

## How COVID-19 May Influence SEC's Enforcement Analysis

By Charles Riely, Scott Walster and Grace Signorelli-Cassady

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Economic analysis is a key part of the U.S. Securities and Exchange Commission's work. The SEC routinely relies on detailed economic and statistical analyses to investigate and prove securities violations,[1] to support SEC rulemaking[2] and to help determine the appropriate amount of disgorgement[3] and penalties to impose for misconduct.[4]

The importance of this economic analysis to the Enforcement Division's work will be particularly apparent in weeks ahead as the division continues to prioritize addressing misconduct related to COVID-19.

Already, the SEC has brought charges against several companies and CEOs for issuing false press releases regarding products claiming to combat COVID-19 and also halted trading of numerous stocks.[5] More SEC action will likely follow; there was reportedly a 35% year-over-year increase in tips, and the commission's leadership has made clear that swiftly responding to the pandemic will be a continuing priority.[6]

As the SEC continues to pursue these cases, it will face a number of unique and complicated analytical issues in weighing the strength of potential charges. As always, it will be important for the SEC and defense counsel to tailor the economic analysis to fit the specific situations and be prepared to vet any economic analysis proffered in support of an alleged violation or a sanction.

### How the SEC Uses Economic Analyses to Prove Violations

Economic analyses can take many forms, and are generally designed to reflect the specific needs of the investigation. The SEC has used such economic analyses to uncover and prove a variety of securities violations, including corporate disclosure violations and insider trading schemes.

#### ***Corporate Disclosure***

COVID-19 has triggered a rise in market volatility and, as a result, many securities



Charles Riely



Scott Walster



Grace Signorelli-Cassady

industry players, including the SEC and the Nasdaq Stock Market, issued warnings of a potential increase in issuer disclosure fraud and other violations.[7] In addition, SEC Co-Director of Enforcement Steven Peiken noted that stress on issuers' financial condition may expose preexisting disclosure violations.[8]

When a corporation is being investigated for corporate disclosure violations such as making false or misleading statements, the SEC often first determines whether the information, once disclosed, impacted the price of the issuer's securities.

This typically assists the SEC in understanding whether investors found the information material, whether they were harmed by the disclosure and whether anyone profited from inflated security prices. The economic analysis required to determine the importance of the disclosed news will, however, be impacted by COVID-19-related volatility.

To understand why economic analyses will require adjustments, it helpful to understand how these economic analyses work under relatively normal market conditions. A common way to determine the impact of information on the price of a security is by conducting an analysis of the company's stock prices through time.

For example, economists may create an event study regression analysis that attempts to isolate the fraud's impact on the security's price, apart from any other market factors,[9] and then test whether the fraud's price impact is statistically significant (i.e., whether the fraud's price impact falls outside the expected range of volatility for the company-specific portion of the security's price movements and, therefore, was unlikely to have been caused by chance).[10]

To continue to be effective, however, these analyses will now have to account for the market volatility in the first weeks of the pandemic. Typically, estimates of expected volatility rely on many months' or a year's worth of historical data.

But a dramatic volatility change such as the extreme COVID-19-related stock-price changes in late February and early March[11] could cause an event study to underestimate volatility and lead to false positive findings of significant price movements.

It will, therefore, be essential for the SEC and practitioners defending against SEC actions to evaluate whether proper estimations of volatility and market relationships were used in evaluating security price movements, and adjust measurement techniques as needed to accurately capture COVID-19 volatility.

Market swings related to COVID-19 will also affect analyses measuring the impact of preexisting disclosure violations that were only exposed after market changes related to COVID-19 began. In reviewing these analyses, the SEC and practitioners should be prepared to ensure that a particular security's apparent price reaction is not being falsely influenced by separate COVID-19-related financial uncertainty.

### ***Insider Trading***

The SEC will also likely investigate and take action against instances of insider trading related to COVID-19. Such insider trading could include, for example, instances where politicians potentially traded on COVID-19 political intelligence, and also instances where everyday employees traded on the company's confidential information, including information related to COVID-19 and its impact on the company.[12]

An essential step in most insider trading cases is to demonstrate that the information at issue was material. When doing this analysis in the current market environment, the SEC may face more analytical challenges in demonstrating that the economic value of any inside information, rather than any other developments, caused the price change.

Demonstrating this will be particularly difficult during COVID-19 because the markets reflect an assortment of constantly changing information.

Thus, the SEC and practitioners will likely use economic analyses that include certain data, specifically intraday and overnight security data, to help price each piece of inside information and determine when markets reacted to the news.

In doing so, the SEC and practitioners will also likely need to gauge when the value of such inside information stops and when additional potentially favorable movements not causally related to the inside information begin.[13]

### **Corporate Penalties**

Economic analysis is also sometimes used to determine the appropriateness of a penalty. This is particularly true where individuals at public companies engage in corporate misconduct, but an action and penalty are brought against the corporate entity.

In that situation, the SEC is mindful that shareholders will potentially be harmed twice by others' wrongdoing — once when the misrepresentation lowers share prices and again by paying the penalty to the SEC.[14]

Therefore, the SEC must balance a desire to protect innocent shareholders who may have been harmed by fraudulent corporate disclosures, including COVID-19-related disclosures, against the SEC's desire to hold public companies accountable for wrongdoing.

One way to balance these competing desires is to consider whether the shareholders received any benefits from the wrongdoing, even if by no fault of their own. Indeed, multiple SEC commissioners have noted that an analysis detailing the presence or absence of a corporate benefit to shareholders could sway their vote on whether to levy fines against a corporation.[15]

Such benefits might include, for example, additional revenue from fraud-related products, or equity offerings and stock-based acquisitions that occur while the fraud is inflating the value of the company's securities.

In addressing the appropriateness of a corporate penalty, practitioners should be prepared to address several COVID-19-related factors.

First, COVID-19 led to slowing of equity offerings and mergers during the economic crisis. Therefore, in addressing a potential corporate penalty, companies should not only be prepared to use economic analysis to address any argument that the misconduct created a corporate benefit, but also to understand that COVID-19 may have limited these benefits.

Second, penalties imposed on companies during COVID-19 have the potential to do even more harm shareholders. That is because COVID-19-related economic uncertainty and lost revenue has already hurt

companies' liquidity and has forced them into new debt financing at a record pace.

Any penalties imposed in this context could increase the risk of an adverse corporate event, such as bankruptcy or restructuring financing at considerably less favorable terms. For these reasons, practitioners should consider their clients' ability to pay a penalty and be prepared to articulate how penalties imposed in the context of COVID-19 run a heightened risk of harming innocent shareholders.

### **Why This Matters**

Counsel should not only ensure that the SEC's economic analysis is being applied appropriately, but should also consider whether an alternative economic analysis might be beneficial or provide an alternate narrative.<sup>[16]</sup>

Further, because many SEC cases are settled long before trial, or even the commencement of litigation, practitioners also should consider deploying economic analysis as a part of defending a case at the investigative stage.

These considerations will only become more imperative in the context of the SEC's burgeoning COVID-19-related investigations and enforcement actions, where the SEC's economic analyses must shift to reflect new and ever-changing market realities.

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*Charles Riely is a partner at Jenner & Block LLP.*

*Scott Walster is a principal at Global Economics Group LLC. Previously, he served as an assistant director at the SEC's Division of Economic and Risk Analysis.*

*Grace Signorelli-Cassady is an associate at Jenner & Block.*

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[1] Economic and Risk Analysis, SEC, <https://www.sec.gov/dera> (modified Jan. 17, 2020); Congressional Budget Justification Annual Performance Plan (FY 2021) and the Annual Performance Report (FY 2019) at 42, SEC, <https://www.sec.gov/files/secfy21congbudgjust.pdf>.

[2] Memorandum from RSFI and OGC to Staff of the Rulewriting Divisions and Offices re: Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16, 2012), [https://www.sec.gov/divisions/riskfin/rsfi\\_guidance\\_econ\\_analy\\_secrulemaking.pdf](https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf).

[3] For example, in *SEC v. Wyly*, the SEC successfully sought two possible disgorgement figures, both totaling over \$100 million, derived from two alternative calculations, one based on the amount of tax payments avoided and the other on an analysis that demonstrated that, but-for the violations, the defendants would have earned far less profits on their security sales. See Brief of Donald R. Miller, Jr., in his Capacity as the Independent Executor of the Will and Estate of Charles J. Wyly, Jr., as Amicus Curiae Supporting Petitioner at 6-8, *Kokesh v. SEC*, 137 S. Ct. 1635 (No. 16-529) (2017), [https://www.scotusblog.com/wp-content/uploads/2017/03/16-529\\_amicus\\_pet\\_donald\\_r\\_miller.pdf](https://www.scotusblog.com/wp-content/uploads/2017/03/16-529_amicus_pet_donald_r_miller.pdf); *SEC v. Wyly*, 71 F. Supp. 3d 399 (S.D.N.Y. 2014).

[4] See *infra* note 15.

[5] Press Release, SEC, SEC Charges Companies and CEO for Misleading COVID-19 Claims (May 14, 2020), <https://www.sec.gov/news/press-release/2020-111>; Press Release, SEC, SEC Charges Company and CEO for COVID-19 Scam (April 28, 2020), <https://www.sec.gov/news/press-release/2020-97>; Chris Prentice, Tips to U.S. Securities and Exchange Commission Surge in Recent Weeks - Official, Reuters (May 12, 2020), <https://uk.reuters.com/article/us-usa-sec-enforcement/tips-to-u-s-securities-and-exchange-commission-surge-in-recent-weeks-official-idUKKBN22O329>.

[6] Chris Prentice, Tips to U.S. Securities and Exchange Commission Surge in Recent Weeks -Official, Reuters (May 12, 2020), <https://uk.reuters.com/article/us-usa-sec-enforcement/tips-to-u-s-securities-and-exchange-commission-surge-in-recent-weeks-official-idUKKBN22O329>. Market participants can track enforcement related developments through the SEC's investor alert webpage. Investor Alerts and Bulletins, SEC, Look Out for Coronavirus-Related Investment Scams - Investor Alert (updated June 10, 2020), [https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia\\_coronavirus?mod=article\\_inline](https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_coronavirus?mod=article_inline).

[7] These industry players have also warned of an increase in market manipulation activity. Nasdaq Warns of Market Manipulation Amid Coronavirus Outbreak, NASDAQ (Mar. 23, 2020), <https://www.nasdaq.com/articles/nasdaq-warns-of-market-manipulation-amid-coronavirus-outbreak-2020-03-23>; Fighting COVID-19-Related Financial Fraud, SEC (modified May 18, 2020), <https://www.sec.gov/fighting-covid-19-related-financial-fraud>.

[8] Steven Peiken, Co-Director, Division of Enforcement, SEC, Keynote Address: Securities Enforcement Forum West 2020 (May 12, 2020), <https://www.sec.gov/news/speech/keynote-securities-enforcement-forum-west-2020>.

[9] Frank Torchio, Proper Event Study Analysis in Securities Litigation, 35 J. Corp. L. 159, 159-68 (2009).

[10] For example, in *SEC vs. Aveo*, during trial, an SEC financial economist used an event study to demonstrate impact of the FDA's recommendations on the pharmaceutical company's stock price was statistically significant and not caused by chance. Trial Transcript, Day 6, at 34, 40-45, *SEC v. Aveo Pharmaceuticals, Inc.*, No. 16-CV-10607 (D. Mass. Nov. 26, 2018).

[11] Ben Winck, The Stock Market's Fear Gauge Slips to its Lowest Since Late February as Virus Concerns Wane, *Bus. Insider* (May 11, 2020), <https://markets.businessinsider.com/news/stocks/stock-market-volatility-index-vix-lowest-february-coronavirus-selling-fear-2020-5-1029188847>.

[12] See generally Insider Trading, SEC Investor.gov, <https://www.investor.gov/introduction-investing/investing-basics/glossary/insider-trading> (last visited June 12, 2020); Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, SEC, Statement from Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, Regarding Market Integrity (Mar. 23, 2020), <https://www.sec.gov/news/public-statement/statement-enforcement-co-directors-market-integrity>.

[13] See generally *SEC v. MacDonald*, 699 F.2d 47, 54 (1st Cir. 1983).

[14] Press Release, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), <https://www.sec.gov/news/press/2006-4.htm>.

[15] Hester Peirce, SEC Commissioner, Lies and Statistics: Remarks at the 26th Annual Securities Litigation and Regulatory Enforcement Seminar (Oct. 26, 2018), <https://www.sec.gov/news/speech/peirce-speech-lies-statistics-102618>; Michael S. Piwowar, SEC Commissioner, Reflections of an Economist Commissioner (Apr. 13, 2018), <https://www.sec.gov/news/speech/speech-piwowar-041318>; Daniel M. Gallagher, SEC Commissioner, Remarks at Columbia Law School Conference (Hot Topics: Leading Current Issues in Securities Regulation and Enforcement) (Nov. 15, 2013), <https://www.sec.gov/news/speech/2013-spch111513dmg>.

[16] For example, in *SEC v. Cuban*, the SEC failed to convince the jury that billionaire Dallas Mavericks-owner Mark Cuban engaged in insider trading, perhaps in part because Cuban's expert witness prepared a study analyzing the market in order to testify that the alleged inside information Cuban relied on when making his trades was not "material" and that the market's later reaction to that information was not "statistically significant." Erin Fuchs, *Why The SEC Lost Its Big Case Against Mark Cuban*, *Bus. Insider* (Oct. 17, 2013), <https://www.businessinsider.com/how-mark-cuban-defeated-the-sec-2013-10?r=US&IR=T>.