The future of SEC enforcement under the Biden administration

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Abstract

Purpose – *To examine what to expect from Chair Gary Gensler's SEC and the new Biden presidential administration following Chair Gensler's U.S. Senate confirmation on April 14, 2021.*

Design/methodology/approach – *Reviews past SEC Chair Jay Clayton's legacy and Chair Gensler's prior regulatory actions and focus, and outlines Chair Gensler's expected initiatives, including a heightened focus on cryptocurrency regulation, investigation of COVID-19-related fraud, and ESG and climate change disclosure.*

Findings – *This change will bring forth a Democratic majority at the SEC which, in turn, suggests that the Commission will change its current emphasis on capital formation to focus more on investor protection, rules required by the Dodd-Frank Act, inspections, examinations, and enforcement*

Practical implications – *Firms should examine their compliance programs in anticipation of heightened advocacy for investor protection; an increased focus on cryptocurrency and blockchain technology, as well as ESG disclosures with an emphasis on climate change; and an increase in inspections and examinations which will drive more enforcement in the fund industry, as well as increases in initiatives regarding transparency, additional disclosures, and investor protection. Organizations will also benefit by reexamining their existing compliance programs with the advice of counsel as a mechanism to mitigate the risk of potential securities laws violations.*

Originality/value – *Practical guidance from experienced securities enforcement and litigation lawyers.*

Keywords *Securities enforcement, U.S. Securities and Exchange Commission (SEC), SEC compliance, SEC regulatory actions*

Paper type *Technical paper*

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On April 14, 2021, the U.S. Senate confirmed the nomination of Gary Gensler for a five year term as the 33rd Chair of the U.S. Securities and Exchange Commission ("SEC" or "Commission").[1] This change will bring forth a Democratic majority at the SEC which, in turn, suggests that the Commission will change its current emphasis on capital formation to focus more on investor protection and the following other areas: rules required by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") such as security-based swaps, compensation, and stress tests for certain SEC registrants like asset managers; and inspections, examinations, and enforcement. Below we examine what to expect from Chair Gensler's SEC, including an expected new enforcement landscape and heightened interest in digital currency, Special Purpose Acquisition Companies ("SPACs"), and new disclosure mandates for issuers on climate and ESG issues.

Jay Clayton's legacy

During his three and a half years as leader of the SEC, recently departed Chair Jay Clayton presided over a record number of rulemakings – over 65 – and led the agency in approving

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numerous regulations, including the introduction of arguably the most comprehensive measure to address broker-dealer conduct when dealing with retail customers, Regulation Best Interest ("Reg BI").[2] Other measures include expanding the "accredited investor" definition (Goody Guillen *et al.*, 2020), providing retail investors with easy-to-understand information about the nature of their relationship with their financial professional through a new Form CRS, enhancing the Commission's whistleblower rules to promote transparency and clarity (Carney *et al.*, 2020), and improving disclosure content requirements to address and reflect changes in technology, business operations, and the economy by adding a description of human capital resources as a specific disclosure requirement.[3]

Regarding enforcement, the number of actions filed against public companies hit a six-year low for the fiscal year ending in September 2020 (Dean Seal, 2020). The decline in cases appears to track with the reduction in the total number of independent actions filed by the Commission, but is undoubtedly, in part, a result of the COVID-19 pandemic which had broad-ranging impacts on the SEC's enforcement activity. However, in 2019, the SEC brought a record 95 enforcement actions targeting publicly traded companies – an increase of 30% from 2018.[4]

Despite the decrease in enforcement activity, the SEC managed to collect a record-breaking $4.68 billion through its enforcement actions, with $3.6 billion coming from disgorgement and $1.1 billion from penalties.[5] The significant accomplishments on this front were magnified when, on June 22, 2020, the U.S. Supreme Court preserved the SEC's ability to seek disgorgement in the federal court context, but held that the amounts are limited to the net profits from the alleged wrongdoing (Barr *et al.*, 2020). Just six months later, Congress passed the National Defense Authorization Act for fiscal year 2021, which extended the statute of limitations for the SEC to seek disgorgement for *scienter*-based securities laws violations from five to ten years (Edgar *et al.*, 2020).

Many of the measures former Chair Clayton pushed through, however, came about on split Commission votes, including Reg BI. These issues are unlikely to become an inherent fixture at the SEC, where Chair Gensler's confirmation results in a now 3–2 split in favor of Democrats, including Commissioners Allison Herren Lee and Caroline Crenshaw. This may very well result in an activist regulatory agenda not experienced during former Chair Clayton's tenure. The SEC's rulemaking agenda may also be shaped by the Financial Stability Oversight Council ("FSOC") and by Congress through the Congressional Review Act ("CRA").

At the first FSOC meeting of the Biden Administration held on March 31, 2021, Treasury Secretary and FSOC Chair Janet Yellen asked interagency staff to assess hedge funds and money market funds, two areas traditionally within the Commission's purview, about the potential financial stability risks associated with open-end funds, particularly focusing on liquidity risks and to reconvene its Hedge Fund Working Group, which last reported to the Council in 2016, to enhance interagency data sharing and improve the Council's ability to identify, assess, and address potential risks to financial stability related to hedge funds as well as any vulnerabilities posed by money market funds.

The CRA establishes an expedited process by which Congress can disapprove and thereby nullify regulations promulgated by various federal government agencies. The CRA requires that all rules be reported to Congress by the Government Accountability Office ("GAO"). Upon receiving the GAO report, Congress then has 60 legislative working days to introduce a special joint resolution of disapproval of the rule.[6] If Congress were to disapprove previously adopted SEC rules using the CRA, and the SEC were to issue a new rule, the succeeding rule must not be substantially similar unless authorized by Congress in a new law. For example, in 2017 Congress disapproved the SEC's resource extraction payments rule,[7] and in December 2020 the SEC adopted, for a third time, a rule to implement this provision mandated by the Dodd-Frank Act.[8]

Gensler's past suggests heightened enforcement

Chair Gensler previously served from 2009 to 2014 as the Obama-appointed Chair of the Commodity Futures Trading Commission ("CFTC"), the tenure of which overlapped with the 2008 financial crisis. While there, he advocated for extensive reform to the swaps market and led the agency when it charged five financial institutions for manipulating LIBOR, the international benchmark of the average interest rate. He was instrumental in implementing much of Title VII of the Dodd-Frank Act, passed by Congress in response to the 2008 financial crisis to formally regulate the over-the-counter derivatives market. Prior to his time at the CFTC, and during the Clinton Administration, Chair Gensler served as both the Under Secretary for Domestic Finance and Assistant Secretary for Financial Markets at the Treasury Department and he was also a Senior Advisor to former U.S. Senator Paul Sarbanes on drafting the Sarbanes-Oxley Act. His post-Treasury career as a regulator has earned him the reputation of being a tough market cop.

Chair Gensler's prior regulatory actions and focus suggest that he will advance a robust investor protection agenda, especially in the wake of recent market volatility and continued challenges that the COVID-19 pandemic poses to the economy. In his opening statement at his nomination hearing before the Senate Banking, Housing & Urban Affairs Committee ("Senate Banking Committee"), Chair Gensler stated that, "when there are clear rules of the road and a cop on the beat to enforce them—our economy grows and our nation prospers." Indeed, the SEC has already started ramping up enforcement. For example, on February 9, 2021, then Acting Chair Herren-Lee announced that the agency would return to authorizing senior officers in the Enforcement Division to issue Formal Orders of Investigation.[9] She stated that the delegation of authority would allow the agency to "act more swiftly to detect and stop ongoing frauds, preserve assets, and protect vulnerable investors."[10]

In an era of heightened enforcement, it is expected that the SEC will continue to hold individuals accountable with more instances of corporate officers facing personal liability for their role in corporate wrongdoing. The 2019 SEC Division of Enforcement Report touted at least three cases in which CEOs, among other corporate officials, were investigated and/or fined in connection with securities violations that their employer companies committed.[11] In 2020, the SEC charged individuals in 72% of standalone enforcement actions, including corporate officers as well as "accountants, auditors, and other gatekeepers."[12] This trend will likely continue.

Expected initiatives

Heightened focus on cryptocurrency regulation

It is also anticipated that cryptocurrency will receive significant SEC attention under Chair Gensler, who taught courses at the MIT Sloan School of Management on blockchain technology and digital currencies. First, innovation in blockchain and digital currency is likely, as the new Chair has already acknowledged the immense impact crypto initiatives have had on the tech and finance industries (Gensler, 2019). Specifically, Chair Gensler noted that, "[c]rypto initiatives have spurred incumbents to update payment solutions and explore new approaches to finance and multiparty database management."[13]

More importantly, it is near guaranteed that the SEC will expand its enforcement prowess in the crypto space. In a 2018 interview with Bloomberg Markets and Finance, Chair Gensler stated that if the "crypto world is going to be part of the future" it has to come within the regulatory scheme to "guard against illicit activity" and "protect investors."[14] He continued, "I think the pure cash cryptocurrencies like bitcoin need more protection, and probably more protection than, frankly, even the oil markets."[15] Chair Gensler also wrote in a 2019 Op-ed for CoinDesk that, "crypto markets have been rife with scams, fraud, hacks, and manipulation"[16] but believes that with regulation will come consumer confidence in the markets:[17] "I believe financial technology can be a powerful force for good – but only if we can continue to harness the core values of the SEC in service of investors, issuers, and the public."

Other continued investigation of COVID-19-related fraud

As the COVID-19 pandemic continues into 2021, the SEC is well-poised to continue investigating COVID-19-related fraud and misconduct. A year ago, the SEC rolled out its Coronavirus Steering Committee to coordinate its investigations into a variety of misconduct. Between March 2020 and the end of the fiscal year, the Enforcement Division opened over 150 COVID-19-related inquires and investigations and saw a 71% increase in tips, referrals, and complaints from the same time the previous year.[18] The COVID-19 era, like other periods of economic crisis, has led to the mass uncovering of misconduct. The SEC will continue to look for and investigate such misconduct throughout Biden's presidency.

ESG and climate change disclosure regime

The SEC will also have a role to play in the Biden Administration's plan to address climate change. President Biden has pledged to require public companies to disclose their impact on the environment, including climate-change-related risks and greenhouse gas emissions. While there is a trend for companies to voluntarily disclose such information due to investor pressure, the SEC will implement mandatory disclosure requirements. During his Senate nomination hearing, Gensler agreed with Senator Elizabeth Warren that companies "should not be able to hide their [climate] risks" from their investors.

On February 1, 2021, the SEC announced Satyam Khanna as the first Senior Policy Advisor for Climate and ESG.[19] And on March 4, 2021, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement.[20] The 22-person task force will "develop initiatives to proactively identify ESG-related misconduct" and will initially focus on "identify[ing] any material gaps or misstatements in issuers' disclosure of climate risks under existing rules."[21] Khanna's appointment and the creation of the task force signal the steps the SEC is already taking to oversee the intersection of climate change and the economy. Already, the SEC has found instances in which investment firms were making potentially misleading statements regarding their ESG investment processes as well as their adherence to the important global ESG frameworks (Chin, 2021).

Conclusion

At his nomination hearing before the Senate Banking Committee, Senators pressed Chair Gensler on recent market volatility, and how the SEC should react to protect consumers when the stock market – per Senator Elizabeth Warren – "functions like a casino." This issue will likely define the early days of Chair Gensler's term, although we anticipate heightened advocacy of investor protection, and forceful reforms to ensure it. Chair Gensler was regarded as having brought energy to the CFTC to fix the problems born of the financial crisis, and he is expected to bring that same energy as Chair of the SEC, this time focusing on the COVID-19 pandemic and its ongoing impacts, cryptocurrency and blockchain technology, and ESG disclosures with an emphasis on climate change.

Additionally, we are likely to see an increase in inspections and examinations which will drive more enforcement in the fund industry, as well as increases in initiatives regarding transparency, additional disclosures, and investor protection. SEC registrants, issuers, and market participants should keep abreast of the various changes and initiatives likely to be announced or discussed in the first few months of Chair Gensler's tenure and examine their compliance policies to make sure that they are well-equipped to handle the increased scrutiny and enforcement that will be the focus of the Biden Administration. A strong compliance program can provide a company – with the advice of counsel – the means to reduce the risk of potential securities laws violations.

The views expressed in this article are those of the authors and not necessarily those of BakerHostetler or its clients.

Notes

1. The Congressional vote confirmed Chair Gensler for the remainder of former SEC Chair Jay Clayton's term, which expires in June 2021. At that time, Congress will engage in another vote on Chair Gensler.
2. Press Release No. 2020-284, SEC, *SEC Chairman Jay Clayton Confirms Plans to Conclude Tenure at Year-End* (Nov. 16, 2020), available at: www.sec.gov/news/press-release/2020-284
3. *Supra* note 1.
4. Reenat Sinay, *SEC Initiative Spurs Record Enforcement Against Public Cos.*, Law360 (Nov. 20, 2019), available at: www.law360.com/articles/1221898. It should also be mentioned that during the course of the COVID-19 pandemic, the usual forums – courts and administrative tribunals – were closed for a period. There should be an uptick in enforcement actions due, in part, to the dissipating impacts of COVID-19.
5. *Id.*
6. *See* 5 U.S.C. § 802(a).
7. Providing for Congressional disapproval under chapter 8 of title 5, United States Code, of a rule submitted by the SEC relating to "Disclosure of Payments by Resource Extraction Issuers." Public Law No: 115-4.
8. Press Release No. 2020-318, SEC, *SEC Adopts Final Rules for the Disclosure of Payments by Resource Extraction Issuers* (Dec. 16, 2020), available at: www.sec.gov/news/press-release/2020-318
9. Public Statement, SEC, Statement of Acting Chair Allison Herren Lee on Empowering Enforcement to Better Protect Investors (Feb. 9, 2021), available at: www.sec.gov/news/public-statement/lee-statement-empowering-enforcement-better-protect-investors
10. *Id.*
11. SEC Div. of Enf't., 2019 Ann. Rep. 5-6 (2019).
12. SEC Div. of Enf't., 2020 Ann. Rep. 4 (2019).
13. *Id.*
14. Bloomberg Mkts. & Fin., *Ex-CFTC Chair Gary Gensler Says Cryptocurrency Needs More Regulation Than Oil*, YouTube (Oct. 15, 2018), available at: www.youtube.com/watch?v=mhmds4gDK7g [hereinafter *Bloomberg Interview*].
15. *Id.*
16. Gensler, *supra* note 18.
17. *See Bloomberg Interview*, *supra* note 20.
18. *See* 2020 Ann. Rep., *supra* note 17, at 2.
19. Press Release No. 2021-20, SEC, *Satyam Khanna Named Senior Policy Advisor for Climate and ESG* (Feb. 1, 2021), available at: www.sec.gov/news/press-release/2021-20
20. Press Release No. 2021-42, SEC, *SEC Announces Enforcement Task Force Focused on Climate and ESG Issues* (Mar. 4, 2021), available at: www.sec.gov/news/press-release/2021-42
21. *Id.*

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