Investigations, Compliance and Defense

The Key Open Questions That Will Determine the Next Four Years of SEC Enforcement

By: Charles D. Riely and Michael F. Linden

As President Biden's administration gets into full swing, many expect future Chairman Gary Gensler's SEC to take a more aggressive approach to enforcement. Public companies and other market participants are left wondering what, exactly, that means. In this client alert, we take a detailed look at where the SEC is starting from, what has happened since January 20th, where it goes from here, and what interest ed parties should be watching for as the "new" SEC ramps up.

The Starting Point

The SEC will be able to pivot efficiently to enforce the new administration's priorities because it is starting from a position of strength. The SEC is overwhelmingly made up of dedicated, career staff who will remain in place through the change in leadership. Although generally perceived to be less aggressive toward financial institutions, public companies, and private funds, the last administration's SEC was still active. It brought cases at or near historically high rates.[1] Those enforcement actions led to record-breaking monetary remedies in the form of penalties and disgorgement.[2] As the SEC pursued the prior administration's new efforts to "address cyber-based threats and protect retail investors,"[3] it also maintained bread-and-butter enforcement priorities, like cases under the Foreign Corrupt Practices Act and actions targeting egregious fraud and non-fraud cases against market participants. In doing so, the SEC continued to develop innovative enforcement techniques, expanding its whistleblower program to record levels and refining its use of risk-based data analytics.[4] In other words, while expectations of a more active SEC are no doubt reasonable, the agency is not starting from a standing stop.

The Open Questions

While the consensus about a more "aggressive" SEC is non-controversial, important questions remain about what that means in practice. As detailed below, these key questions include: what the new administration will prioritize, how the SEC will message those priorities, and how exactly the SEC will ramp up enforcement to execute them.

1. What Will the SEC Prioritize and How Will It Message Those Priorities?

In the first hundred days of the new administration's SEC, interested observers should pay careful attention to Gensler's messaging. Early on in Mary Jo White's tenure, she made it clear she was going to pursue a "broken windows" approach, whereby the SEC's enforcement program was perceived to be "everywhere."[5] Similarly, Jay Clayton laid out his "Main Street investor" focus just months into his term.[6] These speeches acted as organizing principles for White's and Clayton's administrations and shaped how they were viewed going forward. We can similarly expect Gensler to set the tone early on, and market participants would be wise to listen closely.

While the early messaging will be important, there is widespread consensus that the new administration is likely to more assertively address misconduct by major market participants, including public companies and financial institutions. This will involve focus on certain key areas, including:

- *Public Companies*. The SEC continued to pursue cases against public companies during the last administration, most notably obtaining a $500 million penalty against Wells Fargo for misleading investors by opening "authorized or fraudulent accounts for unknowing customers."[7] However, according to a report by Cornerstone Research and the NYU Pollack Center for Law & Business, the SEC in 2020 brought the lowest number of cases against public companies since Fiscal Year 2014.[8] The Gensler SEC will likely redouble efforts to bring cases against public companies, and in practice this will mean more investigations into revenue recognition, improper accounting, and insufficient risk factor disclosures. Where it finds misconduct, the SEC is also likely to seek larger penalties.

- *Private Funds*. Observers expect the new administration to bring more cases against private funds, which faced less enforcement by the last administration's SEC compared to President Obama's. If the Gensler Administration decides to ramp up enforcement in this area, there is an existing roadmap for the sorts of violations the SEC could pursue. According to examination results from the Office of Compliance Inspections and Examinations, private equity and hedge funds frequently fail to disclose conflicts of interest, overcharge investors by inaccurately allocating fees and expenses, and fail to maintain proper policies and procedures related to material non-public information.[9] These deficiencies are all sources of liability that the new administration might choose to pursue.

- *Major Financial Institutions*. Expect more aggressive litigation against large financial institutions in Gensler's SEC as compared to his predecessor. Although the last administration did bring major actions against financial institutions—including the action concerning Wells Fargo detailed above—it focused more heavily on protecting retail investors from smaller-scale fraud. The SEC, under Gensler, may seek to target the actions of large financial institutions on a more regular basis. In his tenure at the CFTC, Gensler was particularly tough on the institutions perceived to be behind the 2008 financial crisis.

- *ESG Disclosures*. Many expect the new administration to pursue rulemaking—and potentially enforcement action—regarding environmental, social, and governance (ESG) disclosure. That would accord with then-candidate Biden's climate plan, which called for public companies to "disclose climate risk and the greenhouse gas emissions in their operations and supply chains."[10] In other words, the SEC's disclosure-related policies and enforcement are likely to target both the environmental impact *of* the business and the risk factors *for* the business caused by climate change. The new administration is already making ESG disclosure a more central focus. On February 1, 2021, Acting Chair Allison Herren Lee appointed Satyam Khanna as the agency's first senior policy advisor specifically focused on ESG issues. In her announcement, Lee highlighted her view that climate risks and other ESG developments are "issues of great significance to investors and the capital markets."[11]

- *Regulation Best Interest*. Regulation Best Interest (Reg BI) went into effect in June 2020 and established that broker-dealers must act in the "best interest" of retail customers whenever they recommend a security or investment strategy involving securities.[12] Expect a significant uptick in actions as the new administration gets it footing and moves from compliance-focused efforts to enforcement. The Gensler SEC may also look for opportunities to tighten the existing rules.

2. How Will the SEC Execute Its New Priorities?

If the SEC is to markedly increase its enforcement, much will depend on how it executes the new priorities. Part of this will be pushing its Enforcement Division to bring more cases. Already, in the first days of the new administration, the SEC has restored the authority of senior officers in the Division to approve so-called Formal Orders of Investigations—the document that authorizes the use of subpoenas—without approval of the Commission or the Enforcement Director. The SEC first delegated that authority to staff in 2009 following the financial crisis, a delegation which continued until 2017, when then-acting Chair Michael Piwowar rescinded it.[13] With their authority restored, agency staff will have less bureaucratic red tape to navigate before launching formal investigations and issuing subpoenas. Acting Chair Lee emphasized that she intended the change to "enable investigative staff to act more swiftly."[14]

In seeking to become more active, the SEC will also continue to use its existing tool belt and work to develop new, more efficient tactics for enforcement. To build cases, the SEC first has to find them. To that end, the new administration will likely continue to rely on advanced data analytics, the whistleblower program, and renewed compliance-related sweeps. In building these cases, the SEC will also be able to use recently passed legislation cementing its power to obtain monetary sanctions.

- *Data Analytics*. The success of the new administration's agenda will depend, first of all, on whether the SEC can further expand its use of data analytics. The SEC has successfully used advanced analytics to target insider trading—for example, by identifying unusual trading patterns. Given the sophistication of the SEC's data analytics program, it has the capability to direct those efforts to pursue the priorities of its leadership. In the last administration, for example, the newly-formed Retail Strategy Task Force applied data analytics to identify large-scale misconduct.[15] Toward the end of the Clayton administration, the SEC also began to apply those same tactics to a broader range of misconduct, including by public companies. One application, the Enforcement Division's Earnings Per Share Initiative "uses risk-based data analytics to uncover potential accounting and disclosure violations caused by, among other things, earnings management practices to mask unexpectedly weak performances."[16] To expand enforcement, especially if the SEC is not given additional resources, staff will have to creatively use data and improve upon past practices to generate case leads.

- *Whistleblower Program*. The whistleblower program, which began in 2011, has grown significantly. 2020 saw a 200 percent increase in the number of individuals given whistleblower awards over the next highest year. In fiscal year 2020 alone, the SEC paid out $175 million in awards to 39 individuals.[17] These headline-making awards will only continue to attract more whistleblowers, who can help the SEC generate case leads more efficiently. With ten years of the program under its belt, the SEC has become adept at evaluating whistleblower tips and taking targeted initial investigative steps to determine whether a tip is worth additional resources. Going forward, expect continued use of the whistleblower program, particularly as remote work environments embolden employees and provide a more tipster-friendly atmosphere.

- *Sweeps and Initiatives.* In the past, the SEC has frequently used industry-wide sweeps of regulatory noncompliance to identify and bring enforcement actions. During the Obama administration, the Enforcement Division—and especially its Specialty Units—frequently used so-called sweeps, where it would use one investigation in an attempt to find similar misconduct at a number of institutions. Although such efforts were less common in the last four years, the last administration did aggressively pursue the Share Class Selection Disclosure Initiative, focusing on mutual fund's practices of charging different fees for similar products.[18] The Gensler SEC may well dedicate resources to similar sweeps and initiatives aimed at large scale wrongdoing or industry-wide practices viewed as problematic.

- *Expanded Power to Obtain Monetary Sanctions.* The new administration will also get the benefit of recent legislation cementing the SEC's ability to obtain monetary sanctions. This legislation, passed as part of the National Defense Authorization Act, among other things, clarified the SEC's power to obtain disgorgement as remedy in civil enforcement actions and extended the statute of limitations for SEC enforcement actions involving fraud and scienter from five years to ten years. [19]

Conclusion

In the end, one thing is sure: the next four years will involve active enforcement. Exactly what that enforcement looks like will become clearer in the first 100 days of the Gensler SEC, as we hear from Gensler about his top priorities and his execution strategy.

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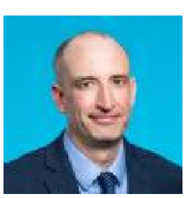

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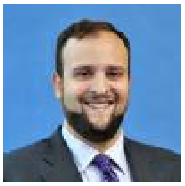

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[1] *See* U.S. Securities and Exchange Commission, Division of Enforcement "2020 Annual Report" at 16, *available at* https://www.sec.gov/files/enforcement-annual-report-2020.pdf.

[2] *Id.* at 17.

[3] U.S. Securities and Exchange Commission, "SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors" (Sept. 25, 2017).

[4] 2020 Annual Report, *supra* note 1, at 5, 9.

[5] Mary Jo White, "Remarks at the Securities Enforcement Forum" (Oct. 9, 2013), *available at* https://www.sec.gov/news/speech/spch100913mjw.

[6] Jay Clayton, "Remarks at the Economic Club of New York" (July 12, 2017), *available at* https://www.sec.gov/news/speech/remarks-economic-club-new-york.

[7] 2020 Annual Report, *supra* note 1, at 3.

[8] Cornerstone Research, "SEC Enforcement Activity: Public Companies and Subsidiaries Fiscal Year 2020 Update," *available at* https://www.cornerstone.com/Publications/Reports/SEC-Enforcement-Activity-FY-2020-Update.

[9] U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, "Observations from Examinations of Investment Advisors Managing Private Funds" (June 23, 2020), *available at* https://www.sec.gov/files/Private Fund Risk Alert_0.pdf.

[10] "The Biden Plan For A Clean Energy Revolution and Environmental Justice," *available at* https://joebiden.com/climate-plan/.

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[12] *See* U.S. Securities and Exchange Commission, "Regulation Best Interest: A Small Entity Compliance Guide," *available at* https://www.sec.gov/info/smallbus/secg/regulation-best-interest#_edn1.

[13] Dean Seal, "SEC Enforcement Gets Obama-Era Investigative Power Back," *Law360* (February 9,

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[14] U.S. Securities and Exchange Commission, "Statement of Acting Chair Allison Herren Lee on Empowering Enforcement to Better Protect Investors" (Feb. 9, 2021), *available at* https://www.sec.gov/news/public-statement/lee-statement-empowering-enforcement-better-protect-investors.

[15] "SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors", *supra* note 3.

[16] 2020 Annual Report, *supra* note 1, at 5.

[17] *Id.* at 5.

[18] Securities and Exchange Commission, "SEC Launches Share Class Selection Disclosure Initiative to Encourage Self-Reporting and the Prompt Return of Funds to Investors" (Feb. 12, 2018), *available at* https://www.sec.gov/news/press-release/2018-15.

[19] Riely et. al., "Recent Legislation Expands SEC's Ability to Pursue Disgorgement" (Jan. 8, 2021), *available at* https://jenner.com/system/assets/publications/20580/original/Recent_Legislation_Expands_SEC_Ability_Pursue_Disgorgement.pdf?1610121726.