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ENFORCEMENT

The 2017 SEC Enforcement Shift: Transition Lull or the New Normal?



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There is no debate that the first half of 2017 saw a significant fall-off in United States Securities and Exchange Commission ("SEC") enforcement activity. There have been no mega-cases and broken window policing seems to be on the decline. A temporary lull would not at all be surprising given the SEC's leadership transitions and the record enforcement results posted by the SEC in 2016. These factors combined with the absence of market disruptions and other trigger events that typically expose frauds and accounting misconduct suggest that the decline in headline grabbing enforcement actions would be both natural and temporary. However, there are other indications that the shift may be policy-driven and thus likely to continue for the foreseeable future.

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The absence of any financial or regulatory crisis means that SEC Chairman Jay Clayton takes office without the burden of having to show material enforcement results. The SEC is strong and has its swagger back, which gives Clayton the luxury of setting his own priorities. He has been quick to acknowledge this freedom, stating "I have inherited an agency with considerably more discretion over its agenda" than the one his predecessors inherited. [Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n, Remarks at the Economic Club of New York (July 12, 2017), https://www.sec.gov/news/speech/remarks-economic-club-new-york.] Clayton has made clear that his focus is on stemming the decline in the number of public companies, increasing the competitiveness of the capital markets, and increasing retail investor participation.

When it comes to enforcement, Clayton sees no need to make "wholesale changes to the Commission's regulatory approach," but rather intends to deploy "significant resources to root out fraud and shady practices in the markets . . . in areas where Main Street investors are most exposed." [*Id* at 2-3.] Affinity fraud, microcap fraud, those who pray on retirees and "those who use new technologies to lie, cheat and steal'' are on the top of his list. [*Id* at 4; *see Securities and Exchange Commission v. PowerTradersPress.com Inc., et al.*, case number 1:17-cv-04133, U.S. District Court for the Eastern District of New York (July 12, 2017).] While this focus will no doubt benefit retail investors, it is not likely to result in many actions against the major financial firms. Clayton's focus reflects many of the same priorities put forward in the Financial CHOICE Act, which ups the penalties for fraud and self-dealing significantly, while at the same time discouraging the SEC from pursuing new theories of liability, launching parallel proceedings, and seeking bars in non-judicial forums. [*See*, H.R.10 - Financial CHOICE Act of 2017.]

Clayton appears skeptical about the supervision and systems cases that resulted in mega fines under his predecessor's enforcement program. Clayton has called out vague SEC rules resulting in ''expensive practice[s] . . . that [go] well beyond prudent management and control architecture'' suggesting that he will not be keen on books and records and internal controls cases based on conduct that did not harm the markets. [Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n, Remarks at the Economic Club of New York at 5 (July 12, 2017), https://www.sec.gov/news/speech/remarks-economic-club-new-york.] His discussion of cybersecurity enforcement – immediately following his new enforcement directors' statements that cyber was a primary focus – is also illuminating. Clayton has gone to great pains to explain that the SEC needs ''to be cautious about punishing responsible companies who nevertheless are victims of sophisticated cyber penetrations . . . [and] needs to have a broad perspective and bring proportionality to this area.'' This rationale is readily applicable to any case involving technical compliance, including anti-money laundering, conflicts of interest, and product due diligence. [*Id*.]

The focus on boiler rooms, microcap fraud and Ponzi schemes plays to the strengths of the SEC Enforcement Division, which has come to model itself along the lines of a U.S. Attorney's Office. The SEC's steady adoption of the tools and tactics of white collar criminal prosecutors is likely to continue as these are the most effective tools for addressing retail fraud and market manipulation. Clayton has the right team in place as well, as he continued the trend of selecting former prosecutors to lead enforcement with the appointment of Steven Peikan. His decision to retain Stephanie Avakian as the other co-head appears to be a vote of confidence in the Division's current tool set.

As stated earlier, there are other factors beyond the control of the SEC and Financial Industry Regulatory Authority (''FINRA'') that explain the recent decline in large dollar fine cases. The first is the long running bull market and the absence of significant market volatility. As Warren Buffett once noted, ''it is not until the tide goes out that we see who has been swimming naked.'' Market disruptions produce the bread and butter regulatory intelligence that is essential to identifying investigative targets. Securities litigation, FINRA arbitrations, and customer complaints regarding their brokers and financial advisors, are all down significantly from their historic levels. Volatility also tends to trigger accounting restatements and other corporate disclosures that result in investigations. It is also logical to presume that the billions of dollars that issuers and broker-dealers have spent on compliance since the 2008 financial crisis have resulted in increased levels of compliance. Similarly, there has to be some accumulated effect stemming from the heightened criminal and civil penalties assessed in the dozen years since Sarbanes-Oxley.

Whether the root cause is intelligent design or the dislocation that naturally results from turnover in senior leadership, there is no doubt that activity is down and likely to remain down through 2017. So what substantive trends will emerge in those cases that do move forward?

It is a certainty that the SEC will be more reluctant to assess large fines in cases where (a) there is no readily identifiable benefit to the shareholders; (b) the shareholders have already suffered loss; (c) there is no actual victim; or (d) the charges are negligence-based, such as books and records violations. We have already seen this in the SEC's recent decision to forego a penalty in a $100 million accounting fraud case noting that ''the settlement takes into account that the fraud occurred entirely under the watch of prior ownership and management, the company's new leaders provided critical information regarding the full scope of the fraudulent conduct, and the company continues to significantly cooperate with our ongoing investigation.'' [*Securities and Exchange Commission v. Desarrolladora Homex S.A.B. de C.V.*, No. 17-civ-00432-L-WVG (S.D. Cal. filed Mar. 3, 2017); *see also In the Matter of Barclays Capital Inc.*, Litigation Release No. 80560 (May 1, 2017) (reducing fine due to cooperation including producing witnesses and chronologies).]

Consistent with Clayton's theme that fraud is the priority, we should see a decline in the use of negligence-based theories of corporate liability, particularly non-scienter based liability under Rule 17(a)(2) and (3). This may actually increase defense costs as it takes more investigative time to establish fraudulent intent than it does to establish negligence.

The SEC staff will also adhere to Clayton's statement in his Confirmation Hearing that ''individual liability is the greatest deterrent.'' The renewed focus on individual liability dovetails perfectly with the focus on fraud, as proof of intent almost always requires the identification of senior corporate executives who harbored that intent. The focus may also prolong investigations as individual liability is as difficult to establish as fraudulent intent (and often turns on the very same facts). Defense costs may also increase as individuals spend freely when indemnified and the pursuit of individuals requires the hiring of separate counsel for each target. Corporations looking to control these costs would be well advised to review the scope of indemnification obligations and applicable insurance coverage.

Finally, the SEC will be extremely sensitive to bringing cases that can be construed as rulemaking by enforcement. This should lead to a decline in systems and supervision cases where the staff cannot point to an underlying violation or actual victim.

Advocacy Tips for the New Normal

The new environment requires a refined defense approach. First and foremost, self-discovery, self-reporting and voluntary remediation will almost certainly generate more credit for cooperation with the current SEC. Even in those instances where the corporation does not find the problem on its own, a strong re-

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sponse that identifies potential victims, terminates wrongdoers, and restores any third-party financial losses will pay dividends. The key to negligence cases will be in developing a strong affirmative narrative demonstrating a lack of scienter at inception. The ability to come out of the box armed with the reasons why the case should be viewed as a good faith technical compliance failure will dramatically increase the odds of the investigation being closed without formal action. We believe that getting before the SEC staff early to present legal and policy defenses is preferable to waiting until the Wells stage to present uncontroverted defense theories.

In the current pro-business climate, there may be additional tactical advantages in matters turning on the company's bona fides to bringing the business leaders to meetings with SEC. This is obviously a bold strategy that requires a thorough vetting of the facts and credibility of the relevant executives. In the right circumstances business leaders can put a face on the company and attest to the good faith reasons for the conduct at issue as well as the remediation efforts. This, in turn, can have a significant effect on the staff's evaluation of management integrity and tone at the top.