SYMPOSIUM

MEASURING THE IMPACT OF SEC ENFORCEMENT DECISIONS

*Stephen J. Choi**

This Article examines several metrics of Securities and Exchange Commission (SEC) decision-making that may be updated on a regular basis using publicly available data to give a picture of how SEC decision-making changes. This Article focuses on SEC actions against public companies and subsidiaries of public companies, using data from 2005 to 2018. The metrics include: the number of SEC actions per year and per month, the ratio of SEC actions to securities class actions by year, the mean abnormal return from an event study of the first public announcement of the problem that led to the eventual SEC enforcement action by year, the fraction of SEC actions with prior disclosure of the underlying violation by year, and the variability of a defendant company's stock price reaction to the initiation of an SEC action by year. The metrics cannot demonstrate what motivates internal SEC enforcement decisions with certainty but may raise questions that guide future research.

INTRODUCTION

Congress created the Securities and Exchange Commission (SEC) in 1934 and tasked the agency with the enforcement of the U.S. securities laws.[1] Today, the SEC enjoys wide discretion in its enforcement decisions, including decisions on whether to bring an action at all, against whom to bring the action, the timing of the initiation and resolution of the action, the venue of enforcement (civil court or an administrative proceeding), and the

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1. *See* Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 338, 347–52 (1988).

remedy sought from enforcement.[2] While the specific characteristics of the underlying securities law violation play into the enforcement decisions, other factors, including the prevailing political environment, media attention, and the SEC's changing priorities, may also affect these choices.

Under its discretion, the SEC brought an enforcement action against Citigroup in October 2011, alleging misleading disclosures related to Citigroup's involvement in a specific collateralized debt obligation during the late 2000s financial crisis.[3] The SEC brought lighter charges than at least some in the market had expected and chose not to charge any top officers or directors of Citigroup, required Citigroup to pay $285 million (which represented 0.3 percent of Citigroup's market capitalization at the time), and allowed Citigroup to settle without admitting or denying the SEC's allegations.[4]

Despite the relatively light SEC enforcement action,[5] the market commentary at the time also noted that the federal district judge presiding over the action, Judge Jed S. Rakoff, may not accept the settlement.[6] Judge Rakoff indeed rejected the settlement in November 2011, only to be overruled by the Second Circuit in 2014.[7]

Relatively little empirical work exists that assesses the SEC's ongoing enforcement choices. The SEC enforcement division publishes an annual report that details its prior fiscal year's overall number of enforcement actions divided by different subject matter categories.[8] Both New York

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2. *See* Molchatsky v. United States, 713 F.3d 159, 162 (2d Cir. 2013) ("[T]he SEC retains complete discretion over when, whether and to what extent to investigate and bring an action against an individual or entity."). For a discussion of the SEC's discretion to bring enforcement actions either in civil court or as an administrative proceeding, see David Zaring, *Enforcement Discretion at the SEC*, 94 TEX. L. REV. 1155, 1157–59, 1164–65 (2016).

3. *See* Complaint at 1–2, SEC v. Citigroup Glob. Mkts. Inc., 827 F. Supp. 2d. 328 (S.D.N.Y. 2011) (No. 11-CV-07387).

4. *See* Press Release, U.S. Sec. & Exch. Comm'n, Citigroup to Pay $285 Million to Settle SEC Charges for Misleading Investors About CDO Tied to Housing Market (Oct. 19, 2011), http://www.sec.gov/news/press/2011/2011-214.htm [https://perma.cc/U37N-58R5]. On October 19, 2011, Citigroup's stock price closed at $29.39 per share with 2.92 billion shares outstanding, giving Citigroup a market capitalization of $85.76 billion at the time of the settlement. *See CRSP Daily Stock: Citigroup Inc.*, CRSP U.S. STOCK DATABASES, http://www.crsp.org/products/research-products/crsp-us-stock-databases [https://perma.cc/6NW8-PSXE] (last visited Oct. 3, 2020) (on file with author).

5. *See* Jesse Elsinger & Jake Bernstein, *Did Citi Get a Sweet Deal?: Bank Claims SEC Settlement on One CDO Clears It on All Others*, PROPUBLICA (Oct. 20, 2011), https://www.propublica.org/article/did-citi-get-a-sweet-deal-banks-says-sec-settlement-on-one-cdo-clears-it-on [https://perma.cc/SF7U-J4B9].

6. *See* Peter Lattman, *Citigroup Deal to Go to Judge Critical of S.E.C. Practices*, N.Y. TIMES (Oct. 20, 2011), https://dealbook.nytimes.com/2011/10/20/citigroup-deal-to-go-to-judge-critical-of-s-e-c-practices [https://perma.cc/SDB9-DY9D].

7. *See* Kevin LaCroix, *Second Circuit Vacates Judge Rakoff's Rejection of SEC's Citigroup Settlement*, D&O DIARY (June 4, 2014), https://www.dandodiary.com/2014/06/articles/securities-litigation/second-circuit-vacates-judge-rakoffs-rejection-of-secs-citigroup-settlement [https://perma.cc/7U6A-LSQ6].

8. *See, e.g.*, U.S. SEC. & EXCH. COMM'N, DIV. OF ENF'T, 2019 ANNUAL REPORT (2019), https://www.sec.gov/files/enforcement-annual-report-2019.pdf [https://perma.cc/V2FH-

University's (NYU) Securities Enforcement Empirical Database (SEED) project and Urska Velikonja, a professor at Georgetown University Law Center, have published reports analyzing the SEC's published enforcement numbers.[9]

In this Article, I explore possible metrics of SEC enforcement decision-making using a dataset of all SEC enforcement actions from 2005 to 2018 against public companies and subsidiaries of public companies. While the SEC also enforces against nonpublic companies and individuals, this Article focuses on public companies and subsidiaries of public companies because securities violations by these entities typically affect large numbers of investors.[10] Thus, enforcement against such violations will have a greater impact on investor protection and on the capital markets.

To assess the impact of SEC decisions, a theoretical first-best metric would compare the actual world with how the world would look without SEC enforcement, keeping everything else the same, and measure the change in investor (or possibly overall social) welfare between these two worlds. Such a measure, however, would be difficult if not impossible to construct. Instead, this Article focuses its analysis on more limited but obtainable metrics. First, it looks at the aggregate number of SEC actions against public companies and subsidiaries of public companies annually. Other factors, such as the overall number of securities law violations in the economy and how the SEC applies its discretion in enforcement decisions, may affect the number of enforcement actions each year. To control for these other factors, this Article examines the number of SEC actions relative to a possible control for the number of violations in the economy: the number of private securities class actions. To the extent outside factors that determine the number of violations in the economy may affect the number of SEC actions and securities class actions in a similar way over time, examining the relationship of SEC actions to securities class actions will at least partially control for these outside factors and isolate the effect of SEC decision-making on enforcement numbers.

Second, this Article looks at the stock price reaction to the first public disclosure of the underlying securities law violations that led to the SEC enforcement actions. Not all securities law violations have the same impact on investors and the economy. Egregious fraud by a company involving scienter on the part of corporate officers will typically have a much larger negative stock price reaction upon the first public announcement of the

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7KXK]. Note that the SEC's fiscal year runs from October 1 to September 30 of the following year.

9. The NYU SEED project is a joint venture between Cornerstone Research and NYU's Pollack Center for Law and Business. *See* NYU POLLACK CTR. FOR L. & BUS., https://www.law.nyu.edu/centers/pollackcenterlawbusiness/seed [https://perma.cc/LS23-KYSC] (last visited Oct. 3, 2020); *see also* Urska Velikonja, *Reporting Agency Performance: Behind the SEC's Enforcement Statistics*, 101 CORNELL L. REV. 901, 910–11 (2016) (critiquing the SEC's reporting of enforcement numbers).

10. In the case of defendant entities that are subsidiaries of public companies, I look at the stock price reaction of the public parent company.

violation than a more technical violation of the securities laws without scienter. Examining the average stock price reaction to the first public disclosure of the underlying securities law violations targeted for enforcement actions provides a measure of the egregiousness of the violations that the SEC chooses to pursue.

Third, this Article looks at the relative proportion of SEC actions where there was disclosure of the underlying violations prior to the enforcement action against those where there was no prior disclosure. To the extent companies uncover securities law violations and consider these violations material to investors, the companies will tend to disclose these violations. Violations with a potentially larger market impact will also involve a greater likelihood that third parties, such as reporters and short-selling firms, will uncover the violations prior to the SEC action and make these violations public. Comparing those SEC actions with and without prior disclosure provides an alternate method of assessing the magnitude of the underlying securities law violations that the SEC chooses to target for enforcement.

Fourth, this Article looks at the variability of the stock price reaction to the first public announcement of the SEC enforcement action, as measured by the standard deviation of the stock price reaction to the announcement of the action. The variability will encompass the market's reaction to the SEC's choices regarding the enforcement action, including the forum (civil court or administrative proceeding), alleged violations charged, specific defendants, and penalties sought. Particularly for actions with prior disclosure of the underlying violation, the market will previously have formed an expectation of how the SEC will use its enforcement discretion. The market reaction to the announcement of the actual enforcement will reflect the unexpected nature of the SEC enforcement action. This Article posits that in times of policy change at the SEC, the market may have a harder time predicting how the SEC will bring enforcement actions from the prior disclosure of underlying securities law violations and thus, the standard deviation of stock price reactions on the eventual enforcement disclosure date will increase.

The metrics this Article examines are, of course, imperfect but, when tracked over time, hopefully add insight beyond the simple tabulated numbers the SEC annually provides. Even imperfect metrics can assist in providing greater transparency in the SEC's enforcement function. The metrics cannot demonstrate with certainty what motivates internal SEC enforcement decisions but may raise questions that guide future research.

I. THE DATASET

To develop metrics assessing SEC enforcement, I employ a dataset of all SEC enforcement actions initiated from 2005 to 2018 involving public companies and subsidiaries of public companies. The dataset combines information on SEC enforcement actions collected by the SEED project from 2010 to 2018 that I obtained from NYU's Pollack Center for Law and Business as well as information I hand coded from 2005 to 2009 using enforcement documents obtained from the SEC's website. I define public companies as including all companies traded on a major U.S. exchange, as identified by the Center for Research in Security Prices (CRSP) database either at the time of the start of the SEC enforcement action or in the five-year period prior to the start of the enforcement action.[11] I include subsidiaries of public companies because many financial institutions are organized in a holding company structure with operating companies as subsidiaries. I exclude SEC actions involving delinquent SEC filings. These actions do not require any showing of negligence or scienter on the part of the corporate defendants and thus take relatively few enforcement resources on the part of the SEC.[12] I also do not include reports of investigations and actions to compel compliance with an administrative subpoena, as these are infrequent and not representative of the SEC's everyday enforcement activities. Lastly, I count multiple enforcement actions that involve the same underlying activities against the same defendant as a single action.[13] The dataset consists of a total of 851 SEC enforcement actions.

II. THE NUMBER OF ENFORCEMENT ACTIONS

The SEC has long highlighted its overall enforcement numbers.[14] The agency also reports its enforcement numbers to Congress for the budget appropriation process.[15] Using the SEC's numbers, the SEED project at NYU publishes an annual report detailing the number of enforcement actions against public companies and subsidiaries of public companies.[16] Professor Velikonja has written several pieces examining the SEC's reporting of its enforcement numbers.[17]

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11. This is the same definition of a public company that is used in the NYU SEED database. *Methodology*, NYU POLLACK CTR. FOR L. & BUS., https://www.law.nyu.edu/centers/pollackcenterlawbusiness/seed/methodology [https://perma.cc/PD27-YRKN] (last visited Oct. 3, 2020).

12. *See* Velikonja, *supra* note 9, at 941–45 ("[D]elinquent filing actions really are different from other enforcement actions. Including them in the overall measure of enforcement output will tend to bias the indicator upward . . . .").

13. The SEC, in its discretion, may bring follow-on enforcement actions following a primary enforcement action against the same defendant for the same underlying violation. These include follow-on actions to impose a suspension or bar or revoke a license. These follow-on actions do not take as many resources as the primary action and, if included in my count, would artificially boost the overall number of SEC enforcement actions. For a discussion of the problems with the SEC's enforcement reporting, see Velikonja, *supra* note 9, at 903–04, 932–40.

14. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Division of Enforcement Publishes Annual Report for Fiscal Year 2019 (Nov. 6, 2019), https://www.sec.gov/news/press-release/2019-233 [https://perma.cc/2EX6-TNDS].

15. For a discussion of the role of the SEC's enforcement numbers in the congressional budget appropriation process for the SEC, see Velikonja, *supra* note 9, at 906, 912–15.

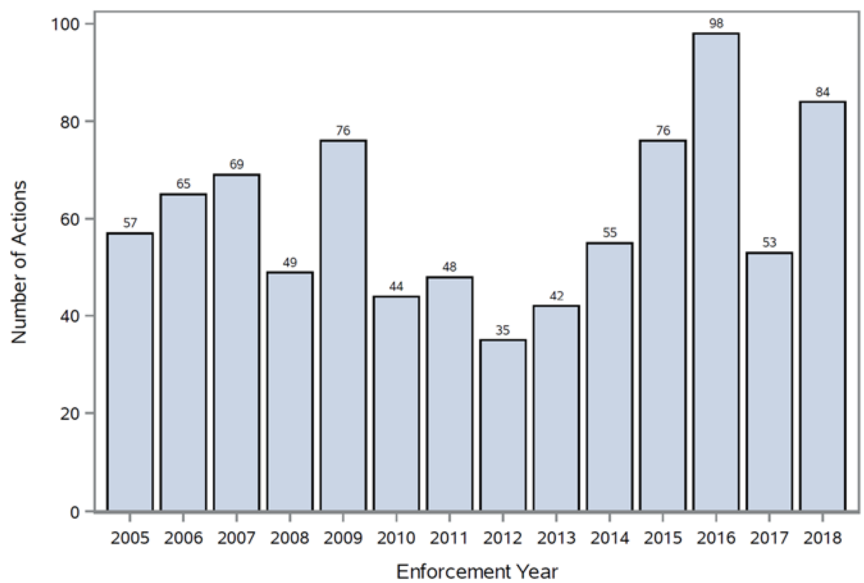
16. *See, e.g.*, CORNERSTONE RSCH., SEC ENFORCEMENT ACTIVITY: PUBLIC COMPANIES AND SUBSIDIARIES FISCAL YEAR 2019 UPDATE (2019), https://www.cornerstone.com/Publications/Reports/SEC-Enforcement-Activity-FY-2019-Update [https://perma.cc/B966-VZRV].

17. *See* Urska Velikonja, *Politics in Securities Enforcement*, 50 GA. L. REV. 17, 30–31 (2015) [hereinafter Velikonja, *Politics*]; Urska Velikonja, *Public Enforcement After* Kokesh*: Evidence from SEC Actions*, 108 GEO. L.J. 389, 394 (forthcoming 2020); Velikonja, *supra* note 9, at 909 n.33; Urska Velikonja, Behind the Annual SEC Enforcement Report: 2017 and

Simply observing that the SEC has initiated a certain number of new enforcement actions in any given year alone is meaningless without knowing the overall incidence of securities law violations in the economy, which in turn may depend on the performance of the economy and other market conditions. Nonetheless, looking at year-over-year trends, so long as no major shift occurs in the economy during this time frame, may help observers outside the SEC identify changes in decision-making within the agency that affect overall enforcement. For example, both the SEED project and Professor Velikonja noted the drop in enforcement actions from the last year of the Barack Obama administration to the first year of the Donald Trump administration.[18] More recently, the SEED project published a report in late 2019 that indicated that the SEC's enforcement numbers in its 2019 fiscal year were at a high point in the SEED data spanning 2010 to 2019.[19]

As a starting point, I tabulated the number of SEC enforcement actions against public companies and subsidiaries of public companies for the 2005 to 2018 period by calendar year, as depicted in Figure 1.

Figure 1: Number of SEC Actions Against Public Companies and Subsidiaries of Public Companies by Calendar Year



Beyond 1–2 (Nov. 19, 2017) (unpublished manuscript) [hereinafter Velikonja, Annual SEC Enforcement], https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3074073 [https://perma.cc/5QNC-PQ9Q].

18. *See* CORNERSTONE RSCH., SEC ENFORCEMENT ACTIVITY: PUBLIC COMPANIES AND SUBSIDIARIES FISCAL YEAR 2017 UPDATE 1 (2017), https://www.cornerstone.com/Publications/Reports/SEC-Enforcement-Activity-2017-Update [https://perma.cc/4AWB-SPP4]; Velikonja, Annual SEC Enforcement, *supra* note 17, at 1.

19. *See* CORNERSTONE RSCH., *supra* note 16, at 1.

Note in Figure 1 that the number of SEC enforcement actions in 2017 was, indeed, less than in 2016. If one looks at the monthly average from February 2017 to December 2017—the months that correspond with the new Trump administration—there was an average of only 3.1 actions per month. This is compared with an average of 8.2 per month in 2016. The difference between the average number of monthly SEC actions during the months in 2017 under the Trump administration and the months in 2016 under the Obama administration is significant at the 1 percent confidence level.

Looking at the broader picture of SEC enforcement actions from 2005 to 2018, it is unclear whether the overall number of actions in 2017 was the product of a change within the SEC or some external factor affecting the number of securities law violations in the economy. To control for external factors, I propose as a metric the ratio of the number of SEC enforcement actions to the number of private securities class actions filed each year.

Private plaintiffs' attorneys drive the filing of securities class actions in the United States. Importantly, unlike the SEC, private plaintiffs' attorneys typically seek one unvarying primary goal: to maximize their own profits. Presumably, as the number of instances of fraud (that provide the possibility of a financial return from litigation) that are uncovered rises in any given year, the number of securities class actions will also rise in that same year. Looking at the ratio of SEC enforcement actions to securities class actions filed in any given year will at least partially control for changes in the underlying number of securities law violations in the economy.

To construct the ratio of SEC enforcement actions to securities class actions filed in a given year, I obtained the annual number of securities class action filings from the Cornerstone Research annual report on securities class action filings.[20] I omitted mergers and acquisitions (M&A) filings from my count of securities class actions. The number of M&A securities class actions filed in federal court has rapidly increased in the past several years. This increase is likely due to a ruling in the Delaware Court of Chancery regarding the potential lack of merits of disclosure-only settlements in M&A objection lawsuits.[21] Because the increase in M&A filings in federal district court in recent years is not due to any overall increase in private litigation in the economy but instead is the result of a shift away from Delaware Chancery Court, I omitted M&A securities class action filings.

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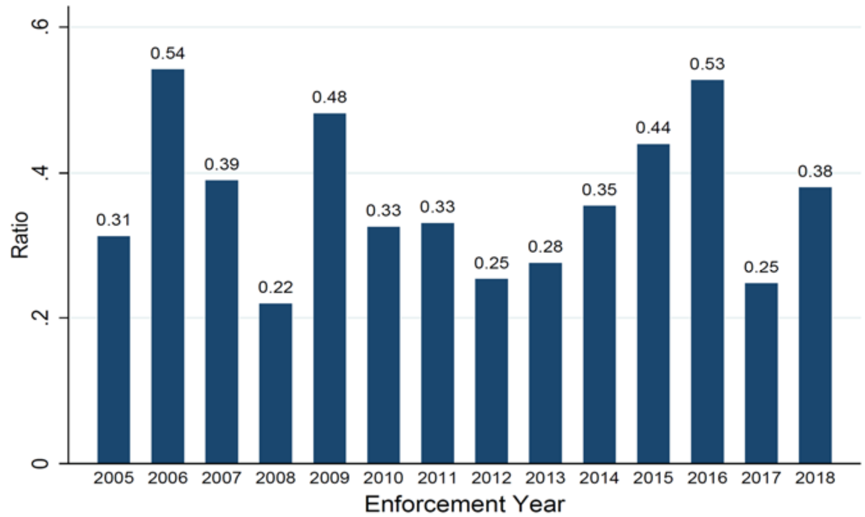
20. *See* CORNERSTONE RSCH., SECURITIES CLASS ACTION FILINGS: 2018 YEAR IN REVIEW 3–6 (2018), https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2018-Year-in-Review [https://perma.cc/B8MP-FXPB].

21. *See In re* Trulia, Inc. S'holder Litig., 129 A.3d 884, 898 (Del. Ch. 2016). For commentary on the *In re Trulia* decision and the subsequent shift to federal courts of M&A objection-related claims recast as disclosure claims, see Sean J. Griffith, *Class Action Nuisance Suits: Evidence from Frequent Filer Shareholder Plaintiffs* 8 (Eur. Corp. Governance Inst. Working Paper No. 502/2020) (forthcoming 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3470330 [https://perma.cc/F6C7-98GY].

Figure 2 depicts the ratio of newly filed SEC enforcement actions to securities class actions (omitting M&A class actions) by calendar year.

Figure 2: Ratio of SEC Actions to Securities Class Actions



Note from Figure 2 that the ratio of SEC actions to securities class actions in 2017 (0.25) is less than half the ratio in 2016 (0.53). Not only did the number of SEC enforcement actions drop from 2016 to 2017 but the number of securities class actions did not,[22] leading to the decline in the SEC action to securities class actions ratio. To the extent the ratio at least partially controls for the overall incidence of securities law violations in the economy, the ratio provides stronger evidence than looking at enforcement numbers alone that something changed in SEC enforcement priorities and preferences in 2017. The ratio jumps back up in 2018 though, indicating that the low in SEC enforcement is localized to 2017.

Several caveats exist to using the ratio of SEC actions to securities class actions as a measure of the intensity of SEC enforcement activity, controlling for the overall incidence of securities law violations in the economy. First, while private plaintiffs' attorneys will consistently seek to maximize profits, the amount of private resources available to bring securities class actions may vary by year (with changes in law firm structure, introduction of greater financing for private litigation, and so on). Some of the variation in the ratio could be due to variations in the resources available to private plaintiffs' attorneys to bring new securities class actions. Nonetheless, to the extent the changes in resources are minimal from year to year, using the SEC actions to

22. The number of non-M&A securities class action filings increased from 186 in 2016 to 209 in 2017. *See* CORNERSTONE RSCH., *supra* note 20, at 5.

securities class actions ratio will provide a rough sense of how SEC enforcement decision-making is changing on a year-over-year basis.

Second, SEC enforcement and private securities class actions may target overlapping but not identical sets of situations. The SEC may target some actions that private plaintiffs' attorneys cannot. Only a subset of the securities laws is available to private plaintiffs' attorneys to allege a violation in a securities class action, including, most importantly, § 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934[23] ("the Exchange Act"), prohibiting fraud in connection with the purchase or sale of securities, and § 11 of the Securities Act of 1933[24] ("the Securities Act"), prohibiting material misstatements or omissions in the registration statement for public offerings.[25] The SEC, in contrast, is tasked with enforcing the entire federal securities legal regime.[26] Nonetheless, while only a subset of the securities laws can be litigated by private plaintiffs' attorneys, to the extent changes in the economy affect the underlying incidence of different types of securities law violations in a similar way, then looking at the ratio of SEC actions to class actions will control for these economy-wide changes.[27]

Third, for the same underlying securities violations, SEC enforcement actions are often initiated sometime after the filing of a securities class action, sometimes over a year later. As a robustness check, I computed the ratio of SEC actions filed in one year to securities class actions filed in the prior year. Under this alternative ratio, the ratio in 2017 (0.28) was less than half the ratio in 2016 (0.57). I also computed the ratio of SEC actions in one year to securities class actions filed in the two previous years. Under this alternative ratio, the ratio in 2017 (0.31) was also less than half the ratio in 2016 (0.63). In both alternatives, the ratio test indicates a downward shift in the intensity of SEC enforcement against public companies and subsidiaries of public companies in 2017 compared with 2016.

Lastly, the number of SEC actions and the number of securities class actions may not be independent of one another. The decision to file a securities class action may depend on the SEC's enforcement activities. Most class actions are filed prior to an SEC enforcement action (if any). However, the public announcement of even preliminary SEC investigation activity may influence the filing of class actions. Several other factors also bear on the decisions of plaintiffs' attorneys to file a class action, including the market capitalization of the corporate defendant, the amount of share turnover, the stock price reaction upon announcement of the underlying

23. 15 U.S.C. §§ 78a–78qq.

24. 15 U.S.C. §§ 77a–77aa.

25. *See* STEPHEN J. CHOI & A. C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 241–405, 569–663 (5th ed. 2019).

26. *See id.* at 857–937.

27. Private plaintiffs' attorneys may also target some actions that the SEC may not. In particular, some securities class actions may be frivolous. Nonetheless, so long as the relative proportion of frivolous to meritorious litigation does not appreciably change from year to year, the amount of private frivolous litigation will not materially affect the comparison of the ratio of SEC enforcement actions to securities class actions from one year to the next.

violation, the presence of a restatement, and so on. It is also possible that the previous filing of a securities class action may influence the SEC's decision whether to bring an enforcement action. For example, there are instances where private recovery has affected the size of the monetary sanctions the SEC seeks in enforcement.[28]

Despite these caveats, even if the SEC action to securities class action ratio only imperfectly controls for external factors and provides an approximate view into changes in SEC enforcement decisions over time, tracking these changes through the ratio will serve as a starting point for more extended analysis. For example, assuming the drop in SEC enforcement actions and the ratio of SEC actions to securities class actions in 2017 from 2016 is not due to external factors, what explains the change in internal SEC decision-making in 2017? One hypothesis is that disruption in SEC enforcement occurs with the transition to a new chairman of the SEC, Jay Clayton in the case of Trump, and new enforcement codirectors, Steve Peikin and Stephanie Avakian.[29] Disruption is temporary and the increase in the number of enforcement actions, as well as the SEC actions to securities class actions ratio in 2018, is consistent with a temporary effect on enforcement. In contrast though, the first year of the Obama administration in 2009 does not show the same drop in enforcement from the prior year.[30] However, the late 2000s financial crisis and the greater need to enforce the securities laws in response to the crisis may explain the absence of a drop in enforcement actions in the first year of the Obama administration.

A second hypothesis is that 2017 is not the anomaly. Instead, 2016 is the anomaly. Possibly in the last year of an administration, SEC leadership attempts to push through as many enforcement actions as possible before regime change. However, the lack of a drop between 2008 and 2009 is inconsistent with this outgoing regime hypothesis. Both Figures 1 and 2 also depict a steady increase in the number of SEC actions and the ratio of SEC actions to class actions from 2013 to 2016, coinciding with Mary Jo White's tenure as chairman of the SEC and her "broken windows" approach to enforcement that focused on smaller magnitude cases to increase overall compliance in the securities industry.[31] Despite the focus on smaller

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28. On February 25, 2010, federal district Judge Douglas P. Woodlock entered final judgment against State Street Bank and Trust Company, pursuant to the consent of the SEC and State Street Bank and Trust Company. As part of the judgment, State Street's undertaking to pay $255,240,472 to injured investors took into account a credit of $349,600,887 for payments State Street had already made to injured investors, including in a class action settlement. *See* Final Judgment as to Defendant State Street Bank & Trust Co., SEC v. State St. Bank & Tr. Co., No. 10-cv-10172 (D. Mass. Feb. 25, 2010), ECF No. 8.

29. Note, though, that Stephanie Avakian was deputy director of the SEC's Enforcement Division from June 2014 to December 2016 and acting director of the Enforcement Division until her appointment as codirector in June 2017. *See Biography, Stephanie Avakian*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/biography/avakian-stephanie [https://perma.cc/F5S9-YXML] (last visited Oct. 3, 2020).

30. *See supra* Figures 1, 2.

31. *See* Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Remarks at the Securities Enforcement Forum (Oct. 9, 2013), https://www.sec.gov/news/speech/spch100913mjw [https://perma.cc/YV68-ZBXV].

magnitude cases, the "broken windows" approach also corresponded with a ramp-up of enforcement against public companies and subsidiaries of public companies from 2013 to 2016.[32] The shift in 2017 may reflect a move away from Mary Jo White's particular emphasis on enforcement.

A third hypothesis is that legal changes affected the SEC's enforcement in 2017. The U.S. Supreme Court decided *Kokesh v. SEC*[33] on June 5, 2017, and held that the SEC's disgorgement remedy is a "penalty" and thus is subject to a five-year statute of limitations.[34] To the extent the SEC had enforcement cases in the pipeline that sought disgorgement and involved violations that took place beyond the five-year statute of limitations, *Kokesh* would have truncated the SEC's ability to bring such actions.

A fourth hypothesis is that a shift occurred in SEC enforcement priorities. In a July 2017 speech given shortly after he became chairman of the SEC, Jay Clayton publicly stated that the SEC would focus on "main street" securities fraud that affected retail investors.[35] In September 2017, the SEC launched a new task force focused on protecting individual investors.[36] One possibility is that the focus on individual investors shifted the SEC's focus toward offering frauds, Ponzi schemes, conflicts of interest, and excessive brokerage fees and away from large publicly traded companies.[37] The drop in 2017 is consistent with the SEC shifting its enforcement focus under a constrained budget. Note, though, that the subsequent increase in 2018, as depicted in Figures 1 and 2, potentially indicates either that the SEC's shift in focus toward "main street" did not in fact negatively impact enforcement against public companies and their subsidiaries or, alternatively, it demonstrates there was at least a partial shift in the SEC's priorities away from "main street" and back toward public companies and their subsidiaries.

An alternative to using annual enforcement numbers is to examine monthly enforcement numbers. Looking at monthly numbers gives an indication of whether calendar factors, in addition to specific characteristics of securities law violations, drives SEC decisions. Normally, one would not expect seasonality to affect SEC decision-making. The presence of

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32. *See* David Zaring, *Mary Jo White's SEC Legacy: Strong on Enforcement but Not on Reshaping Wall Street*, MARKETWATCH (Nov. 16, 2016, 2:00 PM), https://www.marketwatch.com/story/mary-jo-whites-sec-legacy-strong-on-enforcement-but-not-on-reshaping-wall-street-2016-11-16 [https://perma.cc/Z4XR-9Q5K].

33. 137 S. Ct. 1635 (2017).

34. *See id.* at 1644.

35. *See* Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n, Remarks at the Economic Club of New York (July 12, 2017), https://www.sec.gov/news/speech/remarks-economic-club-new-york [https://perma.cc/NCV5-UQP2] (asking "how does what we propose to do affect the long-term interests of Mr. and Ms. 401(k)?").

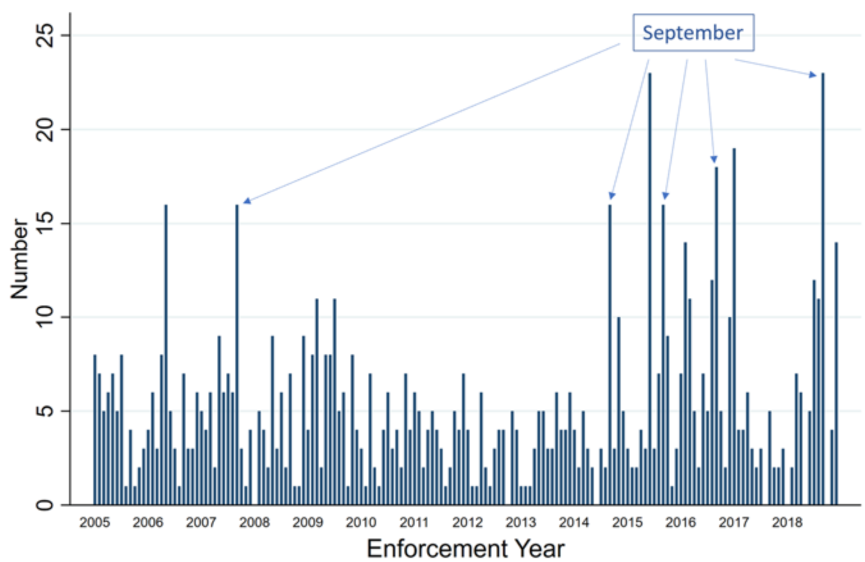
36. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors (Sept. 25, 2017), https://www.sec.gov/news/press-release/2017-176 [https://perma.cc/3JD6-BUKP].

37. *See Oversight of the U.S. Securities and Exchange Commission: Hearing Before the H. Comm. on Fin. Servs.*, 115th Cong. 65 (2018) (statement of Jay Clayton, Chairman, United States Securities and Exchange Commission) ("Going forward, Enforcement will continue to place a priority on misconduct that harms retail investors, such as offering frauds, Ponzi schemes, conflicts of interest and inappropriate or excessive fees.").

seasonality may indicate that factors other than the characteristics of specific cases may drive SEC enforcement decisions.

In a study of all SEC enforcement actions from 1998 to 2014, Professor Velikonja reported that the SEC tended to bring more enforcement actions in September compared with other months—an effect Velikonja labelled the "September Swell."[38] Figure 3 depicts the monthly number of SEC enforcement actions against public companies and subsidiaries of public companies.[39] Unlike Velikonja's earlier study of monthly enforcement numbers, Figure 3's focus on actions against public companies and subsidiaries of public companies allows an assessment of monthly variation excluding the low-cost actions identified by Velikonja and including delinquent filings and follow-on actions brought after an initial primary action against a defendant that are not included in my dataset of public companies and subsidiaries of public companies.

Figure 3: Number of SEC Actions Against Public Companies and Subsidiaries of Public Companies by Month



Note from Figure 3 that, particularly from 2014 onward, there is a "hockey stick" pattern of enforcement actions spiking in the month of September. The mean number of actions in September (9.6 actions) from 2005 to 2018 compared with the mean number in October (2.8 actions) is different at the 1 percent confidence level. Not only is there a "September Swell" effect, there is also an "October Ebb" effect, with significantly lower numbers of actions

38. *See* Velikonja, *Politics*, *supra* note 17, at 30–32.

39. Note that I do not have monthly data on the number of securities class actions from 2005 to 2018, so I did not construct the ratio of SEC actions to securities class actions by month. I leave this for future research.

in the month of October. I compared the mean number of actions in October (2.8 actions) from 2005 to 2018 with the mean number in all months other than September (4.8 actions). The difference is significant at the 5 percent confidence level. To test whether there is a shift in importance in the September and October effects from 2014 onward, I performed a chi-square test of the proportion of actions in the pre-2014 period versus the 2014-onward period that were initiated in September (11.6 percent of all actions pre-2014 and 21.2 percent of all actions 2014 onward), October (4.1 percent of all actions pre-2014 and 5.2 percent of all actions from 2014 onward), and the other months (84.3 percent of all actions pre-2014 and 73.6 percent of all actions from 2014 onward). The difference between these two periods is significant at the 1 percent confidence level.

One hypothesis to explain this pattern is that, particularly from 2014 onward, the SEC has become increasingly focused on the enforcement numbers it reports to the public.[40] SEC enforcement reports typically cover its fiscal year, which runs from October 1 to September 30 of the next year. If the SEC were focused on meeting certain quantitative target goals, the SEC may shift enforcement actions that otherwise would require more time from just after the end of the fiscal year on September 30 to just before the end of the fiscal year. Such a pattern would lead to the hockey stick pattern of enforcement actions spiking in September and dropping in October.

From the outside, it is difficult to discern the motives of SEC officials. Indeed, other hypotheses are possible. It is possible that from 2014 onward, the SEC happened to change the scheduling of meetings for the agency to make enforcement decisions to concentrate in September for reasons other than meeting quantitative targets.

As with the yearly time trends for SEC enforcement actions, the monthly time trend is only suggestive. Such a hockey stick pattern for earnings and other financial results for a publicly traded company may not necessarily indicate an accounting issue but may still cause observers to want to look more closely at the company's internal accounting policies. Similarly, the monthly time trend for the SEC actions raises an issue for further research to determine the precise cause.

III. STOCK PRICE REACTION TO VIOLATIONS TARGETED FOR ENFORCEMENT

Beyond counting the number of actions, observers of SEC enforcement may discern patterns in the agency's enforcement decisions by looking at the stock market reaction to the first public announcement of the problem that led to the eventual SEC enforcement action (referred to here as "the Violation Date"). Different types of enforcement actions may correspond with different stock price reactions. When the SEC targets violations with a

40. *See* Velikonja, *Politics*, *supra* note 17, at 19–26 ("If [the SEC] fails to meet any of the performance goals it has set for itself, it risks losing funds through the budget appropriation process. As a result, the SEC faces intense pressure to at least meet its performance targets, and to exceed them if possible.").

greater impact on investors, I expect that the stock market reaction to the first public disclosure of the underlying securities law violation will be greater than when the SEC targets violations that do not impact investors as much.[41]

Take the example of the SEC's enforcement action against Weatherford International PLC in 2016.[42] According to the SEC, "[b]etween 2007 and 2012, Weatherford, a large multinational provider of oil and natural gas equipment and services, issued false financial statements that inflated its earnings by over $900 million in violation of U.S. Generally Accepted Accounting Principles ('GAAP')."[43] These accounting violations led Weatherford to restate its financials three separate times.[44] The SEC's enforcement action charged Weatherford with fraud under § 10(b) and Rule 10b-5 of the Exchange Act and § 17(a)(1) of the Securities Act, among other securities law violations.[45] As part of a settlement with the SEC, Weatherford agreed to pay a $140 million civil penalty.[46] What did the market think of the underlying violation? March 2, 2011, was the first trading day after Weatherford initially announced nonreliance on its previously issued financial statements relating to errors at issue in the SEC's eventual enforcement action. On this day, over five years prior to the commencement of the SEC enforcement action, numerous financial news agencies reported on this nonreliance and Weatherford's accounting errors.[47] The stock price for Weatherford on March 2, 2011, the Violation Date, fell 10.1 percent.[48]

In comparison, on July 17, 2018, the SEC brought a settled enforcement action against BGC Financial, L.P.[49] According to the SEC:

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41. In an earlier work together with Adam Pritchard, a professor at the University of Michigan Law School, I used event studies of the Violation Date to assess the targeting of securities law violations by the SEC compared with private plaintiffs' attorneys in securities class actions. *See* Stephen J. Choi & A. C. Pritchard, *SEC Investigations and Securities Class Actions: An Empirical Comparison*, 13 J. EMPIRICAL LEGAL STUD. 27, 37 (2016).

42. *In re* Weatherford Int'l PLC, Securities Act Release No. 10221, Exchange Act Release No. 78944, 2016 WL 5390511 (Sept. 27, 2016).

43. *Id.* at *2.

44. *See id.*

45. *See id.* at *17–18.

46. The SEC also charged Weatherford's former vice president of tax and former tax director, each of whom also settled with the SEC. *See id.* at *23–25.

47. *See, e.g.*, Ryan Dezember & Matt Jarzemsky, *Weatherford Discloses Tax-Accounting Errors*, WALL ST. J. (Mar. 2, 2011), https://www.wsj.com/articles/SB10001424052748703559604576176293277481526 [https://perma.cc/5UBL-EJMQ]; Final Transcript, *Weatherford International to Adjust 2007–2010 Results due to "Material Weakness" in its Income Tax Reporting—Conference Call*, WEATHERFORD INT'L, LTD. (Mar. 2, 2011), https://weatherford.gcs-web.com/static-files/f5666f7d-fcc4-42fc-bf46-90ed8f6f4c6e [https://perma.cc/ZD2L-2KFP]; *Weatherford (WFT) Slammed on 10-K Delay Citing "Material Weakness" in Internal Controls*, STREETINSIDER (Mar. 2, 2011, 7:19 AM), https://www.streetinsider.com/Corporate+News/Weatherford+%28WFT%29+Slammed+On+10-K+Delay+Citing+%22Material+Weakness%22+in+Internal+Controls/6336592.html [https://perma.cc/H2UC-3CNN].

48. Note that the -10.1 percent return is the one-day, buy-and-hold raw return.

49. *See In re* BGC Fin., L.P., Exchange Act Release No. 83650, 2018 WL 3434896 (July 17, 2018). BGC Financial's parent company is BGC Partners, Inc., a publicly traded company listed on Nasdaq. *See* BGC Partners, Inc., Annual Report (Form 10-K), at 19, 223 (Mar. 1, 2019).

> These proceedings arise out of BGC's violations of the books and records provisions of the Exchange Act. First, in June of 2014, BGC deleted audio files for the recorded lines of eight registered representatives that were responsive to requests from the Commission staff for these records. As detailed below, the deletion of these audio files occurred because BGC's audio system personnel were not made aware of the existence of the Commission staff's requests. Second, in the instances detailed below, BGC failed to maintain books and records that accurately recorded certain transactions concerning compensation, travel, entertainment, and other expenses.[50]

The SEC charged BGC Financial with willful violation of § 17(a)(1) and Rule 17a-4(j) of the Exchange Act.[51] As part of the settlement, the SEC censured BGC Financial and imposed a cease and desist order on the company.[52] The agency also imposed a $1.25 million civil penalty.[53] There were no prior public disclosures of the underlying violations at issue in the BGC enforcement action, making the date of the initiation of the SEC enforcement action ("the Enforcement Date") also the Violation Date. The stock price for the publicly traded parent company, BGC Partners, Inc., on the Enforcement Date of the SEC's action did not change, with a return of 0.0 percent.[54]

Tabulating aggregate numbers of actions alone will not capture the importance of an SEC enforcement action to the economy. As a proxy for the value of SEC enforcement, I look at the stock price reaction on the Violation Date. In the case where a subsidiary of a public company is the target of an SEC enforcement action, I look at the stock price reaction for the public company parent of the subsidiary. The stock price reaction to the underlying securities law violation captures the market's view of the impact of the violation on the investors of the publicly traded company.

To determine the Violation Date, I performed Nexis and Factiva searches on news stories, press releases, and business wires to determine the first public disclosure of the problem leading to the investigation or class action. I also searched SEC EDGAR filings. When possible, I obtained a time stamp of the initial public disclosure of the violation and treated disclosures that occurred after 4:00 p.m. eastern standard time as having occurred on the next trading day. I also obtained the Enforcement Date from the SEC document initiating the action, which was typically either a litigation release, complaint, or administrative proceeding filing.

To assess the stock price impact of information revealed prior to the SEC Enforcement Date, I performed an event study of the Violation Date to control for overall market movements. For comparison, I also performed an event study of the first public disclosure of the initiation of the Enforcement

50. *In re BGC Fin., L.P.*, 2018 WL 3434896, at *2.
51. *Id.* at *6–7.
52. *See id.* at *7.
53. *See id.*
54. Note that the 0.0 percent return is the one-day, buy-and-hold raw return.

Date.[55] For each event study, I estimated a market model using data for up to 255 trading days and ending forty-six days before the event date. For the market index return in the market model, I used the equally weighted CRSP market portfolio return. I used the market model to estimate expected returns for each event date. For each event study, I computed the one-day abnormal return by subtracting the expected return from the actual return for the event date. Table 1 reports the mean one-day abnormal return for the Violation and Enforcement Dates.[56]

Table 1: Mean One-Day Abnormal Returns for Violation and Enforcement Dates

Date	**N**	**Mean Abnormal Return**	***p* value**	**Positive:Negative**
Violation Date	691	-0.0273	0.000	247:444**
Enforcement Date	690	-0.0014	0.289	340:350

The *p* value is from a test of the null hypothesis that the mean abnormal return is equal to zero, using cross-sectional standard errors for abnormal returns.[57] The significance from a one-sided generalized sign test of the proportion of positive CARs is: $^{+}p < 0.10$, $^{*}p < 0.05$, $^{**}p < 0.01$.

Note from Table 1 that the market reacted negatively to the first public disclosure of a securities law violation, on average, with a -2.73 percent abnormal return. This return is significantly different from zero at the 1 percent confidence level. In contrast, the abnormal return on an SEC enforcement action announcement is not significantly different from zero.[58]

55. Note that for some of the SEC actions there was no disclosure of the violation prior to the enforcement announcement and the Violation Date in such actions is the Enforcement Date. I separately compute the abnormal return for Violation Dates with prior disclosure to the Enforcement Date and the abnormal return for Violation Dates with no prior disclosure. *See infra* Table 2.

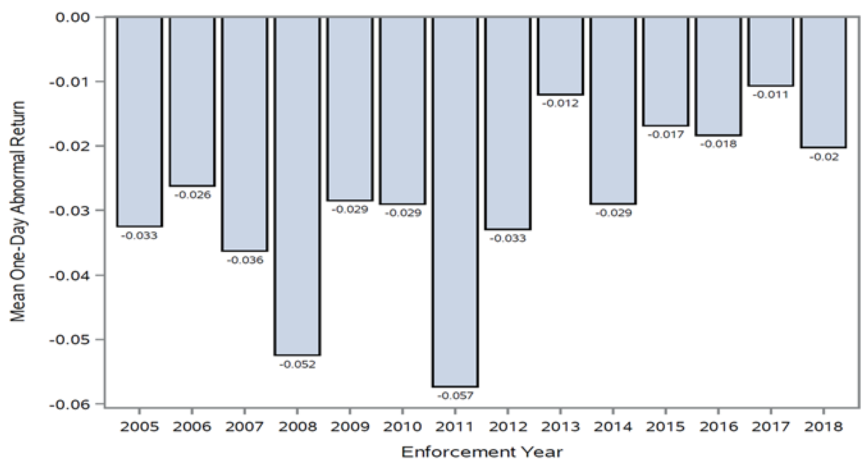
56. It is possible that for some of the dates the disclosure occurred after the close of trading. For robustness, I also performed a two-day event study going from the event date (0) to the next trading day (+1). The two-day cumulative abnormal return (CAR) for the Violation Date is -3.34 percent and is significant at the 1 percent level. The two-day CAR for the Enforcement Date is -0.03 percent and is not significantly different from zero.

57. For a discussion of event study methodology, see generally A. Craig MacKinlay, *Event Studies in Economics and Finance*, 35 J. ECON. LITERATURE 13 (1997). I also tested the null hypothesis that the mean abnormal return is equal to zero using a standardized cross-sectional test following an article by Ekkehart Boehmer, Jim Musumeci, and Annette B. Poulsen. Ekkehart Boehmer et al., *Event-Study Methodology Under Conditions of Event-Induced Variance*, 30 J. FIN. ECON. 253, 259–60 (1991) (the BMP test). I obtained the same qualitative results as in Table 1 using the BMP test.

58. These results differ from those in an earlier study by Karpoff, Lee, and Martin. *See* Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 591 (2008). Karpoff et al.'s sample, unlike

Figure 4 depicts the mean abnormal return on the Violation Date each year from 2005 to 2018.

Figure 4: Violation Date Abnormal Return



As depicted in Figure 4, the mean abnormal return is lowest in 2017 with a mean abnormal return of -1.1 percent. The difference between the 2017 return and the mean return for the other years in the sample (-2.9 percent) is significant at the 5 percent confidence level, although the difference between the 2017 return and the 2016 return (-1.8 percent) is not significant.[59]

There are several caveats to looking at stock price reactions to the underlying securities law violations over time. First, my analysis focuses only on the first public disclosure of the underlying securities law violations. It is possible that the true extent of a company's securities law violations may become public over time across a series of disclosures. Focusing on just the first public disclosure date may understate the overall market reaction to specific securities law violations. Nonetheless, to the extent the average amount of understatement for SEC enforcement actions is similar from one year to the next in my sample, a comparison of the mean abnormal return for different years will reflect differences in the SEC's targeting of enforcement

mine, focuses only on SEC enforcement actions involving financial misrepresentation from 1978 to 2005. *See id.* at 581. Using their sample, they report a -25.24 percent mean abnormal return for what they call "trigger events" that led to the SEC enforcement and are identified by looking at federal proceedings. *See id.* at 590–91. They report a -9.60 percent mean abnormal return for the initial announcement of a "regulatory event," which they define as an "official administrative or litigation release by the SEC or the DOJ." *See id.* at 591–92.

59. For the *t*-test of differences in abnormal returns by year, I used a Satterthwaite *t*-test to account for the possibility of unequal variances. As discussed in Part VI below, there are considerable differences in the variance of abnormal returns by year in the dataset. To examine whether 2017 is different from the other years in my sample, I performed a test of the equality of variances for the variance in the 2017 abnormal returns and the variance in the abnormal returns for the other years. The test rejected the null hypothesis that the variances are equal at the 5 percent confidence level.

actions based on the impact on investors of the underlying securities law violations.

Second, the pool of securities law violations in the economy in any given year may vary. Some years may have violations with greater negative stock market reactions as compared with other years. The large average negative abnormal returns in 2008–2012 in Figure 4, for example, may be the result of the late 2000s financial crisis. One possible control for the pool of securities law violations would be to use the abnormal return on the Violation Date for securities class actions as a control. If the pool of securities law violations changes from year to year, the abnormal return on the Violation Date for securities class actions should vary with this changing pool. I leave the construction of such a control to future research.

Lastly, looking at the stock market price reaction to the underlying violation may not fully capture the social value of enforcement. It is possible, for example, in the case of the BGC Financial enforcement action discussed above, that the deterrent effect of the SEC enforcement action on all financial firms in the future may sum to a large overall impact on social welfare in a way not captured by looking solely at the stock price reaction for BGC Financial upon announcement of the violation. In addition, it may be that enforcing the securities laws against a brokerage firms' registered representatives may not greatly affect *shareholder* value for the brokerage firm but nonetheless increase value for the *customers* of the brokerage firm.

Despite the imperfect match between stock price reaction on the Violation Date and the social value of enforcement, looking at the stock price reaction to the first disclosure of the violation over time provides information on the SEC's enforcement priorities and the opportunity cost of these priorities. It may be that SEC actions that target violations that do not result in large stock price declines may nonetheless have high social value. But identifying those actions without a large Violation Date stock price decline at least poses the question of exactly how such other social value exists and whether this value offsets the opportunity cost of expending limited SEC enforcement resources on such actions as opposed to other violations that resulted in large negative stock price declines.

IV. Prior Disclosure Versus No Prior Disclosure Actions

Most SEC enforcement actions occur after a prior disclosure of the violation. In my sample from 2005 to 2018, 74.5 percent of the SEC enforcement actions had public disclosure of the underlying violation before the initiation of the action. I posit that market participants will tend to uncover and corporations will tend to voluntarily disclose more material violations of the securities laws. Accordingly, those SEC enforcement actions that occur when there is no prior disclosure of the violation tend to not involve as major securities law violations. The enforcement action against BGC Financial discussed in Part III is an example of an enforcement action that did not have any disclosure of the underlying violations prior to the initiation of the action. Looking at the fraction of actions that the SEC brings where there is no prior disclosure of the underlying securities law violation provides another way of assessing the impact of the actions that the SEC brings.

As a check on whether no prior disclosure SEC enforcement actions involve violations with less investor impact than actions where there is prior disclosure of the violations, I computed the mean one-day abnormal return from an event study for the Violation Date for those actions with disclosure of the violation prior to the enforcement action. I also computed the mean one-day abnormal return from an event study for the Violation Date for those actions with no prior disclosure of the violations. Because the Enforcement Date is the first time that the market learns of the underlying securities law violation for the no prior disclosure actions, I use the Enforcement Date as the Violation Date for the actions without prior disclosure. Table 2 reports the results from the event study.

Table 2: Mean Abnormal One-Day Returns on the Violation Date for Actions with and Without Prior Disclosure of the Violation Prior to the Enforcement Date

Date	N	Mean Abnormal Return	*p* value	Positive:Negative
Violation Date with Prior Disclosure	499	-0.0364	0.000	164:335**
Violation Date with No Prior Disclosure (the Enforcement Date)	192	-0.0037	0.025	83:109^{+}

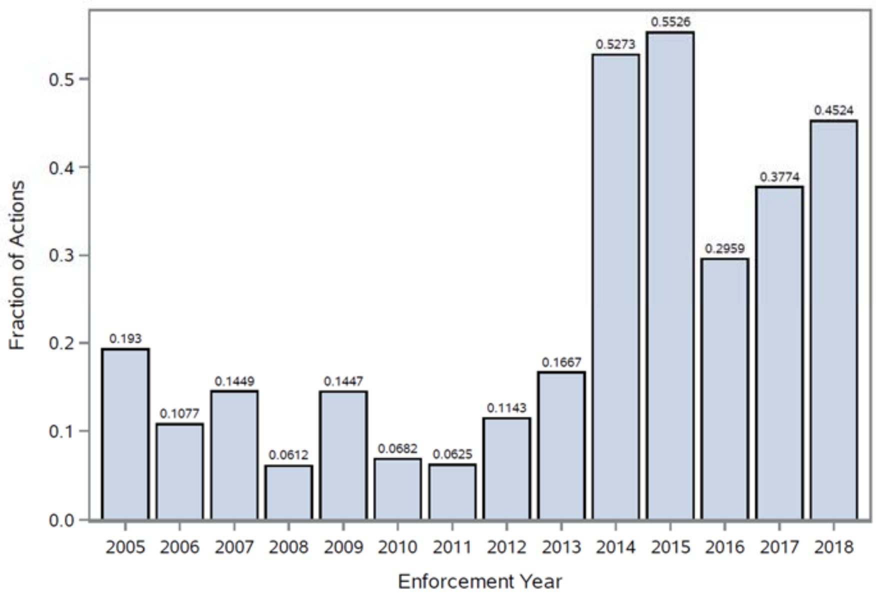
The *p* value is from a test of the null hypothesis that the mean abnormal return is equal to zero using cross-sectional standard errors for abnormal returns.[60] The significance from a one-sided generalized sign test of the proportion of positive CARs is: $^{+}p < 0.10$, $^{*}p < 0.05$, $^{**}p < 0.01$.

Note from Table 2 that the abnormal return for the Violation Date for actions with prior disclosure of the violation is -3.64 percent, while it is -0.37 percent for the Violation Date for actions with no prior disclosure (i.e., the Enforcement Date). This is an almost tenfold decrease in magnitude. The difference in abnormal returns for no prior disclosure and prior disclosure actions is significant at the 1 percent confidence level.

60. For a discussion of event study methodology, see MacKinlay, *supra* note 57. I also tested the null hypothesis that the mean abnormal return is equal to zero using a standardized cross-sectional test. *See supra* note 57. I obtained the same qualitative results as in Table 2 using the BMP test.

Note that most of the no prior disclosure actions involve financial institutions, such as BGC Financial. While 40.7 percent of the actions with prior disclosure involved companies in Standard Industrial Classification (SIC) one-digit code 6 (Finance, Insurance, and Real Estate), 89.1 percent of actions with no prior disclosure were in SIC code 6.[61] This difference is significant at the 1 percent confidence level. Figure 5 depicts the fraction of all SEC actions against public companies and subsidiaries of public companies that are no prior disclosure actions by year for the 2005 to 2018 period.

Figure 5: Fraction of SEC Actions Against Public Companies and Subsidiaries of Public Companies with No Prior Disclosure



Note from Figure 5 that the mean fraction of SEC enforcement actions that did not follow a disclosure of the underlying violations was 0.12 from 2005 to 2013. From 2014 onward, the fraction of SEC enforcement actions that did not follow a disclosure of the underlying violations increased to 0.43 on average. The difference between these two fractions is significant at the 1 percent level.

What explains the increase in the fraction of no prior disclosure actions from 2014 onward? One hypothesis is that the SEC enjoys greater discretion in the timing and nature of enforcement actions against the financial institutions it regulates. When the SEC faces pressure to meet numerical enforcement goals, for example due to the congressional appropriations

61. For a list of the SIC codes used by the SEC, see *Division of Corporation Finance: Standard Industrial Classification (SIC) Code List*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/info/edgar/siccodes.htm [https://perma.cc/JL5S-VHNF] (last visited Oct. 3, 2020).

process, the SEC may turn to financial institutions as "easy" targets (which are under close regulation by the SEC) and allege increasingly more marginal, technical violations to boost its enforcement numbers.[62]

The lack of market reaction on average to the no prior disclosure actions is consistent with such actions being viewed by the market as more marginal. Other explanations are possible. A competing hypothesis is that enforcement actions against financial firms brought by the SEC from 2014 onward targeted violations that financial firms did not consider material to the firms' investors and thus were not disclosed prior to the enforcement action. Despite the lack of materiality to investors, the enforcement actions could still have improved overall social welfare when taking into account the benefits to other groups, such as the benefits to customers of a brokerage firm, for example, when the SEC enforces the brokerage firm's duties to supervise its brokers. One may wonder, though, why a brokerage firm's shareholders would not capture the benefits to customers who are better protected against broker misconduct to the extent the customers are more willing to buy and sell securities through that brokerage firm. It is possible that industry-wide "sweeps" by the SEC may not result in greater customer confidence accruing to any single brokerage firm, explaining the lack of materiality to the investors of a specific firm. However, the sweep may still benefit the customers of all brokerage firms in the aggregate. Another alternative hypothesis is that firms redefined what they view as a "material" violation from 2014 onward, which lead to a shift in firm violation disclosure practice and a rise in no prior disclosure SEC enforcement actions. It is unclear, however, why firms would have changed their view of materiality in this time period.

Given possible competing hypotheses to explain the rise of no prior disclosure enforcement actions from 2014 onward, the analysis of prior versus no prior disclosure actions is only a starting point. But by raising the question of why there is such a pattern—the increasing fractions of no prior disclosure actions from 2014 onward—the no prior disclosure metric may help focus research on answering this question.

V. VARIABILITY IN SEC ENFORCEMENT DECISIONS

The SEC enjoys broad prosecutorial discretion in whether and how it brings enforcement actions.[63] Using this discretion, the SEC may bring a

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62. Professor Velikonja posits a similar dynamic may lead the SEC to bring more delinquent filing enforcement actions that are strict liability and provide the SEC a low-cost way of increasing the number of enforcement actions. *See* Velikonja, *supra* note 9, at 969 ("Contested cases consume greater resources, so the agency has an incentive to bring cases that are more easily brought: delinquent filing actions where targeted firms put up no resistance, strict-liability offenses, and actions that do not allege violations of the antifraud provisions of securities laws.").

63. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Issues Report of Investigation and Statement Setting Forth Framework for Evaluating Cooperation in Exercising Prosecutorial Discretion (Oct. 23, 2001), http://www.sec.gov/news/headlines/prosdiscretion.htm [https://perma.cc/J54E-6P93].

civil action instead of an administrative proceeding. The SEC action could: allege negligence instead of fraud, impose a smaller or larger penalty, target a broader or narrower range of corporate activities, or bring charges against a broader or narrower set of defendants.

How the SEC uses its enforcement discretion will potentially affect the stock price response to the announcement of an SEC enforcement action. Determining the variability in abnormal returns for the stock of companies that face SEC enforcement actions due to the agency's discretion is difficult because the abnormal return may vary due to other factors. The announcement of an SEC enforcement action may contain new information on the underlying securities law violations. Defendant companies in different industries may face greater (or lesser) amounts of variation due to an enforcement action. The underlying securities law violation may also affect the variation that occurs when the SEC announces an enforcement action. Violations that involve allegations that a financial firm failed to supervise its brokers may have less variation in the market response than an enforcement action where the violations involve the Foreign Corrupt Practices Act.[64]

While I leave the determination of a full set of controls for the various factors that may affect the variability in how the market responds to an enforcement action for later research, I take a first-cut analysis of variation due to the SEC's use of discretion for similar types of SEC actions. I focus on the subset of actions in my sample that the SEC treated as an Accounting and Auditing Enforcement Release (AAER) action involving financial reporting.[65] Focusing on only AAER actions at least partially controls for the nature of the underlying securities law violations that may affect the variability of the market's response to an enforcement announcement.

I only use those actions with disclosure of the underlying financial reporting related violation that occurred prior to the SEC enforcement action announcement. Focusing on actions with prior disclosure reduces the importance of price movements on the Enforcement Date due to information related to the violations. The presence of prior disclosure of the violations also allows the market to form predictions on the type of enforcement action that the defendant company will face. The subsequent price reaction on the Enforcement Date will incorporate the market's reaction to the *unexpected* nature of the enforcement action. It is possible that even with prior

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64. 15 U.S.C. §§ 78dd-1 to 78dd-3.

65. The SEC provides a list of AAER actions on its website. *See Accounting and Auditing Enforcement Releases*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/divisions/enforce/friactions.shtml [https://perma.cc/8PPH-83BY] (last visited Oct. 3, 2020). The SEC notes the following on its AAER list:

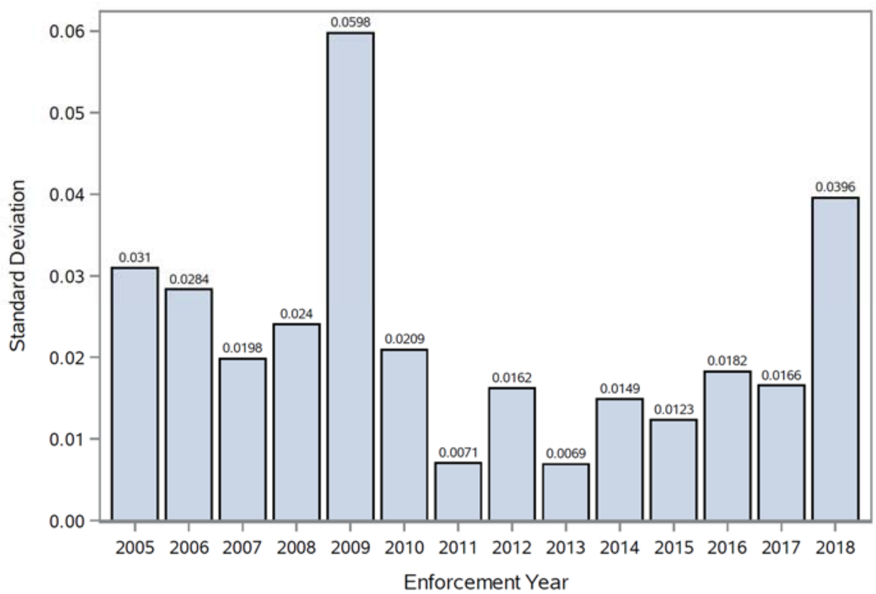
> The list below provides links to financial reporting related enforcement actions concerning civil lawsuits brought by the Commission in federal court and notices and orders concerning the institution and/or settlement of administrative proceedings. This list only highlights certain actions and is not meant to be a complete and exhaustive compilation of all of the actions that fall into this category.

Id. While not comprehensive, the SEC's AAER list focuses on a common category of SEC violations—those involving financial reporting.

disclosure, some new incremental information on the underlying violation may be disclosed on the Enforcement Date. Any incremental new disclosure will likely turn on the nature of the violation and the disclosure practices of firms that committed the violations (which determines the amount of prior disclosure and thus what information is left undisclosed up to the Enforcement Date) and not on the SEC's use of discretion. To the extent the factors that affect how firms disclose their securities law violations remain relatively constant from one year to the next, the level of variability due to new information about the underlying violation should also remain constant. Observing changes in the variability over time will therefore reveal changes in the predictability of SEC decision-making.

To measure the overall variability of the SEC's use of discretion, I computed the standard deviation of the one-day abnormal return to the enforcement action announcement annually from 2005 to 2018 for AAER enforcement actions with prior disclosure of the underlying violations. Figure 6 depicts these standard deviations by year.

Figure 6: Standard Deviation of Enforcement Date Abnormal Returns AAER Actions with Prior Disclosure



From Figure 6 note that there were two spikes in the standard deviation of abnormal returns for the announcement of an AAER SEC enforcement action that follows a prior violation disclosure. In 2009, the first year of the Obama administration, there was an increase in the standard deviation of abnormal returns to more than double the year prior and the year after. Similarly, in 2018, the second year of the Trump administration, there was an increase in the standard deviation to more than double the prior year. A test of the difference between the variances of abnormal returns in 2009 and 2018 compared with the other years in my sample rejects the null hypothesis of no difference at the 1 percent confidence level.

Why might the SEC's use of discretion relative to prior market expectations change in 2009 and 2018? One hypothesis is that in the early years of a new administration, with typically a new SEC chairman, there is greater uncertainty in how the SEC will apply its discretion, leading to greater variability on the enforcement announcement date. Another explanation is that the SEC changed its enforcement priorities in specific years, for example in 2009 and 2018, leading to greater unpredictability in the market response to an enforcement action. In 2009, for example, in the fallout from the late 2000s financial crisis, the SEC was under intense pressure to bring enforcement actions. This pressure may have affected SEC internal enforcement decisions in ways that the market was not entirely able to predict. Several other factors may have also negatively affected the market's ability to predict the SEC's use of its discretion in enforcement actions, such as: the arrival of a new SEC chairman, the shift in priorities toward "main street" fraud, and the initial drop in enforcement actions against public companies in 2017, followed by an increase in 2018. These other factors may have resulted in a higher standard deviation for abnormal returns on the enforcement date in 2018.

Figure 6 provides at least a preliminary view into the importance of the SEC's discretion in how it prosecutes enforcement actions and how the use of this discretion may vary from market expectations in certain time periods. While only the first step, providing analysis on the variability of the abnormal return over time, as with the other metrics above, can help pose an important question: why did unpredictability increase in 2009 and 2018?

CONCLUSION

While the SEC reports enforcement statistics on an annual basis, many of the internal decisions within the SEC that lead to enforcement actions remain opaque to outside observers. This Article takes preliminary steps in constructing several metrics of SEC decision-making that may be regularly updated using publicly available data to demonstrate how SEC decision-making changes over time. While no one measure is perfect, the different measures this Article constructs help identify when changes and new patterns of enforcement arise. Once identified, these changes and new patterns may focus attention in the marketplace and lead to more research on internal decision-making at the SEC.