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SEC Speaks 2022: Ongoing Efforts to Restore Public Trust, Aggressive Enforcement Agenda - McGuireWoods

On Sept. 8 and 9, 2022, Securities and Exchange Commission Chairman Gary Gensler, Division of Enforcement Director Gurbir Grewal and senior officials from the Enforcement Division convened at the annual SEC Speaks conference. Enforcement Director Grewal opened the enforcement panel by discussing the Enforcement Division's continued efforts to restore trust in government and the legal and regulatory processes.

For its part, Director Grewal stated, the Enforcement Division is focused on hiring, promoting and retaining a diverse and talented workforce to make it more efficient and effective. He explained that an Enforcement staff that broadly reflects the country's diversity can foster trust and encourage victims to come forward, and it enables the Enforcement Division to protect all investors. Director Grewal also sought to dispel the notion that the SEC is "picking winners and losers and stifling innovation in the crypto space," and conveyed unequivocally that crypto remains an enforcement priority and the crypto industry will not have immunity "from the application of well-established regulations and precedents."

Building on Director Grewal's theme of restoring trust, Deputy Director Sanjay Wadhwa emphasized the Enforcement Division's commitment to deter misconduct, shape industry behavior and ensure accountability through enforcement actions. Deputy Director Wadhwa stressed the SEC's expectation that market participants engage in proactive compliance, noting meaningful consequences for those who fall short, such as cases involving admissions of violations in settlements. To further shape behavior, Deputy Director Wadhwa highlighted efforts to provide greater transparency to market participants into how the Enforcement Division rewards firms that provide extraordinary cooperation to Enforcement staff in investigations. Deputy Director Wadhwa also discussed the Enforcement Division's practice of empowering front-line Enforcement staff to make key decisions in the enforcement process, including limiting meetings with senior Enforcement officials in connection with the Wells process.

Deputy Director Wadhwa and other panelists rounded out the discussion by highlighting enforcement priorities, including regulation of crypto markets, the aggressive use of remedies, a willingness to litigate, disclosures and fiduciary obligations in the municipal securities space, broker-dealer gatekeeper responsibilities and protection of whistleblowers.

Reining in Crypto Markets

Chair Gensler focused his opening remarks on the SEC's intent to continue applying existing rules and regulations to all aspects of the crypto industry — from tokens to stablecoins to intermediaries — explaining that new technologies do not diminish the need for investor protection. Rejecting requests for additional clarity, Chair Gensler noted that his predecessor, Chairman Jay Clayton, spoke frequently about the applicability of the federal securities laws to the crypto space, as has the SEC through Section 21(a) Reports of Investigation and enforcement actions. Although Chair Gensler's remarks portend an aggressive enforcement posture, he also offered an olive branch,

inviting crypto projects and intermediaries to work with the SEC to comply with existing regulations and stressing the benefits of true cooperation and meaningful engagement.

Director Grewal echoed Chair Gensler's resolve to apply longstanding and well-established rules to the crypto markets, reiterating his belief that the "*Howey* and *Reves* tests remain vital and accurate means of identifying instruments that fall within the jurisdiction of the securities laws." He dismissed the suggestion that the SEC is picking winners and losers in the digital asset space and preventing innovation by not giving crypto markets a free pass, asserting that doing so would require the Enforcement Division to abandon its responsibilities to capital markets and the investing public.

Crypto Assets and Cyber Unit Chief David Hirsch emphasized the importance of registration in primary and secondary crypto markets. He explained that requiring registration encourages the development of enhanced compliance functions and robust protocols to promote accountability and to prevent misconduct.

Aggressive Use of Remedies

Expanding the initiative publicized at SEC Speaks 2021 to aggressively seek stark remedies in enforcement actions and settlements, Deputy Director Wadhwa indicated that market participants who do not undertake proactive compliance measures could face vigorous enforcement to further the programmatic goals of deterring misconduct, shaping conduct and promoting accountability. (For highlights from SEC Speaks 2021, see McGuireWoods' Oct. 25, 2021, alert.)

Illustrating this precept, Deputy Director Wadhwa pointed to the 2021 settlement with a registered broker-dealer and investment adviser for its failure to maintain and preserve written communications on personal devices, resulting in an admission and civil monetary penalties to the SEC and Commodity Futures Trading Commission totaling $200 million. Citing the number of law firm client mailings on the action, Deputy Director Wadhwa explained that significant remedies against a major financial institution garner widespread attention and help to repair trust by demonstrating a commitment to evenhanded enforcement.

Chief Counsel Samuel Waldon reiterated the approach to officer and director bars that Director Grewal announced at SEC Speaks 2021, which includes seeking an officer and director bar even against a person who was not serving as an officer or director at the time of the conduct, or was not even an employee of a public company, if there is egregious conduct and there is a chance the individual might have the opportunity to serve as an officer or director of a public company in the future. Chief Counsel Waldon also made it clear that Enforcement staff will seek bars in any settlement, not just those involving scienter-based violations, where the facts show a person is unfit to serve in an officer or director role.

In the realm of gatekeeper accountability, Deputy Director Wadhwa and Chief Counsel Waldon discussed the Enforcement Division's increased use of Sarbanes-Oxley Act Section 304 orders, which permit the SEC to order the disgorgement of bonuses and incentive-based compensation earned by the CEO and CFO in the year following the filing of any financial statement that the issuer is required to restate because of misconduct. This remedy is available even where the CEO and/or CFO did not engage in misconduct, thus incentivizing implementation of robust internal controls and inducing companies to address matters of the tone at the top and corporate culture.

Importance of Proactive and Effective Cooperation

To help restore trust in the SEC and its legal and regulatory processes and to shape conduct, Deputy

Director Wadhwa and other staff members described efforts to include in settlement documents details of the Enforcement Division's evaluation and assessment of creditworthy cooperation. Common among firms benefiting from cooperation has been early self-reporting of violations and robust remediation efforts.

An example of this approach includes a recent settlement with an issuer in which the administrative order contained specific details regarding its cooperation that "substantially advanced the quality and efficiency of the staff's investigation and conserved Commission resources" — such as "providing detailed explanations [of how certain transactions worked], summarizing witness interviews, and providing other relevant information to the staff[.]" The SEC's press release also referred to these efforts as an important consideration in assessing sanctions.

A second example discussed was an administrative order that expressly cited the company's cooperation as a basis for limiting the financial penalties imposed. The cooperation included voluntary disclosure of information not uncovered in the government's investigation and providing detailed updates on the issuer's internal investigation, as well as sharing key documents identified through the investigation.

In another matter identified by panelists, no penalty was imposed against an issuer in recognition of its extraordinary cooperation. This cooperation included, among other things, self-reporting of issues (including those giving rise to the settlement) uncovered during an unrelated internal investigation that did not reveal anything of substance, management and board personnel changes and reimbursement to the company of improper expense reimbursements.

Enforcement Leadership Declining Nonessential Wells Meetings

Deputy Director Wadhwa emphasized the Enforcement Division's ongoing efforts to streamline the Wells process and empower front-line staff. Deputy Director Wadhwa confirmed that he and Director Grewal have been declining requests for Wells meetings in cases that did not involve novel legal issues or important policy questions (without providing insight into how they are making these determinations). He insisted the Wells process remains important, but that they are mindful of the investment of time and resources by the Enforcement staff and by respondents and their counsel. Respondents should treat their interaction with front-line staff as the primary method to achieve resolution of their cases; they should not expect a second bite at the apple with officials higher up the chain.

Enforcement Division Litigating More Cases

Chief Litigation Counsel Olivia Choe's comments centered on how the Enforcement Division is not afraid to litigate. This year, the SEC has tried 15 cases in federal court — the most since 2015 and up from just five last year — involving the gamut of alleged violations, including insider trading, investment-adviser frauds, Ponzi and offering schemes and commission splitting. Chief Litigation Counsel Choe touted the SEC's record of success in 2022, noting favorable jury verdicts in 13 cases and nine victories on summary judgment.

Enforcement staff members also offered a reminder that they are continuing to pursue insider trading cases and noted the increase in such litigated actions. Relatedly, Enforcement staff observed an uptick of activity around insiders' family members and other close relations who — due to work-from-home conditions during the pandemic — may have been exposed to insider conversations that previously would have taken place in a company's offices.

In addition to litigating alleged substantive violations, the SEC has also been busy litigating

enforcement of subpoenas and other orders. Chief Litigation Counsel Choe discussed unsuccessful efforts by the founder of an electric car manufacturer to quash a subpoena the SEC served after he made Twitter posts that potentially violated a 2018 settlement agreement. She also cited a failed attempt by subpoena recipients to avoid compliance by arguing they had not been properly served through counsel, as an example of the SEC standing its ground to enforce its processes. Lastly, Chief Litigation Counsel Choe detailed the SEC's willingness to pursue civil contempt orders when defendants attempt to evade penalties or hide assets, citing cases resulting in the seizure of a boat and incarceration of an evasive defendant.

Disgorgement Post-*Liu*

Chief Counsel Waldon described how the SEC has continued to seek broad disgorgement awards following the U.S. Supreme Court's 2020 decision in *Liu v. SEC*, in which the Supreme Court held that the SEC has the statutory authority to seek a disgorgement award that does not exceed a wrongdoer's net profits and is awarded for the benefit of victims. (For background, see McGuireWoods' June 24, 2020, analysis of the case.) He stated that the Enforcement Division staff will pursue legal theories supporting disgorgement even where the funds would not be returned to investors and instead would flow to the Department of the Treasury. He noted that in insider trading cases, the SEC will continue seeking disgorgement of trading profits and losses avoided in addition to prejudgment interest and penalties. Further, in insider trading cases not involving disgorgement claims, the SEC will seek "two-times penalties" plus a penalty equal to the amount of prejudgment interest the SEC would have sought had it claimed disgorgement.

SEC Solicitor Michael Conley and Senior Appellate Counsel David Lisitza discussed courts' support for the Enforcement Division's efforts to impose joint-and-several disgorgement post-*Liu*. In *Liu*, the Supreme Court discussed the SEC's practice of holding multiple defendants jointly and severally liable for disgorgement, a practice that was at odds with traditional equitable principles. The Supreme Court acknowledged a general rule against joint-and-several liability at equity but did not set a firm rule prohibiting an order disgorging from one defendant profits that accrued to another. Instead, recognizing the common law permitted liability among partners engaged in "concerted wrongdoing," the Supreme Court left open the door for some flexibility to impose joint-and-several disgorgement. Without articulating a standard for concerted wrongdoing, the Supreme Court left it to lower courts to determine whether joint-and-several disgorgement was warranted on a case-b--case basis, given the "wide spectrum of relationships between participants and beneficiaries of unlawful schemes."

Since the Supreme Court's decision, the SEC has continued to pursue joint-and-several disgorgement and courts have granted it — relying on multiple defendants' active participation in a scheme to satisfy the "concerted wrongdoing" requirement. In *Liu* following remand, the district court found concerted wrongdoing between two individual defendants, finding relevant that they were a married couple, had commingled finances and had both played active roles in the scheme — with one setting up fraudulent businesses and the other helping to secure investors for them and later accepting misappropriated investor funds.

In a 2022 decision, the U.S. Court of Appeals for the Fourth Circuit affirmed joint-and-several disgorgement from a company and its chief executive. Though the executive argued the district court based his joint-and-several liability solely on his status as a control person, the Fourth Circuit made clear that it was mindful of *Liu* and instead looked at his active participation in an illegal scheme with the company. For example, the court noted that he was the "mastermind and architect" of an investment program the company used to lure investors through fraudulent means; also, the executive and the company — together — were alleged to have made misrepresentations to investors, formed shell companies to deceive investors about the program's success and created fake

escrow accounts purportedly to hold stock as collateral for investments. Other recent district court rulings likewise have focused on active participation as a basis for finding concerted wrongdoing to support joint-and-several disgorgement.

Senior Counsel Kerry Dingle discussed post-*Liu* decisions from the U.S. Courts of Appeals for the Second, Fifth and Seventh Circuits that addressed the deduction of legitimate expenses when calculating disgorgeable net profits. In each case, the district court ordered disgorgement after finding the SEC met its burden of making a reasonable approximation of the disgorgeable profits. Although the respective defendants sought deductions — for example, arguing that diverted funds had been offset by contemporaneous transfers to the original destinations or disputing the SEC's valuation of certain assets — the district courts found their arguments insufficient to show the SEC's approximation was not reasonable; and in each case, the respective Circuit Courts affirmed.

Senior Counsel Dingle drew three general principles from these cases. First, these decisions maintained the pre-*Liu* practice of placing the initial burden on the SEC to propose a reasonable approximation of profits causally related to the fraud before shifting the burden to the defendant to show the SEC's approximation was not reasonable. Second, to the extent there is uncertainty or ambiguity around making a reasonable approximation — such as how to value an unconventional asset or how to isolate disgorgeable profits within commingled funds — the wrongdoer bears the consequences of the uncertainty. Finally, to meet its burden of reasonable approximation, the SEC does not need to trace particular funds all the way from their source to the defendant's personal accounts or personal expenses. Collectively, these cases speak to the wide latitude courts may be inclined to give the SEC in making a reasonable approximation of disgorgeable net profits, as well as the high bar a defendant must clear to challenge the SEC's calculation.

Continued Focus on Municipal Securities

Public Finance Abuse Unit Deputy Chief Rebecca Olsen discussed the Enforcement Division's continued focus on the municipal securities market, including on conduct by issuers, broker-dealers and municipal advisers.

The Enforcement Division's spotlight on school district issuers persists, with three such actions involving alleged misrepresentations of financial information in bond offering documents. In one case, the district provided investors and the credit union agency with misleading budget projections. The SEC charged the district for its omission of payroll liabilities from its financial statements included in bond offering documents. In a currently litigated matter against a city, the SEC alleges that the issuer misled investors with outdated financial statements and a failure to disclose that the district was experiencing financial distress due to overspending. In discussing these actions, Olsen emphasized the importance of providing retail investors with accurate financial information in the bond offering documents and with a truthful picture of the financial risk of investments.

Olsen also highlighted several enforcement actions against broker-dealers for unfair dealing. One case involved a financial conflict of interest between a broker-dealer underwriting a municipal bond offering and its affiliate, which purchased nearly all the bonds in a municipal issuer's tender offer. When recommending the purchase price between its affiliate and the issuer, the broker-dealer did not disclose its affiliate's financial interest. This violated the underwriter's obligation to deal fairly with its municipal clients. The SEC also brought a series of actions against broker-dealers for unfair dealing to retail investors. Specifically, in several bond offerings, broker-dealers allocated municipal bonds to "flippers," who purchased bonds to sell to other broker-dealers or to the same firm for its own inventory, rather than the retail investors entitled to priority allocation.

Regarding municipal adviser misconduct, Olsen emphasized the SEC's first-ever case enforcing

MSRB Rule G-42 on the duties of non-solicitor municipal advisers. The SEC brought enforcement actions against an advisory firm and its two principals for a failure to disclose their fee-splitting arrangement with an underwriting firm. As a result of this conflict of interest, which was undisclosed to the firm's charter school clients, the firm violated its duties of loyalty and care to its clients.

Focus on Broker-Dealers as Gatekeepers

Assistant Director Stacey Bogert focused her remarks on the gatekeeping function broker-dealers serve and their responsibility to maintain market integrity. She discussed the most significant areas of the Enforcement Division's focus in the last year: Regulation BI and Form CRS, the filing of Suspicious Activity Reports (SARs) and cybersecurity.

In the first action of its kind, the SEC brought a case under Regulation BI regarding a broker-dealer's standards of conduct in four areas: disclosure obligations, care, conflict of interest and compliance. The SEC charged a broker-dealer with a violation of Regulation BI's duty of care obligations as it sold L Bonds, a high risk and illiquid investment, to customers on fixed incomes with moderate risk tolerances. According to the SEC, this was a failure to exercise reasonable diligence regarding the risks and rewards of the investment for its clients and it failed to establish a reasonable basis that the investment was in the clients' best interest. Bogert was clear that with this action, as well as guidance including FAQs and compliance guides, the Enforcement Division is now initiating enforcement actions under Regulation BI.

Similarly, the Enforcement Division brought approximately 40 cases regarding compliance with Form CRS filing requirements. Such actions, which Assistant Director Bogert indicated will remain an enforcement priority, have involved both failure to file Form CRS on a timely basis and failure to include all required information.

Assistant Director Bogert also commented on two cases involving failures to timely file SARs. She emphasized the importance of this tool in detecting fraudulent behaviors; consequently, firms must continue to develop and implement effective policies and procedures reasonably designed to identify suspicious activity and file SARs with FinCEN.

Assistant Director Bogert further spoke about the Enforcement Division's scrutiny of broker-dealers' safeguarding of customer records and information through written supervisory procedures designed to mitigate identity theft, as required by Regulations S-P and S-ID. The Enforcement Division brought 11 cases against broker-dealers in the last year for failure to have reasonable policies and procedures, even though all had identity theft prevention programs. Assistant Director Bogert emphasized that it is insufficient for broker-dealers to merely include an identity theft policy; instead, policies and programs must be tailored to each broker-dealer's specific business and regularly updated.

Enforcement Remains Committed to Whistleblowers

Office of the Whistleblower Chief Creola Kelly reported on the continuing importance of whistleblowers to Enforcement Division efforts, with $1.3 billion awarded to 281 individuals since the program's inception in 2010 and $226 million to 78 individuals so far in 2022. Chief Kelly also reaffirmed the Enforcement Division's commitment to protecting whistleblowers, including vigilant protection of whistleblowers' identities and strong enforcement of violations of Rule 21F-17. Recent enforcement actions reveal the Enforcement Division's expansive interpretation of Rule 21F-17, which prohibits "imped[ing] an individual from communicating directly with the [SEC] about a possible securities law violation."

For example, a recent matter involved an employee of a nonpublic company who submitted a whistleblower tip to the SEC regarding the company's financial data and 30 days later raised similar concerns internally to the company's CIO. The SEC found that the CIO violated Rule 21F-17 by changing the employee's network access rights and surreptitiously accessing and monitoring the employee's personal email and social media accounts — even though the employee did not know about these actions, the CIO did not know about the whistleblower submission, and there was no evidence that the CIO took any steps to impede the employee from communicating with the SEC about a possible securities law violation.

What Lies Ahead

At the 2021 SEC Speaks conference, Director Grewal laid out a plan for a less respondent-friendly enforcement process, with the intent to improve perceptions of the SEC's fairness and to enhance public confidence in financial markets. Remarks at SEC Speaks 2022 uniformly projected an unwavering, if not enhanced, commitment to that course, as well as an emboldened Enforcement staff.

Under Director Grewal, the Enforcement Division — particularly front-line staff — is likely to push aggressive timelines during investigations and not shy away from aggressive settlement and litigation postures armed with full support from senior enforcement officials. Market participants and their counsel should not expect a lengthy Wells process (if any at all) or access up the chain for further advocacy to the extent an impasse is reached with the investigative staff. Thus, ongoing proactive engagement with the Enforcement staff will be important at every stage of the enforcement process.

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