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2023 Mid-Year Securities Enforcement Update

Client Alert | August 7, 2023

I. Introduction

In our prior update, we noted that the Division of Enforcement has maintained its aggressive, heightened enforcement agenda through an escalation of existing remedies, including increased penalties, individual bars and admissions. That trend continued in the first half of 2023.

A. Active Enforcement Continues

The Commission has so far not slowed its enforcement strategy, and is unlikely to do so in the months ahead. In the Consolidated Appropriations Act of 2023, Congress agreed to give the Commission $2.2 billion in funding for the current fiscal year, a $210 million increase over the prior fiscal year.[1] The Commission is planning to use the increased funding to hire 400 more staff members, including 125 new personnel for its Enforcement Division. Of those 125 new hires for the Enforcement Division, 33 will be joining the Crypto Assets and Cyber Unit, a sub-unit of the Commission that has already seen heightened activity this year. With a rapidly expanding workforce, the Commission could end up filing even more enforcement actions this year than the 760 it filed in fiscal year 2022—a 9% increase over the prior year.[2]

With the funding to accomplish its goals, the Enforcement Division is bringing actions across the entire range of its jurisdiction, with special focus on some areas. It is clear, for example, that the SEC will do all it can, short of new rulemaking, to tamp down the development of cryptocurrency markets and investments. The SEC also continues to use broad sweeps involving technical violations against registered entities as a way to send deterrent messages and extract large fines—and then repeat those sweeps on a new round of registrants. In the area of financial reporting and accounting, this Commission has brought a number of technical accounting and disclosure cases against issuers and individuals, and has pushed the boundaries of its own jurisdiction to bring charges relating to harassment and workplace misconduct under the guise of non-disclosure and internal controls failures. As all administrations do, the SEC has maintained a steady diet of insider trading cases, and used some of those cases to send a message tied to its rulemaking. The same is true in the cybersecurity area, where we now have final rules that will no doubt provide additional bases for the SEC to bring new cases. Finally, the SEC recently awarded its largest whistleblower bounty in the history of the program—greater than the entire amount awarded in all of 2022—that evinces a program that has been wildly successful at attracting more and better tips from individuals with first-hand knowledge of potential wrongdoing.

B. Focus on Cryptocurrency

Under Chair Gensler, the SEC has undertaken an aggressive enforcement campaign focused on crypto assets and platforms. The current enforcement posture breaks with past Commission statements and is premised on the recently articulated view that it is “clear” the securities laws already apply to the cryptocurrency industry. Underscoring that viewpoint, Gensler has discussed the importance to the Commission of “rooting out

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noncompliance [in crypto markets] through investigations and enforcement actions."[3] Industry participants, members of Congress, and an SEC Commissioner have criticized the SEC's approach, so it remains to be seen whether the Commission will ultimately prevail in its current enforcement efforts. While Chair Gensler points out that the Commission has "successfully brought or settled more than 100 cases against crypto intermediaries and token issuers," that success has generally been in the form of settled orders.[4] Litigated matters have sometimes had different outcomes. For instance, in the SEC's ongoing litigation against Ripple, the District Court for the Southern District of New York ruled that the SEC could not establish as a matter of law that a crypto token was a security in and of itself[5]—a ruling that has widely been considered a "landmark legal victory for the cryptocurrency industry."[6] Judge Rakoff's recent decision in *SEC v. Terraform Labs* agreed with this aspect of the *Ripple* ruling, although that decision rejected *Ripple's* distinction between institutional and secondary-market purchasers in assessing whether a securities offering took place.[7] There is no doubt this area will develop further in the coming months.

C. Rulemaking Barely Slows Down

The last six months have also seen a continuation of this Commission's rapid pace of rulemaking. Over the past year, the SEC has promulgated new rules at a scale and breadth that is close to last year's record-breaking pace. The proposed and final rules have significant implications for registrants, issuers and market structure. Each new rule or proposal typically exceeds 200 pages in length. Many are explicit in their goal to increase potential liability and compliance costs. Most remarkable about this rulemaking effort is that it lacks any Congressional imprimatur. Notably, almost every new rule is approved over the dissent of the Republican Commissioners. Even the Public Company Accounting Oversight Board, which is overseen by the SEC, has gotten into the act and recently issued a 140-page proposal that would drastically change current audit approaches and result in a significant expansion of auditor obligations. The SEC's rulemaking frenzy shows no sign of abating, and from an enforcement standpoint, each new rule is yet more fertile ground for future enforcement action.

D. Is Everyone Overworked?

Putting aside the quantitative metrics of enforcement actions and rulemaking proposals, there are voices among Commission leadership arguing that the agency is trying to do too much—overregulating, over-enforcing, and overworking the staff—without taking the time to be thoughtful about its agenda. For example, two Commissioners recently dissented from a fairly routine decision to file an amicus brief because they and their staff were not given enough time to engage in a "robust deliberative process." As the dissent put it: "Because the Commission has limited resources, it . . . cannot pursue every item on its wish list all at once, but instead it must prioritize. It is not clear to us that such prioritization is taking place."[8] The SEC's frenetic pace increases not just the short-term risk of potential enforcement investigations, but also longer-term expenses and risks as increased regulation raises the burden on legal and compliance infrastructures. More regulation and more enforcement begets higher costs of compliance and greater risks of compliance foot-faults.

E. Challenges to the SEC's Home Court Advantage

Another issue that could have lasting consequences for the SEC's agenda: successful challenges to the SEC's ability to bring enforcement actions in its home court before administrative law judges ("ALJ"). Over the past few years, the agency has seen challenges to its authority—statutorily expanded by Dodd-Frank—to bring any enforcement matter in an administrative proceeding before an ALJ. With the simultaneous expansion of the SEC's view of existing enforcement tools and the significant increase in new, highly technical rules and regulations, the SEC's ability to bring all manner of claims before an ALJ ratchets up the risks for registrants, issuers, and individuals. But as things stand right now with challenges to ALJs, the SEC is filing contested matters only in federal district

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court. So for now, those who are willing to litigate against the SEC will have the right to an Article III judge, a jury, greater access to discovery, and the Federal Rules of Civil Procedure—if they challenge the SEC in court.

II. Commissioner and Senior Staffing Update

As reported in our 2022 Year-End Alert, the Commission was back to its full strength with five commissioners as of July 2022, and that remains unchanged through the first half of 2023. That said, there continued to be significant changes in the senior leadership of the regional offices, as well as several changes at the national level.

- In January, Paul Munter was appointed as the Chief Accountant, a position he has held on an acting basis since January 2021.[9] As Chief Accountant, Munter will continue leading the Office of Chief Accountant, an office he joined back in 2019 as Deputy Chief Accountant.
- Also in January, Silvestre A. Fontes was named Regional Director of the Boston office.[10] Fontes previously served as Assistant Regional Director of the Boston office through 2011, but left the Commission and is now returning to the lead the office. Fontes most recently worked as Chief Compliance Officer of Bracebridge Capital LLC, a Boston-based private fund adviser.
- In April, Deborah J. Jeffrey was appointed Inspector General of the SEC.[11] Jeffrey most recently served as the Inspector General of AmeriCorps, and before that, was the Vice Chair of the District of Columbia's attorney discipline system.
- Also in April, Eric R. Werner was named Regional Director of the Fort Worth office.[12] Werner served as the Acting Co-Regional Director, and served as the Associate Regional Director of Enforcement in the same office since 2018. Werner has held a variety of positions over his 26-year career at the SEC, including at the SEC's Home Office, Office of Chief Counsel, and Complex Financial Instruments Unit, among others.
- Finally, in June, it was announced that Michele Layne, Director of the Los Angeles Regional Office, would be leaving the SEC after more than 27 years of service.[13] Cindy Eson and Kate Koladz were named Acting Co-Directors of the office.

III. Aggressive Enforcement

A. "Attention-Grabbing" Sweeps

The Commission has increasingly favored enforcement sweeps over the course of the last few years—i.e., tackling multiple similar enforcement actions at the same time, and not in a piecemeal fashion.[14] In fact, the Commission has carried out at least 65 enforcement actions since 2021 that first arose out of an enforcement sweep, imposing over $1 billion in penalties in the process. Most of the offenses targeted in these sweeps share a few common characteristics: (1) investment advisers or broker-dealers (i.e., the institutional actors that the Commission directly regulates) allegedly committed the targeted offenses; (2) the targeted offenses were all strict liability or simple negligence violations; (3) the alleged facts were all relatively uncomplicated in nature; and (4) the Commission primarily sought "uniform remedies such as censures, cease-and-desist orders, penalties, and undertakings," and not individualized remedies such as disgorgement.

Gurbir Grewal, the Director of the Commission's Enforcement Division, has repeatedly emphasized the Commission's commitment to an enforcement strategy based on conducting enforcement sweeps. Calling the sweeps a "powerful tool," Grewal has said that the Commission often uses the sweeps because they have "much more of an attention-grabbing deterrent effect than doing these cases serially."[15] Quickening the pace of investigations through the use of sweeps is, according to Grewal, an important aim of the Commission, and the number of sweeps is therefore likely only to grow in the months and years to come.

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B. Sweeps Can be Repeated

As we wrote in our 2022-year end update, the Commission obtained over $1 billion in settlements from fifteen broker-dealers and one affiliated investment advisers last year for not retaining business related communications on personal devices. As foreshadowed, the Enforcement Division's subsequent sweeps included a focus on investment advisers.

Early this year, the Commission began asking some of the country's largest investment advisers to undertake a self-review of whether their employees had communicated about firm business using unapproved channels.[16] The category of records that investment advisers are required to maintain is narrower than the broker dealer communications that were the main target of Commission's first sweep. (Certain records required under the Commodity Exchange Act were also implicated in the 2022 sweeps.) Under Exchange Act Rule 17a-4(b)(4), broker dealers have to retain "all communications . . . relating to [their] business as such" while Investment Advisers Act Rule 204-2(a)(7) generally requires investment advisers to retain only communications recommending investments, recording a receipt or disbursement of funds or securities, or placing orders. It remains to be seen how the Commission intends to apply the record-keeping requirements of the Advisers Act to the subject communications.

Separate from the second sweep targeting investment advisers, in May 2023, the Commission announced twin settlements with two dual registrants (broker dealers and investment advisers) who had self-reported—in response to the Commission's publicly announced encouragement in December 2021. The firms agreed to pay penalties of $15 million and $7.5 million, respectively—well below the fines in the first sweep, but still well above the fines in prior recordkeeping settlements.[17] More important, the settlements provide no visibility into the benefits the firms received from self-reporting.

In June 2023, the Commission settled with a dual registrant for violation of the recordkeeping regulations when it mistakenly deleted almost 50 million communications that the registrant's archive vendor said would be maintained. The firm agreed to pay a $4 million fine.[18] According to the Order, the firm self-reported the violation to the Commission in January 2020.

Meanwhile, FINRA fined a registered representative $15,000 and banned her from working with any FINRA member for fifteen months on allegations that she sent client documents by text using a personal device and then made false statements to investigators from her employer and FINRA.[19]

Putting aside the risks of enforcement investigations, registrants should also anticipate questions about electronic recordkeeping and off-channel communications by employees in the context of routine compliance examinations. The Examination Priorities Report for 2023 foretells a concentration this year on registrant compliance and supervisory programs about electronic communications related to firm business.[20]

C. Focus on Cryptocurrency

As previewed above, Chair Gensler has discussed the importance to the Commission of "rooting out noncompliance [in crypto markets] through investigations and enforcement actions." These actions typically involve alleged failures to register as broker-dealers, exchanges, or transfer agents and as to products with the Commission, and/or for allegedly misleading investors.[21]

Industry participants, members of Congress, and an SEC commissioner have criticized the SEC's approach. In April, members of the House Financial Services Committee questioned Chair Gensler about the SEC's impact on the crypto industry. The Committee's Chairman, Rep. Patrick McHenry (R-NC), noted that Gensler's "[r]egulation by enforcement is not sufficient nor sustainable." The problem, according to McHenry, is that Gensler is "punishing digital asset firms for allegedly not adhering to the law when

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they don't know it will apply to them."

Commissioner Hester Peirce has expressed similar sentiments. In her April statement titled "Rendering Innovation Kaput,"[iii] she said: "[a] commission serious about regulating — and not destroying — [the crypto] market would reflect on this near unblemished record of regulatory failure and do something about it." She added that "the Commission dismisses the possibility of making practical adjustments to our registration framework to help entrepreneurs register, and instead rewards their good faith with an enforcement action." Among other things, critics of the current enforcement approach question the extent of the Commission's statutory authority in this area and object to its failure to first adopt rules setting forth clear standards and feasible registration requirements.

It remains to be seen whether the Commission will prevail in its current enforcement efforts. While the Commission has touted its enforcement success—according to Gensler, the Commission has so far "successfully brought or settled more than 100 cases against crypto intermediaries and token issuers"—that success has generally been in the form of settled orders.

During the first half of 2023, the Commission brought cases against two prominent crypto platforms, alleging that they failed to register as securities exchanges and broker-dealers.[22] It also filed complaints against various other crypto exchanges, all for allegedly not registering with the Commission.[23] In addition, the Commission charged a handful of individuals in connection with alleged schemes which raised more than $45 million in sales of unregistered crypto assets.[24] In particular, the Commission alleged the respondents "falsely claimed that investors could generate extravagant returns by investing in a blockchain technology." The Commission has brought similar charges against high-level former FTX employees,[25] as well as others.[26]

Litigated matters have not always gone the SEC's way. In June, the SEC filed settled actions against two of the country's largest crypto platforms in the District of D.C. and the Southern District of New York. On the immediate heels of these actions, though, the District Court for the Southern District of New York in the SEC's ongoing litigation against Ripple ruled that the SEC could not establish as a matter of law that a crypto token was a security in and of itself—a ruling that has widely been considered a "landmark legal victory for the cryptocurrency industry."[27] Judge Rakoff's recent decision in *SEC v. Terraform Labs* agreed with this aspect of the Ripple ruling, although it rejected Ripple's distinction between institutional and secondary-market purchasers in assessing whether a securities offering took place.[28]

D. Insider Trading

As in prior administrations, the Commission has maintained steady attention on insider trading, bringing a handful of cases in the first half of 2023. In addition to standard tippee/tipper cases, and in a nod to the continuing work-from-home environment, the SEC announced charges against a registered representative at a New York-based broker-dealer and a compliance officer for an international payment processing company who allegedly obtained material nonpublic information from his girlfriend's laptop when she was working from home during the COVID-19 pandemic.[29] The girlfriend was an employee of an investment bank. Both the broker and the compliance officer traded on this information and made combined profits of more than $750,000. The broker also recommended the stock to his customers, resulting in profits for customers and commissions for the stockbroker. The SEC and DOJ filed parallel actions in federal courts.

The SEC also brought insider trading claims against a CEO for allegedly trading on the basis of material nonpublic information even though he had traded in accordance with a Rule 10b5-1 plan.[30] Rule 10b5-1 provides an affirmative defense to insider trading where a person demonstrates that, before becoming aware of the MNPI, the person adopted a written plan for trading securities that specified the amount of securities to be traded, the price, and the date on which the sale was to occur.[31] The Rule 10b5-1 plan

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must be entered into in good faith, and not as part of a plan or scheme to avoid the securities laws. The SEC's complaint alleges that the CEO was aware of MNPI when entering the plans and adopted the plans as part of a scheme to evade insider trading prohibitions because he knew that the company was likely to lose one of its largest customers at the time he entered the trading plans. This case was filed shortly after the SEC issued final rules governing the use of Rule 10b5-1 plans[32] and may be another instance in which the SEC was sending a message designed to buttress its rulemaking efforts.

IV. Investment Adviser Industry Actions

A. Disclosure Failures

The Commission continues to increase regulation of Investment Advisers, with an increased focus on the private fund market as it grows to a more than $25 trillion industry with tens of thousands of funds in operation.[33] In May, the Commission adopted new amendments to Form PF for hedge fund and private equity advisers.[34]

Private funds have come under intense scrutiny as the Commission pursues ever increasing levels of disclosure from funds in order to more closely regulate the market.

In February, the Commission settled against a large religious organization and its asset management firm for disclosure failures.[35] According to the settled order, in order to obscure the total assets under management, the asset management firm formed separate entities, allocated the religious organization's assets among the entities and filed individual Forms 13F on behalf of the separate entities, all while maintaining control over all the equity investments. The asset management firm and the religious organization both agreed to pay a $4 million and $1 million penalty respectively for violations of the Exchange Act for misstating information.

The Commission's asset management docket also included perennial Advisers Act themes, such as inaccurate valuations, erroneous fee calculations, and failure to fully disclose and mitigate conflicts of interest:

In late May, the Commission charged an advisory firm for failure to adopt and implement adequate written policies to value assets in the managed funds.[36] The Commission alleged that the firm's written policies were not reasonably designed to value client holdings and assess fees leading to incorrect calculations of fees and inaccurate performance reporting. The case was settled without admission or denial of Commission findings with a civil penalty of $275,000 and other sanctions.

In mid-June, the Commission announced and enforcement action against an investment advisory firm for its failure to disclose material information to investors, failure to waive required advisory fees, and inadequate policies to ensure sufficient oversight of fee waivers.[37] The firm agreed to a cease and desist order and a combined $9 million in penalties. (For a previous Gibson Dunn alert offering more detailed analysis on this topic, please click here.)

The Commission also brought an action against a former investment adviser for failure to disclose a conflict of interest arising from his personal relationship with a film distribution company in which the adviser's fund had invested millions of dollars.[38] In the course of his employment, the company allegedly helped his daughter secure an acting opportunity in a 2018 film production. He consented to entry of the order and payment of a $250,000 penalty.

The Commission instituted a settled action in May against two registered investment advisers for breach of fiduciary duty and compliance failures after they allegedly invested client funds in leveraged exchange traded funds ("ETFs"), despite the unique risks posed by those types of products.[39] According to the settled order, the advisers misunderstood

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the riskiness of these particular products, and as a result, were unable to evaluate whether investing in them was in their client's best interests. The advisers settled without admitting or denying the Commission's findings, and agreed to disgorgement, civil penalties, and other sanctions.

The SEC also instituted a settled action against a New Jersey asset management firm and its founder for alleged improper trading of certain fixed income securities.[40] The order found that the firm's rebalancing trading in bonds among advisory clients resulted in an increase in the prices of such bonds at a higher rate than other similar securities. Over time, the increase in bond values resulted in higher net asset valuation of portfolios and increased fees to the adviser. The company and founder agreed to pay approximately $19.3 million in combined fees and penalties to settle the matter.

B. New Liquidity Rule

In early May, the Commission instituted its first enforcement action against a mutual fund adviser and certain officers of the adviser and trustees of the mutual fund for violation of the Liquidity Rule.[41] The Liquidity Rule prohibits mutual funds from investing more than 15 percent of net assets in illiquid investments. The Commission alleged, among other things, that the parties ignored restrictions and disregarded advice to decrease the fund's exposure to illiquid assets. All parties resolved the allegations with the SEC, and paid a range of civil penalties and other sanctions.

V. Retail Wealth Management – Reg BI

The Commission adopted Regulation Best Interest ("Reg BI") in the first half of 2019.[42] Reg BI sets a standard of conduct for broker-dealers and associated persons when they make recommendations to retail clients. It requires broker-dealers to: act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer, and address broker-dealer conflicts of interest with those clients. Reg BI is understood as being composed of four component obligations: the (1) care obligation; (2) disclosure obligation; (3) conflict of interest obligation; and (4) compliance obligation.[43]

There has been a dearth of Commission enforcement actions relating to Reg BI thus far. By contrast, FINRA has recognized Reg BI as an enforcement priority for 2023. Indeed, FINRA brought its first Reg BI case last September in an action alleging that a registered representative recommended an inappropriate series of transactions to one of his retail customers in order to generate commissions and trading costs.[44]

The trend of FINRA bringing Reg BI cases has continued thus far in 2023. In May, FINRA expelled a New York broker-dealer, and suspended and fined its CEO for Reg BI violations, among other things.[45] FINRA found that the firm made material misrepresentations to customers in connection with the sale of risky pre-IPO securities. In announcing the case, FINRA said "Firms . . . must reasonably surveil for, and respond to, red flags of excessive trading and churning. When firms, particularly those with significant disciplinary histories, commit egregious sales practice and supervisory violations, expulsion from FINRA membership may be warranted." In the first five months of 2023, FINRA served over 150 breach of Reg BI arbitrations, representing a nearly five-fold increase compared to the same time last year.[46]

The Commission has not brought any high-profile Reg BI cases since the one case it brought last year.[47] However, it is expected that there will be more coming down the pike as the Commission's Staff has now published multiple Staff Bulletins setting forth the Staff's opinions on implementation of Reg BI.[48] In many respects, the Bulletins depart, sometimes substantially, from the guidance issued by the Commission in the Adopting Release for Reg BI. This Staff's deviation from the Adopting Release heightens the ambiguity about the proper scope of a registrant's compliance and supervisory programs that were designed to be consistent with the guidance in the Adopting Release.

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VI. Cybersecurity

Cybersecurity is top-of-mind at the Commission, at least in part due to high-profile data breaches and ransomware attacks that have exposed sensitive consumer information into the hands of bad actors.[49] In February 2022, the Commission proposed new rules for cybersecurity risk management for investment advisers, registered investment companies, and business development companies.[50] The proposals suggest a new cybersecurity risk management regime designed to both prevent attacks in the first instance and respond to them with additional disclosures. In March, the Commission reopened the comment period on the rules and amendments.[51] The Commission has indicated it does not plan to approve the new cyber rules until at least October 2023.[52]

The Commission finalized and adopted a cybersecurity risk governance rule for public companies in late July 2023.[53] The final rule imposes new reporting requirements on companies that suffer material cybersecurity incidents, raises questions concerning the scope of materiality, and requires new Reg S-K disclosures about how companies govern cybersecurity risks. Commissioner Pierce criticized the final rule as being overly broad and reading "like a test run for overly prescriptive, overly costly disclosure rules covering a never-ending list of hot topics."[54] (For a previous Gibson Dunn alert offering more detailed analysis on this topic, please click here.)

Enforcement actions relating to cybersecurity risk have continued in parallel with and in support of the rulemaking. In March, 2023, the Commission instituted a settled action against a public company that manages donor data for non-profits, for allegedly misleading disclosures with respect to a cyber-attack that occurred in 2020.[55] Shortly after the attack, the company publicly announced that donor bank account information had not been compromised. The Commission alleged that the company's quarterly statement omitted the full extent of the attack by categorizing it as a mere hypothetical possibility after they were already aware of the full impact. The company agreed to a $3 million civil penalty to settle the charges. The SEC settled this matter before its proposal on cybersecurity disclosure and governance for public companies had been finalized, but the message sent by the settlement was in line with many of the requirements that were proposed and could be seen to buttress those requirements, especially the governance-related aspects.[56] We expect more cybersecurity enforcement, especially now that new rules are in place for public companies.

VII. Financial Reporting and Disclosure

A. Financial Reporting and Accounting Cases Remain Steady

Public company financial reporting and disclosure failure cases, long seen as the bread-and-butter of SEC enforcement, have continued at a similar pace as in previous years. There were several notable cases in the first half of 2023.

1. Fraud and Financial Manipulation

The SEC filed an action against three executives at an Alabama-based shipbuilding company for engaging in a fraudulent revenue recognition scheme by manipulating cost estimates in order to allow its parent company to meet or exceed expectations.[57] The complaint alleged that the executives artificially decreased the cost of specific shipbuilding projects by tens of millions of dollars in order to aid the parent company's estimates for earnings before interest and tax ("EBIT"). The case remains ongoing.

The SEC filed an action against the founder of a student loan assistance company that was acquired by, and subsequently dissolved by a large financial services firm.[58] The SEC alleged that the founder fraudulently enticed and sold her company after misrepresenting the amount of student data that she had. The founder benefited from the $175 million acquisition, receiving roughly $9.7 million in stock, millions in trusts, and a $20 million retention bonus as a new employee of the financial services firm. In addition to

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the SEC's charges, parallel criminal charges were announced and are pending as well.

The SEC filed and settled complaints against a health supplement company's former executives with charges ranging from improper revenue recognition practices to fraud and improper disclosures.[59] The Commission alleged that the executives inflated their quarterly revenues and gross profits. Several executives settled charges with a range of sanctions and civil penalties, while charges against other executives remain pending.

2. Disclosure Failures

The SEC settled with a leading financial news organization in connection with alleged misleading disclosures related to its subscription service.[60] According to the order, the organization failed to disclose to customers that valuations for certain fixed-income securities could be based on a single data input despite being aware that their customers used it to decide fund asset valuations and could be inappropriately impacted. Without admitting or denying the SEC's allegations, the organization agreed to pay a $5 million penalty and make improvements to the subscription service.

The SEC settled charges against a transportation company and its former CEO for their failure to disclose perks provided to the former CEO and other executives, as well as compensation the CEO received for using his own private plane for travel by company executives.[61] The company and CEO agreed to pay $1 million and $100,000 in civil penalties, respectively.

B. Increasing Market Focus on Environmental, Social, and Governance ("ESG") Strategies for Fund Managers and Public Companies

Stakeholders and investors have increasingly incorporated ESG into their investment strategies. Many large investment managers have committed themselves to considering ESG factors in their voting and investment decisions.[62] Public companies have also begun to address ESG at their annual general meetings at record-high rates,[63] such as by hosting "Say on Climate" votes and votes on diversity, equity, and inclusion.[64] Companies have also increased their voluntary reporting on ESG matters. In fact, in 2021, nearly 100% of the S&P and 81% of the Russell 1000 published a sustainability report.[65]

Opposition to ESG has also grown.[66] When a large investment manager announced a position on energy investments in state pension funds, 19 state attorneys general wrote to the CEO in dissent,[67] some states issued rules limiting such investments, and other states refused to even meet with certain investment managers. Other opponents have expressed concerns about so-called greenwashing, whereby companies allegedly overstate ESG-driven benefits in disclosures. In response to this criticism, some investment managers have scaled back their ESG efforts,[68] or at least are scaling back their discussion of ESG, which has led to complaints of "greenhushing"—or saying less about ESG efforts to avoid the ire of those opposing ESG.[69]

C. Commission's Proposed Rules on ESG Reporting

Despite the pushback, a new wave of government enforcement and regulation is forcing companies and investors to grapple with how to address ESG within legal, risk and compliance regimes. Other government agencies, such as the FTC and some state attorneys general, have begun to bring enforcement actions and lawsuits related to ESG disclosures.[70] The Commission has also been active on this front, introducing four new ESG rules in 2022, and bringing several enforcement actions for insufficient controls:[71]

- **The Climate-Related Disclosure Rule Proposal** would require companies to disclose climate change-related risks that are "reasonably likely to have a material impact on [their] business, results of operations, or financial condition."[72] Covered entities would also need to disclose their plans and processes for managing climate-related risks (if applicable). Finally, companies would have to

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disclose their direct greenhouse gas ("GHG") emissions, indirect emissions from purchasing electricity and energy, and emissions from "upstream and downstream activities" in their value chain. The Climate-Related Disclosures Rule may be finalized later this year,[73] but is almost certainly going to be challenged in litigation given the enormous costs it is likely to impose on public companies.

- **The Cybersecurity Risk Governance Rule** requires companies to disclose cybersecurity incidents and policies for managing cybersecurity risks.[74] As discussed above, the rule was recently finalized.
- **The Enhanced Disclosures by Certain Investment Advisers and Investment Companies about ESG Investment Practices Rule** applies to funds and tailors disclosure requirements to how "central ESG factors are to a fund's strategy."[75] Funds that integrate ESG alongside other factors must describe their investment process. Funds that focus more significantly on ESG (Focused Funds) must provide more detailed disclosures, such as a "standardized ESG strategy table overview." And funds that target a specific ESG goal (Impact Funds) must disclose how they measure progress on their objectives.[76] The rule also requires funds that consider environmental factors to disclose the carbon footprint and "weighted average carbon intensity" of their portfolio. The Enhanced Disclosures Rule is expected to be finalized in 2023.[77]
- **The Reporting of Executive Compensation Votes by Institutional Investment Managers Rule** was adopted by the Commission in November 2022 and requires mutual funds to provide proxy voting records. Although mutual funds had to report proxy votes prior to the 2022 rule, the new rule also requires reporting of votes in certain categories, such as climate, compensation, and human rights.[78]

Criticism of these proposals has been robust. Companies have expressed concerns about the cost of compliance with the Climate Disclosure Rule and possibly incurring penalties for incorrect disclosures. In addition, investment managers have expressed concerns that the Commission might finalize the fund disclosures rule before the public company disclosure rule. This timing, managers fear, would require funds to disclose their portfolio's emissions before companies do so, leading to inaccurate reporting.[79] Several members of Congress have also requested information about the Commission's Climate Disclosure Rule and even introduced legislation to remove Gensler as chair of the Commission.[80]

The Commission is still planning to propose other ESG-related rules targeting diversity and inclusion. For example, the Commission expects to propose a rule requiring companies to disclose information about human capital, such as workforce composition and diversity of board members.[81] The Commission has already approved Nasdaq's Board Diversity Rule, requiring certain Nasdaq-listed companies to comply with diverse board requirements.[82]

D. Commission Use of Existing Rules for ESG Enforcement Actions

The Commission has decided not to wait to finalize its ESG rules to bring cases against firms that it believes are misstating or omitting material information about its ESG-related activities or failing to maintain adequate disclosure controls and procedures around ESG-related information. In March 2021, the Commission created a Climate and ESG Task Force within its Division of Enforcement,[83] and the task force and broader division have since targeted disclosures under existing Commission rules.

For example, the Commission has penalized financial services firms for improper disclosure of ESG-related information through the provisions of Section 206 of the Advisers Act,[84] which require advisers to adopt provisions reasonably designed to prevent violations of the Act. The Commission has indicated that it will continue such enforcement actions, but the SEC filed no new cases in the first half of 2023.

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Although much of the Commission's early ESG rhetoric focused on energy and climate, the Commission is now directing its attention to social and governance issues too. For example, a recent enforcement action highlighted the Commission's efforts to enforce disclosure control violations related to the "social" element of ESG.[85] In the case, the SEC alleged that the company was aware of potential weaknesses around its ability to maintain a healthy workplace culture, but "lacked controls and procedures . . . to collect and analyze employee complaints of workplace misconduct," and consequently "did not assess whether any material issues existed that would have required public disclosure." Commissioner Peirce dissented from the order, explaining that the company had not violated a securities law and that the matter was better suited for the EEOC.[86]

VIII. Whistleblower Program Generates Record-Breaking Awards

We have cataloged significant Commission Whistleblower awards in our previous alerts for many years. That said, the eye-popping payouts this year make it worthwhile to take stock of the program as a whole. Last year, the Commission received a record-high 12,300 tips of potential corporate misconduct, and of those, it paid out awards in 103 cases, totaling $229 million.[87] In 2023, the SEC awarded $279 million to two anonymous whistleblowers for a single case.[88] Even absent this sizeable award, 2023 appeared off to an impressive start. In January alone, the Commission awarded over $50 million in just three awards.[89] These payouts and the number of whistleblower tips the SEC receives each year suggests the program has been quite a success for the agency.

While the Commission's decision-making process for awarding payments is somewhat opaque, two key factors appear to drive the Commission's payment decisions: utility and compliance. Regarding utility, a recent example is instructive. In a case with multiple whistleblowers, one potential whistleblower had his claims denied by the Commission because they "didn't aid the agency's enforcement action." Submitting a tip alone is insufficient—even if the subject of the tip is ultimately sanctioned—since a tip must contain "original information" that points to a violation of securities laws and leads to a successful enforcement action. Moreover, original information must be the product of "independent knowledge or independent analysis," and "[n]ot already known" to the Commission, among other narrow exceptions.[90] Indeed, the Commission confirmed that the successful whistleblower was successful largely because of their "sustained assistance including multiple interviews and written submissions."[91] While it is unclear whether the unsuccessful whistleblower's claims were denied because the information was helpful-but-unoriginal or unhelpful-but-original, either combination is sufficient to bar an award.

Additionally, the information must be compliant with all statutory reporting guidelines. For example, the Third Circuit recently upheld the Commission's denial of a whistleblower award stemming from a settlement of alleged inaccurate disclosures. The claimant, whose request for an award was denied by the Commission, filed an application claiming to have significantly contributed to the report that ultimately led to the settlement.[92] The Third Circuit rejected that argument, though, because the SEC had received the report from a public website and not from the claimant directly. Indeed, the SEC and the Third Circuit both held that it was undisputed that the claimant failed to follow the prescribed method of submission to qualify for an award, and doing so is a requirement under the whistleblower rules.

The whistleblower program raises a related question on cooperation. In spite of its aggressive enforcement strategy, the Commission has also continued to encourage companies to cooperate with the Commission before and during investigations. Recently, at the Securities Enforcement Forum in May, Director Grewal stressed that enforcement "should not be a game of gotcha" in which the Commission "hold[s] all of [its] cards close to the vest and surprise[s] you at the 11th [sic] hour and hold[s] something for trial."[93] Instead, it is a "truth-seeking mission" and "should be a collaborative process" between companies and the Commission.

In May, Grewal applauded two firms for their "great cooperation" during the electronic

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communications investigation and asserted that the Commission rewards people for "self-reporting and cooperating." Still, despite the firms' cooperation, the Commission did ultimately insist on hefty fines in each instance, thereby calling into question the purported benefits of deciding to cooperate with the Commission. Navigating the SEC's opaque cooperation posture is made all the more challenging by the risk of whistleblowers.

IX. Rulemaking Continues in High Gear

Currently, there are 18 rules in the preliminary stages of rulemaking and 37 rules in the final stages of rulemaking.[94] Not since 2011 has the Commission had such a robust agenda—and the Commission did so then only to implement the recently-enacted Dodd-Frank Act of 2010.[95] Measured by page-count of the proposed rules, the SEC issued more pages of proposed rules than during any year going back to 1995 (and probably ever). This year is shaping up to be another outsized year for new proposals, considering that we may see rules on human capital disclosures later this year. (*See* Figure 1 below.)

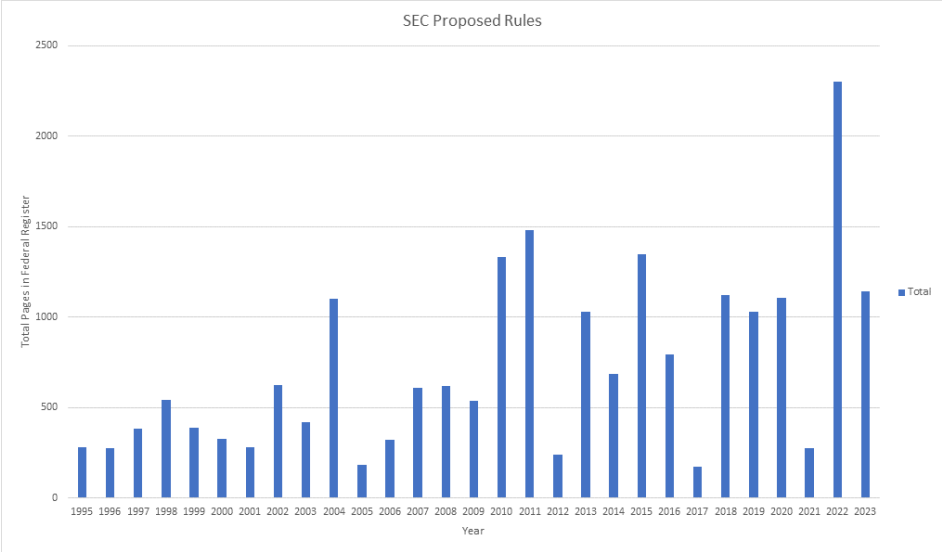


Figure 1 - Annual SEC Proposals by Number of Federal Register Pages[96]

In several instances, the proposed rules seem to push the boundaries of the Commission's congressionally granted authority, leading to significant backlash, especially in light of the accelerated pace of its rulemaking. House Financial Services Committee Chair Patrick McHenry, for example, has expressed concerns that the hasty adoption of rules is "undermining the quality of our securities laws."[97] Commissioner Hester Peirce has taken a similar stance, saying in May that "it's difficult to figure out what the effects of all those rule changes will be" and that due to the hurried pace, Commission staff "don't have the time to necessarily think through everything."[98] The pace of SEC rulemaking will eventually slow, but the lasting effects of the many new rules being put forward by the SEC will be with us for many years.

Another rulemaking effort that has flown under the radar but is worth noting comes from the Public Company Accounting Oversight Board ("PCAOB"). Its new rule could drastically expand the scope of audits. On June 6, 2023, the PCAOB proposed for public comment a draft auditing standard, *A Company's Noncompliance with Laws and Regulations*, PCAOB Release 2023-003, that could significantly expand the scope of audits and potentially alter the relationship between auditors and their SEC-registered clients.[99] In a rare move, two PCAOB Board members—the two accountants on the Board—dissented from the proposal based on a range of concerns, including that it would unduly expand the scope of the public company audit.

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The Current AS 2405 mirrors in substantial part Section 10A of the Securities Exchange Act of 1934, which requires the auditor to perform "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts."[100] The Proposed AS 2405 would go further and require the auditor to: (i) identify all laws and regulations "with which noncompliance could reasonably have a material effect on the financial statements,"(ii) incorporate potential noncompliance with those laws and regulations into the auditor's risk assessment, and (iii) identify whether noncompliance may have occurred through enhanced procedures and testing.[101] As part of these procedures, an auditor would be required, among other things, to obtain an understanding of management's own processes to identify relevant legal obligations and investigate potential noncompliance.[102]

Upon identifying an instance of potential noncompliance, the auditor must perform procedures to understand the nature of the matter, as well as to evaluate whether in fact noncompliance with a law or regulation has occurred.[103] These procedures go beyond those required by the Current AS 2405 and Section 10A. Importantly, the proposed procedures would appear to require the auditor to undertake significant steps even in cases where it appears unlikely that the identified conduct will have a material effect on the financial statements and even in cases where the noncompliance itself is still in question.

After identifying an instance of potential noncompliance, the auditor would communicate both with management, the audit committee (unless the matter is clearly inconsequential) and, in some cases, the board of directors as a whole.[104] The Proposed AS 2405 contemplates that this communication may occur in two stages, the first after the auditor learns of the matter and the second after the auditor has conducted an evaluation of the matter.

This is a sweeping proposal, spanning more than 140 pages, that could drastically change current audit model and potentially expand the financial statement audit into a compliance audit. The dissenting statements underscore both the significance of this proposal and the range and magnitude of the concerns, for auditors and SEC registrants alike. The procedures in Proposed AS 2405, and other proposed amendments to PCAOB auditing standards, likely would substantially expand the scope of most audits in relation to identifying, assessing, and addressing potential noncompliance with laws and regulations, particularly for audits of complex, global organizations. The auditor's increased responsibility to identify, evaluate, and report on legal compliance could alter what information the issuer may need to share with the auditor to help ensure that sufficient audit evidence is obtained, as well as the training and quality controls that might be necessary to achieve reasonable assurance that the auditor can evaluate and act on the information received. Notably, too, the increased sharing of information from the audit client to the auditor that is required under the Proposed AS 2405 would present significant increased risk to the audit client's legal privileges. These are but a few of the significant issues presented by the Proposed AS 2405. Companies and their auditors will want to follow these proposals carefully.

X. Challenges to the Administrative State

The Commission typically has two venue options when it authorizes an enforcement action: file a complaint in federal district court before an Article III judge or institute an administrative proceeding before an administrative law judge ("ALJ"). The SEC's power to use administrative proceedings and how it operates those proceedings have been the subject of numerous challenges in the past ten years.[105] These challenges have been part of the larger attack on the administrative state that has affected other federal agencies. Because of these challenges, the current SEC Enforcement practice has been to file contested matters in federal district court. Two developments in the past six months further challenge the SEC's authority to bring enforcement actions before ALJs.

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Although for most of the SEC's existence, only certain types of cases could be brought before an ALJ, over the years and then through the Dodd-Frank Act, the SEC gained the power to bring virtually any enforcement action, including those seeking monetary damages, before an ALJ. This has put litigants charged with SEC violations in the unenviable position of having to defend themselves without the same right to civil discovery or procedure they would have in district court and without the right to trial by jury, but instead before a judge appointed by the SEC, whose chambers are in the same building as the SEC, and with any appeal brought before the Commission that approved the enforcement action in the first place. For obvious reasons, as the SEC's authority to bring cases before such inhouse tribunals has expanded, resistance has grown to their use.

First, the U.S. Supreme Court held on April 14, 2023 that a respondent in an administrative proceeding may bring a collateral attack on the constitutionality of the proceeding itself in federal district court rather than waiting years for the SEC to finish the administrative process being challenged.[106]

Michelle Cochran, a certified public accountant who was subject to an SEC administrative proceeding, sued the SEC in federal district court while the enforcement action was pending. She argued that the agency's basic structure and operations were unconstitutional and the pending enforcement action unlawful. The district court dismissed Cochran's complaint, holding that the specialized judicial-review provisions in the Exchange Act deprived the district court of jurisdiction by funneling review of final agency orders to the federal courts of appeals. The Fifth Circuit reversed. It recognized that structural constitutional challenges to an agency's administrative proceedings were *not* the sort of claims Congress meant to funnel to the courts of appeals through the statutory review scheme, and the Supreme Court affirmed. The Court held that federal district courts have jurisdiction to resolve certain challenges to the structure or existence of the SEC and its proceedings, rejecting the government's argument that litigants can raise such challenges only on review of a final agency action, after many of years litigation, before the court of appeals.

The decision allows people and businesses subjected to SEC (and FTC and potentially other) administrative enforcement actions to promptly raise certain structural challenges in court, without having to first complete long and costly agency proceedings (which often settle before a final order). As the Court recognized, permitting suits to proceed in federal district court allows regulated parties to vindicate the "here-and-now injury" of being subjected to unconstitutional administrative processes. The decision—issued with no dissent—reflects the current Court's strong interest in reining in excesses of the administrative state by reinforcing constitutional limitations on the structure, composition, and operation of administrative agencies. The decision will almost certainly keep pressure on the SEC to file contested claims in district court, providing regulated entities challenging SEC actions with greater procedural rights and protections than are available in administrative proceedings.

The second major development is the Supreme Court's decision to hear arguments in *SEC v. Jarkesy*, a case involving constitutional challenges by an investment adviser charged with fraud in an administrative proceeding.[107] In 2013, the SEC instituted proceedings against George Jarkesy and his advisory firm for alleged mismanagement of a pair of hedge funds with $24 million under management. Jarkesy initially responded by suing the agency, arguing that its structure and enforcement powers violated the Constitution, but the D.C. Circuit said that type of challenge had to wait until a final order had been entered by the Commission and challenged in the Court of Appeals (a decision that was overruled by *Cochrane*). After nearly a decade of litigation before the ALJ, who ultimately ruled for the SEC, Jarkesy brought his constitutional challenges before the Fifth Circuit.

In May 2022, the Fifth Circuit agreed with Jarkesy. It held that the SEC violated the Constitution by filing an enforcement action seeking monetary penalties for fraud before an

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ALJ, rather than in federal court before a jury. Specifically, the court held that Jarkesy and the other defendants were deprived of their right to a jury trial; that Congress impermissibly delegated legislative powers by granting the SEC unfettered discretion in choosing whether to bring matters before ALJs; and that restrictions on the removal of SEC ALJs constricted the president's constitutionally mandated oversight over inferior government officers. On June 30, 2023, the Supreme Court granted the SEC's petition for a writ of certiorari agreeing to hear the case next term. It is not clear what the Court will hold in the case, but it is yet another challenge to the SEC's authority to bring cases before ALJs.

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