed by its experience following the 2007-2008 financial crisis, when the SEC viewed financial products as having substantially more risk than had been disclosed when they were sold. Although those products involved mortgage backed securities and other derivatives based on the housing sector, a pandemic-caused market crisis might impact a broader range of investment products and transactions.

We expect that Enforcement staff also will be sensitive to potential complaints that, as the crisis unfolded, professionals assured investors that their investments were secure, only to have a product or portfolio collapse in the ensuing weeks or months. As the staff identify leads for new investigations, they will turn to a traditional investigative technique: requesting large batches of email, lining up internal communications against external communications with investors, and flagging any perceived inconsistencies. Investment advisers and broker-dealers should ensure that they accurately describe the investment risks in all of their relevant product disclosures, be particularly careful when completing investor questionnaires, and be sure that descriptions of their strategies for responding to the crisis are materially accurate and not misleading.

2. Misuse of Material, Nonpublic Information

The Co-Directors of the Enforcement Division issued an unusual statement on March 23 in which they reminded corporate insiders to appropriately safeguard material nonpublic information, and urged public companies to follow established disclosure controls and procedures.[2] The statement noted that as market conditions change quickly, insiders may be more likely to have material, nonpublic information about a company's performance. By referring not only to company insiders but also "consultants and other outside professionals," the Co-Directors may be suggesting a concern about the number of insiders

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[2] *Statement from Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, Regarding Market Integrity* (March 23, 2020) (**https://www.sec.gov/news/public-statement/statement-enforcement-co-directors-market-integrity)**.

and others, such as doctors and lab personnel, who have material, nonpublic information about drug companies' progress toward developing a vaccine. The SEC is adept at monitoring trading and will look at trades by company insiders such as, for example, trading in advance of any material announcements about vaccine development. Similarly, the statement warns broker-dealers and investment advisers to comply with policies and procedures designed to prevent the misuse of material, nonpublic information, which are required under Exchange Act Section 15(g) and Advisers Act Section 204A.

3. Trading Platforms Operating Under Pressure

A narrow but important category concerns market infrastructure, such as trading platforms, data feeds, and online customer interfaces. Other than Reg SCI, which applies to a limited group of exchanges and other entities,[3] there are few SEC regulations governing the operation of the systems that form the circulatory system of the securities markets. Nevertheless, as elevated trading volumes and volatility test the market's infrastructure, the staff will be attuned to the potential temptation to push through an operational problem instead of pausing in a way that could prevent harm but reveal the problem. If a platform fails, SEC examiners and possibly Enforcement staff may question decisions made in the midst of the failure.

4. Protecting Investor Assets

A core goal of the federal securities laws is keeping investor assets safe. Several rules require broker-dealers and other regulated entities to segregate and protect customer assets. For example, Securities Exchange Act Rule 15c3-3, known as the Customer Protection Rule, requires broker-dealers to protect their customers' funds and securities and prevent investor assets from being used to finance a broker-dealer's business activities. Rule 15c3-1, the Net Capital Rule, also imposes liquidity standards on broker-dealers. These are highly complex rules for the uninitiated, and they are not commonly the subject of enforcement proceedings. For that reason, the Enforcement Division may rely on examiners in the Office of Compliance Inspections and Examinations ("OCIE") and staff in the Division of Trading and Markets ("TM"), who have more hands-on experience with these rules. Following a sudden market downturn, OCIE, TM and Enforcement might work together to identify and address potential violations.

5. Scammers Taking Advantage of Investor Anxiety

Professional fraudsters may seek to use anxiety about the coronavirus to defraud investors. Online chatrooms are filled with stock promotions touting microcap companies in trendy industries. Although there certainly are legitimate microcap companies in real industries, the world of microcap stocks unfortunately has a higher risk of fraud than other segments of the market. As the world strives forward to decrease coronavirus infections and treat those struck ill, some fraudsters probably will look to profit by selling bogus stories of miraculous treatments. Last month, the SEC warned investors to be aware of coronavirus-related investment scams,[4] and the SEC already has announced two trading suspensions connected to treatment of COVID-19, one involving promotion of a product to treat the coronavirus and the other involving purported international marketing rights to a treatment.[5]

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[3] *Regulation Systems Compliance and Integrity*, 79 Fed. Reg. 72251 (Dec. 5, 2014) (final rule release) (**https://www.sec.gov/rules/final/2014/34-73639.pdf**).

[4] *Look Out for Coronavirus-Related Investment Scams—Investor Alert* (Feb. 4, 2020) (**https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_coronavirus**).

[5] *Trading Suspension of the Securities of Eastgate Biotech Corp.* (Feb. 24, 2020) (**https://www.sec.gov/litigation/suspensions/2020/34-88265.pdf**), and *Trading Suspension of the Securities of Aethlon Medical, Inc.* (Feb. 7, 2020) (**https://www.sec.gov/litigation/suspensions/2020/34-88142.pdf**).

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We expect that staff at every government agency want to contribute to society's response to COVID-19, including at the SEC. For the SEC's Enforcement Division, that could mean producing a list of cases designed to show the SEC protecting investors from some of the unique harms that flow from a market crisis. For public companies, company executives, SEC registrants and securities professionals, these initial weeks of the market reaction are a time to be vigilant about the accuracy of disclosures and descriptions of risks, attentive to their handling of material, nonpublic information, and careful when monitoring trading platforms that are operating under extremely stressful conditions.

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