

Framing The Legacy Of The SEC Under Clayton

By Stephen L. Cohen, Nader Salehi and Paul Bello (September 23, 2020)

On Sept. 17, U.S. Securities and Exchange Commission Chairman Jay Clayton and Division of Enforcement Director Stephanie Avakian delivered back-to-back speeches regarding the performance of the SEC's enforcement program at the University of Pennsylvania Carey Law School's Institute for Law and Economics.

The apparently coordinated speeches signaled the start of the expected election year retrospectives for the Clayton administration with the 2020 presidential election fast approaching.

The speeches present notable perspectives of what the enforcement program has achieved over the last few years along with useful signals regarding the agency's continuing priorities for enforcement as we await the outcome of the election.

Framing the Legacy of the Clayton Administration

Clayton reflected on the oversight, management and performance of the enforcement program and highlighted examples of how the program has "yielded significant, long-term benefits to U.S. investors."

He likened the division to a "high-end professional services business" comprised of talented and experienced professionals having "a combination of guidance, freedom, and support that enables them to take action and maximize their effectiveness." He highlighted his deference to Avakian and former Co-Director Steven Peikin and their strong coordination with the policymaking divisions.

Avakian echoed Clayton's general sentiments about the efficiency and effectiveness of the enforcement program even during challenging times, closely matching the chairman's articulated themes. She highlighted process changes, coordination and resource allocation as key to the program's success.

In terms of substance, Clayton and Avakian highlighted a number of initiatives and areas of emphasis designed to have "lasting impacts on Main Street investors," the defining, albeit sometimes ambiguous, theme of the Clayton administration.

Issuers

Although Clayton was noticeably silent regarding the division's successes against issuers, Avakian emphasized the division's success in this area, which she attributed to strategic changes in the division's approach to matters involving financial fraud.

Specifically, Avakian noted the division's proactive use of internal and external tools along with routinely looking at all public information available for an issuer, including the issuer's filings, tweets or blog posts and related commentary from analysts, shorts and competitors, in order to develop a "deep understanding" of an issuer. She also touted a streamlined



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approach to investigations that has yielded success in accelerating financial fraud investigations.

As issuers consider these developments in the context of their own public statements and filings, it is also worth noting the following areas of emphasis that Avakian cited through specific actions:

- Fraudulent accounting practices that misrepresent an issuer's underlying financial condition;
- Intentional distortions of non-GAAP metrics and other key performance indicators;
- Misrepresentations or omissions in connection with risk factors;
- Materially misleading and incomplete disclosures;
- Failures by auditors; and
- Continued emphasis on the Foreign Corrupt Practices Act.

Registered Firms

In addition to issuers, Avakian stressed the division's continued focus on misconduct by registered firms, while noting that such cases often required complex investigations and expertise. Specifically, she highlighted cases involving the following areas of emphasis and spanning across banks, brokerage firms and registered exchanges:

- Improper conduct in connection with the American depositary receipt prereleases;
- Sales of unsuitable products;
- Complex market structure cases; and
- Cases against exchanges and similar market participants.

Interestingly, neither Clayton nor Avakian focused on cases against private fund advisers notwithstanding the public focus on such firms by the examination and enforcement programs in speeches and alerts in recent years.

Share Class Selection Disclosure Initiative

Both Clayton and Avakian touted the success of this self-reporting initiative aimed at investment advisers' conflict of interest disclosures related to the selection of mutual fund share classes. This initiative has returned a considerable amount to investors, at least in the aggregate, and accounted for a significant number of the division's statistics for fiscal year 2019.

Critics and industry groups, however, have complained about the coercive nature of this initiative and the one-size-fits-all approach unfairly affecting some participants.

For example, former SEC Commissioner Paul Atkins warned in a July 2019 ThinkAdvisor blog post that:

Alarmingly, in neither announcing the Initiative nor the subsequent settlements did the SEC cite violations of any particular rule or regulation as support for its view of the sufficiency of the disclosure — a disclosure that had long been standard in the industry — but instead referred to previously pressured settlements that do not carry the weight of law.

Whistleblower Program

Avakian cited to the success of the SEC's Whistleblower Program, calling the program "critically important" and reporting that the SEC has paid out 25 awards this year totaling approximately \$133 million.

Avakian noted that the division has been "flooded" with an increasing number of quality tips as well as claims for awards and has taken steps to more efficiently manage the program.

The continued success and expansion of this program should serve as a reminder to issuers to regularly review their compliance and whistleblower programs. Notably, the 10-year anniversary of the program also marked the passing of the half-billion-dollar mark for awards and saw the largest award to date — \$50 million this past June.

The commission is considering amendments to the program's rules this week.

Initial Coin Offerings

Clayton was particularly proud of the progress made on initial coin offerings after recalling the "mess" of ICO activity in late 2016 and 2017.

In his remarks, Clayton said the division was "nimble" in its response to ICOs and cited to the July 2017 Section 21(a) report of investigation, the cyber unit and the close coordination between the division and the SEC's policy divisions and offices as restoring order "while leaving room for distributed ledger and other technologies to drive cost savings and innovation."

Avakian seconded Clayton's characterization of the division as "nimble in its response to the ICO explosion." She also highlighted as a success the division's emergency action against Telegram Group Inc.

Commissioner Hester M. Peirce, however, has been an outspoken critic of the commission's approach to ICOs in many regards, including lamenting the commission for not providing innovators with guidance as to the difference between tokens that are and are not securities and by challenging the basis for the Telegram enforcement action.

Continuing Focus on Individual Accountability

Holding individuals accountable remained a "critical part" of the enforcement program during the Clayton administration. According to Avakian, roughly 70% of cases brought by the division during the Clayton administration involved charges against individuals. In her remarks, Avakian was proud of the division's efforts to act against misconduct by C-suite executives and gatekeepers, and specifically cited to the division's actions against executives at Tesla Inc., Theranos Inc. and Valeant Pharmaceuticals, among others.

Looking closer at the 70% figure cited by Avakian, the division's statistics for individual accountability have remained consistent during this administration. Based on the division's annual reports, standalone actions involving charges against one or more individuals ranged from a high of 73% in 2016-2017 to 69% in 2019, although that number excludes the 95 actions brought pursuant to the share class selection disclosure initiative, which applied only to entities.

Nonetheless, Avakian's remarks signal the division's ongoing focus on individual accountability, which should continue as a priority in the near term. The division's 2020 annual report to be released in a few months will reveal whether the challenges in fiscal year 2020 — namely the COVID-19 pandemic — have had an effect on the division's statistics for individual accountability.

Reflecting on Challenges

Clayton and Avakian are both well liked by staff within the agency, and it is not surprising that their speeches offered glimpses of introspection for the challenges they faced.

Specifically, Clayton expressed regret for the commission's inability to recover sufficient investor money stemming from the R. Allen Stanford fraud, calling the recoveries to date "virtually non-existent."

Separately, Avakian pointed to the government shutdown and COVID-19 pandemic as "extraordinary challenges" that have forced the division to change directions. Avakian noted that the division's regular portfolio of ongoing investigations and litigations has faced "significant challenges" this year even though the division has filed more than 315 new enforcement actions since mid-March.

Regardless of those new enforcement actions, Avakian's statements may serve as a preview for the division's 2020 annual report that, in some regards, must have been affected by the COVID-19 pandemic.

Avakian spent significant time during her speech acknowledging the challenge of three recent U.S. Supreme Court decisions for the enforcement program. The court's 2018 *Lucia v. SEC* decision invalidated the appointment of the agency's administrative law judges, which forced the SEC to reconsider roughly 200 cases on remand, some of which were more than a decade old.

Also in 2018, the court in *Kokesh v. SEC* held that the five-year statute of limitations in Title 28 of the U.S. Code, Section 2462 applies to SEC disgorgement orders, which caused the SEC to forgo approximately \$1.1 billion in disgorgement from filed cases and to reevaluate disgorgement considerations for existing investigations, settlements and litigation.

More recently, this June the court in *Liu v. SEC* provided limitations for the SEC's ability to obtain disgorgement in certain circumstances, holding that it should reflect net profits, and that legitimate expenses should generally be backed out. It also held that disgorgement should be returned to victims — as opposed to the U.S. Department of the Treasury — and limited collective liability for disgorgement.

Framed together, these cases represent significant blows to the division's traditional approaches to financial remedies. Although these high-profile cases unquestionably impact scores of cases, as Avakian made clear in her speech, the division will undoubtedly seek

other avenues to achieve results limited by the court's decisions.

For example, Avakian warned that the division will likely seek higher penalties as a means to offset the limitations that Liu placed on the SEC's disgorgement authority. Whether and how this admonition will be implemented by any new SEC administration, as well as the impact of each of these court decisions, which leave many open legal and policy questions, will be closely watched over the coming year.

Pushing Forward With Enforcement Priorities

With Clayton and Avakian cementing their legacies and laying the groundwork for the next SEC administration, it is important to note that the career enforcement staff will continue pushing forward with their dockets. Regardless of the outcome of the 2020 presidential election, one should expect to see a continued focus on many, if not all, of the priorities discussed above.

Issuers need to appreciate the close scrutiny their public filings are getting from the staff and continue to improve their compliance programs as the whistleblower program continues to grow.

Registered firms should review their compliance programs, as the division continues to coordinate with the exam program with ever-improving sophistication.

FCPA enforcement will remain a stable part of the division's work. And, the staff will continue to use technology to detect and combat insider trading with steady focus.

While Clayton and Avakian likely will spend the next few months communicating the themes discussed above, issuers, registered firms and all other entities or individuals falling within the SEC's purview should remain vigilant because the enforcement staff undoubtedly will. That has always been the case irrespective of who is in charge.

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