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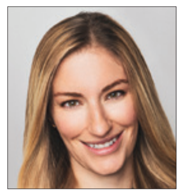
Expert Analysis

Beyond Penalties and Disgorgement—What To Expect From the SEC in 2023



By **Jonathan H. Hecht**

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In Fiscal Year 2022, the SEC pursued what it described as a "robust" enforcement agenda and, according to enforcement director, Gurbir Grewal, was "working with a sense of urgency to protect investors, hold wrongdoers accountable and deter future misconduct in our financial markets." We see nothing to suggest this approach to enforcement will change in 2023. The Division of Enforcement will likely continue to use "every tool in its toolkit" and expect that public companies and other market participants will think rigorously about their business and appropriately tailor compliance practices and internal controls and policies to match. When there are, however, violations of the federal securities laws, we can expect the commission to seek and impose remedies that it believes meaningfully punish the wrongdoer and also deter future misconduct.

This focus on robust enforcement was borne out in the SEC's fiscal year 2022 results. What jumps out immediately from the results are the significant financial remedies that the commission sought or imposed. In fact, the commission set a new record for monetary relief in a single year, with the total, including disgorgement, pre-judgment interest, and civil penalties, reaching nearly $6.5 billion. Civil penalties accounted for $4.2 billion of the total, which is the largest single-year amount in that category in the SEC's history—and more than was ordered the past three years combined. This jump in civil penalties, however, does not paint the complete picture. Importantly, the commission pursued—and we expect will continue to pursue—more aggressive remedies beyond disgorgement of ill-gotten gains and civil money penalties. Those regulated by the SEC should take particular note of what is likely to be a continued aggressive stance with regard to other impactful remedies including admissions, corporate governance and other compliance undertakings, officer and director bars, and executive compensation claw backs pursuant to Sarbanes-Oxley Section 304 and think proactively about steps that will help mitigate the risk of becoming subject to such sanctions.

Admissions

In the past year, in addition to large civil penalties and orders of disgorgement, the SEC also required admissions as part of numerous settled resolutions. This seemingly heightened focus on admissions was announced by

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Director Grewal at the beginning of fiscal year 2022 when he explained: "when it comes to accountability, few things rival the magnitude of wrongdoers admitting that they broke the law, and so, in an era of diminished trust, we will, in appropriate circumstances, be requiring admissions in cases where heightened accountability and acceptance of responsibility are in the public interest." He continued: "admissions also serve as a clarion call to other market participants to stamp out and self-report the misconduct" that may be occurring within their firms.

In 2023, we expect the division to remain focused on admissions in certain types of cases as a powerful enforcement tool. Grewal reiterated that "admissions are an incredibly powerful accountability measure and you should expect us to continue seeking admissions." Specifically, Grewal pointed to 19 settled enforcement actions, all of which involved admissions of wrongdoing, which he called "an important aspect" of the settlements. The SEC's 17 off-channel communication actions involved violations by broker-dealers (and one registered investment adviser) of books and records requirements resulting from the use of personal devices and other "off-channel" communications methods. These matters were notable not only because of the significant financial fines imposed—over $1.2 billion—but because they also required each settling party to admit that their conduct violated the federal securities laws.

Based on statements by SEC leadership emphasizing the importance of admissions we expect to see a continued focus on this form of relief as part of resolutions in 2023. This trend is particularly true in enforcement actions against registered institutions such as broker dealers and investment advisors and matters involving the most egregious conduct.

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Corporate Governance and Compliance Undertakings

In certain instances, the SEC imposes requirements of settling parties to "undertake" steps to affect future compliance with the federal securities laws or places particular limitations on the activities of registered parties. Sanjay Wadhwa, deputy director of enforcement, recently explained that undertakings "deter misconduct, ensure accountability, and positively shape behavior by encouraging proactive compliance" and that when a firm "agrees to implement robust improvements to its compliance policies and procedures, and the SEC's order lays out those improvements, other market participants are provided with one potential roadmap of what proactive compliance looks like."

The resolutions of the above-referenced off-channel communications actions provide examples of the extensive undertakings the SEC has been and may to continue requiring to not only deter and prevent future misconduct, but to also provide detailed examples of compliance to other industry participants. The firms in these actions were required to engage compliance consultants to, among other things, conduct comprehensive reviews of the firms' policies and procedures relating to the retention of electronic communications found on personal devices and to implement safeguards to prevent future violations.

Officer and Director Bars

At the beginning of 2022, Grewal stated that officer and director bars banning individuals from serving as an officer or director of a public company permanently or for some number of years "are a critical tool in our efforts" and hinted at the increased use of officer and director bars, which the SEC and courts have the authority to impose in cases involving certain scienter-based violations. There is no legal requirement that the individual be an officer or director of a public company, nor an employee of a public company at all. Grewal explained, "when considering whether to recommend seeking a bar, we generally think about whether the individual is likely to have an opportunity to become an officer or director of a public company in the future … if there is egregious conduct and a chance the person could have the opportunity to serve at the highest levels of a public company, we may well seek an officer and director bar to keep that person from being in a position to harm investors again."

In addition, the division's chief counsel recently reiterated this approach to officer and director bars, stating that "the division is seeking O&D bars more broadly" and that "one way is by seeking O&D bars when appropriate" in actions involving egregious conduct against individuals who have not served as an officer or director, or was not even an employee of a public company at the time of the misconduct. He also indicated that the division would consider recommending "equitable" bars pursuant to Exchange Act Section 21(d)(5) in actions where an individual is not fit to serve as an officer or director, even though the matter did not involve scienter-based violations.The SEC's continued and increased use of officer and director bars is a real and meaningful risk for the market going forward.

Executive Compensation Claw Backs Pursuant to Sarbanes-Oxley Section 304

The SEC continues to focus on individual accountability. As in past years, more than two-thirds of the SEC's stand-alone enforcement actions in fiscal year 2022 involved at least one individual. But according to Grewal, "more is required to ensure accountability from senior executives at public companies and incentivize them to prevent misconduct at their firms." That is why the SEC recently has been more aggressive in requiring certain executives to return bonuses and other incentive-based compensation following misconduct at their firms pursuant SOX 304, even when executives were not personally culpable of the underlying allegations.

Wadhwa explained that order requiring claw backs under SOX 304 "provide a form of public accountability for senior executives who presided over a firm at which misconduct occurred that required their firms to restate their financials." He went on to explain that requiring return of certain compensation and bonuses "incentivizes senior executives to prevent and detect such misconduct at their firms." We can expect a continued focus on SOX 304 in the coming year.

Conclusion

In the coming year, we expect the SEC to continue to pursue not just aggressive financial remedies, but also significant nonmonetary and SOX 304 relief. To mitigate risk those regulated by the SEC should think proactively about the establishment and implementation of their compliance policies and procedures and whether there is room to enhance them and tailor them more directly to their business. And, if market participants find themselves in the crosshairs, they should consider seriously self-reporting and remediating the violations. In addition, investigated parties should take careful note of the real and significant benefits that can accrue from cooperating with the investigation in a manner that saves the SEC time and resources. This past year, the SEC reduced penalties, or even imposed no penalties at all, where firms self-reported violations, cooperated with SEC investigations and took remedial measures.