Wall Street LAWYER
Securities in the Electronic Age

November 2020 ▪ Volume 24 ▪ Issue 11

SEC UPDATES RULES ON AUDITOR INDEPENDENCE

By Mark S. Bergman, David S. Huntington, Brian M. Janson, John C. Kennedy, Raphael M. Russo and Tracey A. Zaccone

David Huntington, Brian Janson, John Kennedy, Raphael Russo and Tracey Zaccone are partners in the New York office of Paul, Weiss, Rifkind, Wharton & Garrison LLP. Mark Bergman is a partner in Paul Weiss' London office. This is adapted from a client memo published on October 20, 2020 and is reprinted with permission. Contact: mbergman@paulweiss.com or dhuntington@paulweiss.com or bjanson@paulweiss.com or jkennedy@paulweiss.com or rrrusso@paulweiss.com or tzaccone@paulweiss.com.

In an effort to modernize its auditor independence rules, the SEC recently adopted amendments to certain auditor independence requirements set forth in Regulation S-X.[1] Under the amendments, certain relationships and services that previously would have run afoul of the independence requirements, and that the SEC believes do not impair the objectivity or impartiality of auditors, will be permitted. By reducing some of the compliance-related challenges and burdens associated with the scrutiny of these relationships and services, the SEC expects that auditors, their clients, and audit committees will be able to more meaningfully focus their attention on those relationships and services that may in fact pose threats to auditor independence. In addition, by increasing the scope of permitted services and relationships, these amendments should, as noted by SEC Chairman Clayton, "improve competition and audit quality by increasing the number of qualified audit firms from which an issuer can choose."

In their joint dissenting statement, SEC Commissioners Crenshaw and Lee expressed concern that these amendments continue a general trend toward relaxing auditor independence requirements, and that the amendments allow auditors too much discretion, without adequate guidance or supervision, to assess the "materiality" and "significance" of certain relationships, and as a result, their own independence.

New Term: "Entity under Audit"

For greater clarity and to reduce the risk of interpretative circularity, and to better focus certain required analyses and inquiries, the SEC has introduced a new term, "entity under audit," in Rule 2-01 to distinguish between the specific entity under

IN THIS ISSUE:

SEC Updates Rules on Auditor Independence	1
Continued Recent Judicial Receptivity to *Caremark* Claims	5
SEC Enforcement's Third Quarter: More Cases, Broader Reach	9
New Guidance on PPP Loans Provides a Route to Avoid SBA Approval of a Borrower's Change-in-Ownership	18
SEC Speaks: A Roundup	21
From the Editor	33

THOMSON REUTERS®

42599266

audit, and the broader "audit client" (which latter term includes affiliates of the entity under audit).

Amendments to the Affiliate Definitions

Entities Under Common Control

Currently, entities under common control ("sister entities") are considered affiliates for the purpose of evaluating auditor independence. The SEC has amended Rule 2-01(f)(4) to include a dual materiality standard for assessing whether entities under common control are affiliates for the purpose of assessing auditor independence. Under this new dual materiality threshold, only if both (a) the entity under audit is material to the controlling entity and (b) the sister entity is material to the controlling entity, will the sister entity be considered an affiliate of the entity under audit.

The SEC initially proposed introducing a single materiality standard to the affiliate definition for entities under common control (which would require a determination of whether the sister entity was material to the controlling entity), but in response to comments, adopted the dual materiality threshold. As a result, the common control/affiliate analysis will conclude if a determination is made that an entity under audit itself is not material to the controlling entity, alleviating the burden of conducting a materiality analysis for each sister entity.

Investment Company Complex

The amendments make similar changes in the case where the entity under audit is an investment company or an investment advisor or sponsor. In those circumstances, the auditor and audit client must look to the definition of "investment company complex" or "ICC" set forth in Rule 2-01(f)(14), as amended, to identify affiliates.

Materiality

While the release provides certain examples to illustrate the application of these amended rules, the SEC expressly declined to provide any specific guidance on materiality. Instead, the SEC stated it expects auditors and their audit clients to continue to use approaches already developed to determine materiality under current rules, and reiterated that any materiality analysis would require consideration of both qualitative and quantitative factors.

Wall Street Lawyer
West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

©2020 Thomson Reuters

For authorization to photocopy, please contact the **Copyright Clearance Center** at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400, http://www.copyright.com or **West's Copyright Services** at 610 Opperman Drive, Eagan, MN 55123, copyright.west@thomsonreuters.com. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered; however, this publication was not necessarily prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

Copyright is not claimed as to any part of the original work prepared by a United States Government officer or employee as part of the person's official duties.

One Year Subscription ● 12 Issues ● $ 1,296.00
(ISSN#: 1095-2985)

Harmonized Look-Back Period for First-Time Filers

The amendments harmonize the "audit and professional engagement period" for purposes of assessing auditor independence for domestic issuers and foreign private issuers that are first-time filers. Domestic issuer first-time filers will now be subject to the same, shorter look-back period as foreign private issuer first-time filers—starting the "first day of the last fiscal year" before the issuer first filed or was required to file a registration statement or report with the SEC (instead of the current much longer period covering the financial statements as well as the period of the engagement of the auditor to audit or review the financial statements).

The SEC confirmed that this shorter look-back period will be applicable also to reverse mergers that are in substance similar to an IPO.

Business Relationship Rule

Under the current business relationship rule (Rule 2-01(c)(3)), the accounting firm or any covered person may not, at any point during the audit and professional engagement period, have "any direct or material indirect business relationship with an audit client or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors or substantial stockholders" other than the provision of professional services (*i.e.*, the audit engagement and any permitted non-audit services) or as a consumer in the ordinary course of business.

The amendments focus the analysis on those associated persons with decision-making capacity over the entity under audit:

- "audit client's officers, directors" is to be replaced with "audit client's officers or directors that have the ability to affect decision-making at the entity under audit"; and
- "substantial stockholders" is to be replaced with "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence of the entity under audit."

The latter change, replacing the previously undefined term "substantial stockholder" with "beneficial owners with significant influence," reflects the updates the SEC made to the loan provision in 2019 and the concept of "significant influence," which is also used elsewhere in Regulation S-X.

Corresponding Loan Provision Changes

For consistency, the SEC made conforming changes to the loan provision (Rule 2-01(c)(ii)(A)) to reflect the changes made to the business relationship rule—*i.e.*, focusing on officers and directors with decision-making authority, and focusing on decision-making authority/significant influence over the entity under audit (as opposed to the audit client).

Particular Relationships

Student Loans

The amendments add student loans to the list of permissible loans an accountant may have without compromising independence. To qualify, the student loans must be obtained from a financial institution under its normal lending procedures, terms, and requirements, and must be obtained prior to the individual becoming a covered person in the firm. The SEC clarified that this exception will also include student loans obtained by immediate family members of the covered person, and will not be subject to dollar limits.

Mortgage Loans

The amendments clarify that multiple mortgage loans (instead of just one) are permissible without

© 2020 Thomson Reuters

compromising independence, so long as they were obtained from a financial institution under its normal lending procedures, terms and requirements, are collateralized by the borrower's primary residence and were obtained prior to the individual becoming a covered person in the firm. The SEC declined to extend this exemption to loans collateralized by a non-primary residence.

Credit Cards/Consumer Loans

The amendments expand the prior exception for credit card balances owed to audit clients to include consumer loans, provided that, as was the case prior for credit card balances, any aggregate outstanding consumer loan balance must be reduced to $10,000 or less on a current basis taking into consideration the payment due date and any applicable period.

Transition for Inadvertent M&A Violations

The amendments adopt a framework (in revised Rule 2-01(e)) to allow audit firms and their clients to transition out of services or relationships that, due to a pending merger or acquisition, will no longer meet the independence standards. Specifically, an accounting firm's independence will not be impaired by services and relationships that would otherwise be considered independence violations if:

- the accounting firm is in compliance with applicable independence standards related to such services or relationship (both when the services/relationship originated and throughout the period in which applicable independence standards apply);
- the accounting firm has or will address the services/relationship promptly under relevant circumstances as a result of the occurrence of the merger or acquisition; and
- the accounting firm has in place a quality control system that includes: procedures and controls that monitor the audit client's merger and acquisition activity to provide timely notice of a merger or acquisition, and procedures and controls that allow for prompt identification of such services or relationships after initial notification of a potential merger or acquisition that may trigger independence violations, but before the effective date of the transaction.

The SEC noted that where a service/relationship resulting in an independence violation is identified only *after* the effective date of a transaction, the audit firm and the audit client's audit committee will need to consider all relevant facts and circumstances in their evaluation of the auditor's objectivity and impartiality, and may also seek consultation with the SEC's Office of the Chief Accountant.

Prompt Transition

In the adopting release, the SEC was clear that it expects that the problematic service/relationship to be addressed before the effective date of the merger or acquisition. Nonetheless, for those situations where an orderly transition may not be possible without significant disruption, the SEC stated its expectation that the service/relationship be addressed promptly after the effective date of the transaction, and in any event, no later than six months after the effective date of the transaction. The SEC deliberately did not include a reference to the six-month transition period limit in the rule for fear of it becoming standard practice in all situations, even when a shorter period would be reasonable and more appropriate.

Reverse Mergers

The SEC clarified that this transition framework does not apply to merger transactions that are in substance similar to IPOs. As noted above, auditor

© 2020 Thomson Reuters

independence in connection with such transactions should be evaluated using the look-back period, as amended.

Application of General Independence Standard

The SEC affirmed its view that any relationships and services that may now be permissible under amended Rule 2-01(c) or 2-01(e) remain subject to the general independence standard set forth in Rule 2-01(b).[2] In response to comments it received expressing concern about the scope of relationships and services to be so considered, the SEC clarified that the types of relationships and services that must be evaluated under Rule 2-01(b) "are those that are known or should be known to the auditor because of the nature, extent, relative importance or other relevant aspects of the relationships or services."

Effectiveness and Transition

The amendments will take effect 180 days after publication in the *Federal Register*. Auditors may choose to voluntarily comply with the amendments on an early basis at any time after publication of the amendments in the *Federal Register*, provided that if they do so, the final amendments must be applied in their entirety from the date of such early compliance. These rules will apply prospectively only, from the date of adoption or effectiveness, as applicable (with exceptions for the revisions to the exemptions regarding student loans, consumer loans and multiple mortgages).

ENDNOTES:

[1]*Available at* https://www.sec.gov/rules/final/2020/33-10876.pdf.

[2]The general standard includes, in part, that the "Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement."

CONTINUED RECENT JUDICIAL RECEPTIVITY TO *CAREMARK* CLAIMS

By Gail Weinstein, Mark H. Lucas, Matthew V. Soran, Erica Jaffe, and Maxwell Yim

Gail Weinstein is a senior counsel, and Mark Lucas, Matthew Soran, Erica Jaffe and Maxwell Yim are partners, in the New York office of Fried, Frank, Harris, Shriver & Jacobson LLP. Contact: gail.weinstein@friedfrank.com or mark.lucas@friedfrank.com or matthew.soran@friedfrank.com or erica.jaffe@friedfrank.com or maxwell.yim@friedfrank.com.

Delaware courts have repeatedly emphasized that a *Caremark* claim is "possibly the most difficult theory in corporation law upon which a plaintiff may hope to win judgment," and, traditionally, the courts have routinely dismissed *Caremark* claims at the pleading stage. However, *Teamsters Local 443 Health Services & Insurance Plan v. Chou*[1] is now the fourth decision in just over a year in which the Delaware courts have allowed a *Caremark* claim to proceed beyond the pleading stage of litigation. While the express articulation of the standard for pleading a valid *Caremark* claim has not changed, and while each of these recent cases has presented an alleged factual context that was particularly egregious, directors should be mindful that, unlike in the past, there is now a trend of decisions in which the court has rejected early dismissal of *Caremark* claims.

"*Caremark* claims" relate to directors' duty to oversee and monitor a corporation's operational viability, legal and regulatory compliance, and finan-

© 2020 Thomson Reuters

cial performance and reporting. Under *Caremark*, directors can have personal liability for failing to prevent corporate harm when they have done so under egregious circumstances involving their knowing bad faith. A successful *Caremark* claim requires a pleading showing that either (i) the directors "utterly failed to implement" any reporting or information system or controls, or (ii) having implemented a system of controls, the directors "consciously failed to monitor" or oversee its operations (such as by consciously disregarding "red flags," particularly if involving noncompliance by the company with regulatory requirements that are the "central issue" and "mission critical" to the business), thus disabling themselves from being informed of risks or problems requiring their attention. In the following recent cases, the courts have denied early dismissal of *Caremark* claims:

AmerisourceBergen

In *Teamsters Local 443 v. Chou* ("*AmerisourceBergen*"), stockholders of AmerisourceBergen brought *Caremark* claims against the directors for alleged failings that cost the company or its affiliates about $900 million in civil and criminal penalties for what the court characterized as allegedly "operat[ing] a criminal enterprise." The business of the company's subsidiary pharmacy business ("Pharmacy") involved buying single-dose vials of oncology drugs from manufacturers, transferring the drugs from the vials to syringes, and then selling the syringes for injection into cancer patients. The manufacturers of the single-dose vials would intentionally include an "overfill" amount of medication that provided for an excess amount that could be used to make up for human error and to permit a loss of some medication to avoid air bubbles when filling the syringes. Any overfill not used was to be discarded. Pharmacy, however, illegally saved and pooled together the overfill amounts and used the accumulated amounts to fill additional syringes for sale—which led to contamination of the syringes that were filled with the medication that had been pooled from various vials. The contamination was reflected in the presence of "floater" particles in the syringes. Pharmacy removed the floaters, allegedly so that the contamination would not be visible. In addition, Pharmacy, which was not registered with the Food and Drug Administration, allegedly was operated in a way to make it appear that it was state-licensed (so that it could avoid oversight by the FDA). In 2017, Pharmacy's direct parent entity pleaded guilty as part of a criminal investigation conducted by the Department of Justice. The court wrote: "The allegations here are a prime example [of potential *Caremark* violations]: Flouting laws meant to ensure the safety and purity of drugs destined for patients suffering from cancer is directly inimical to the central purpose of ABC's business." The court noted that the directors "ignored such red flags as did exist, and, in addition, permitted a woefully inadequate reporting system" with respect to Pharmacy's oncology supply services business line.

Hughes

In *Hughes v. Hu*, the Court of Chancery refused to dismiss *Caremark* claims based on the alleged failures of the audit committee process of Kandi Technologies, a Chinese company. The committee allegedly met only once a year, and only for minutes, notwithstanding that it knew (including from its independent auditor) about material weaknesses in the company's internal controls. The court concluded that the alleged facts indicated that the audit committee "met sporadically, devoted inadequate time to its work, had clear notice of irregularities, and consciously turned a blind eye to their continuation," which led the company to continue to suffer "pervasive problems with its internal controls." Although Kandi had publicly pledged to correct these shortcomings, it apparently had done little to ad-

© 2020 Thomson Reuters

dress the issues—for example, in the following two years, it met only five times, for an hour or less each time, and generally only to approve the company's annual report, as required by federal securities laws. Also, the committee and the board allegedly frequently had to act by written consent after the committee meetings to address issues that were not addressed at the meetings. The court did not view the allegations as claiming only that monitoring systems that were in place (including the audit committee, an audit department, a code of ethics, and an independent auditor) should have been more effective. Rather, the court viewed the allegations as supporting an inference that the audit committee had never implemented its own system for reporting and monitoring, but instead had chosen to rely on management (including for decisions such as replacing the auditor and establishing the appropriate policies for approving conflicted related party transactions, although the committee allegedly knew that management had not been accurately reporting related party transactions). Although a New York federal court had dismissed a federal securities lawsuit against Kandi on the basis that its required restatement of financials had resulted in no changes to the company's net income, the Court of Chancery ruled that, in a *Caremark* action, the director defendants still could be liable for incidental damages (*e.g.*, the costs of the restatement, reputational harm, and the costs of litigation related to the restatement).

Clovis

In *In re Clovis Oncology, Inc. Derivative Litigation*,[2] the Court of Chancery denied a motion to dismiss the plaintiffs' *Caremark* claim alleging that individual directors should be held financially liable for failing to monitor the development of the biotech firm's only promising experimental drug and for allowing the firm to publish inflated performance results. Clovis (which had no products or sales revenue, and only the single promising lung cancer drug in its pipeline) committed to a well-accepted clinical trial protocol under FDA regulations to test the drug. The company then allegedly engaged in "serial noncompliance" with the protocol and the regulations, most crucially by falsely reporting the drug's "objective response rate" ("ORR"), which measured the percentage of patients experiencing meaningful tumor shrinkage as verified by confirmation scans. When the FDA identified the problem, Clovis announced the actual clinical results, after which the company's stock price plummeted and the company was liable for significant securities fraud and regulatory settlements and penalties. The board allegedly had received reports that the ORR reported to the FDA and publicly was inflated because it included responses not verified by confirmation scans. Citing the vast discrepancies between the company's public statements and the information the board of directors had received, the court characterized the directors as having approved an annual report "with hands on their ears to muffle the alarms." Given that the protocol and FDA regulations governing the clinical trial were "mission critical regulatory issues" for the company's sole potential product, the court declined to dismiss the *Caremark* claim at the pleading stage.

Marchand

In *Marchand v. Barnhill*,[3] the plaintiff-stockholder claimed that the directors of Blue Bell Creameries USA, Inc., a company that only made ice cream, breached their fiduciary duty of loyalty under *Caremark* by having failed to oversee and monitor the company's food safety operations. The suit was brought after an outbreak of listeria contamination in the company's ice cream led to the sickening and (in three cases) the death of consumers who ate the ice cream—as well as the recall of all of the company's products, the shuttering of all

© 2020 Thomson Reuters

of its plants, and, ultimately, a liquidity crisis that led it to accept a dilutive private equity deal. The Court of Chancery had dismissed the suit on the basis that Blue Bell's food safety operations were subject to a reasonable system of oversight through the extensive regulatory scheme to which the company was subject (which included inspections and reports by federal and state regulators). The Delaware Supreme Court overturned the dismissal, however, after finding that the facts alleged in the complaint indicated that *the board itself* had taken no action to assure a system for oversight of food safety *at the board level*. Notably, in *Blue Bell*, the alleged facts were extreme in terms of both the board's inattentiveness (for example, the board minutes reflected that the board never discussed anything about food safety, even in the midst of the unfolding listeria crisis) and its dire consequences (*i.e.,* the deaths of consumers of the ice cream).

Other *Caremark* Cases

We note that, in other recent cases, the court has dismissed *Caremark* claims at the pleading stage and has stressed "that directors are not omniscient, that their eyes cannot be on every sparrow, and that *not* every failure of oversight is the result of bad faith" (see, for example, *In re GoPro, Inc.*;[4] *Owens on Behalf of Esperion Therapeutics, Inc. v. Mayleben*;[5] *In re LendingClub Corp. Derivative Litigation*;[6] and *Rojas v. Ellison*[7]). And, again, we emphasize that the alleged facts in each of *Marchand, Clovis, Hughes*, and *AmerisourceBergen* are extreme, reflecting repeated, consistent and total lack or failure of systems for reporting and/or monitoring systems relating to the companies' core business and having disastrous effects on human health or life. At the same time, it is noteworthy that there is now a trend of four recent cases that were *not* dismissed. Moreover, we would highlight that, in *AmerisourceBergen*, Vice Chancellor Glasscock (i) rejected the company directors' argument that the court should take into account the fact that Pharmacy was only a small part of AmerisourceBergen's overall business; (ii) stressed that, even in *Caremark* cases, stockholders are entitled to the benefit of all reasonable inferences at the pleading stage; and (iii) emphasized that boards of companies operating in a business where outside regulations govern its "mission critical operations" must exercise oversight more rigorously. Further, we would note that the increased prevalence of and judicial receptivity to stockholders' requests under DGCL Section 220 to obtain books and records for investigation prior to commencing litigation likely will continue to facilitate stockholders' ability to bring *Caremark* claims. These factors may harbinger greater judicial reluctance to dismiss *Caremark* claims at the pleading stage than has been the case in the past.

Practice Points

Boards should consider on a regular basis whether regulatory compliance (or other) risks exist and should take steps to address them. The following should be kept in mind:

- *Need for* ***board-level*** *oversight and monitoring.* A board should establish *board-level* systems for oversight and monitoring of the issues central to the company's operations—and not rely only on *non*-board-level mechanisms such as the oversight provided by the regulators themselves or reports from management on the company's operations *generally*. A board should consider establishing and maintaining one or more board committees to oversee and address the company's compliance with and risks related to the regulations, and other matters, central to its business; regular processes and protocols requiring management to keep the board apprised of key compliance and other practices, risks

© 2020 Thomson Reuters

or reports; and a schedule for the board to consider on a regular basis whether compliance (or other) risks exist and steps taken to contain them. Periodic reviews of the effectiveness of compliance reporting and monitoring systems should be undertaken by the audit, compliance and/or other relevant committees of the board, with reports on the results furnished to the full board. Board minutes should reflect the board's monitoring and oversight efforts, including those to establish, implement and maintain oversight systems; the board's regular discussion of key compliance and other issues; and management's disclosure to the board of compliance and other key risks and developments.

- *Need for management involvement.* Management—and also the audit committee and the outside auditors—should keep the board focused on, and apprised of key developments with respect to, issues and risks that are central to the business. There should be regular processes and protocols requiring management to keep the board apprised of key compliance and other practices, risks or reports; and when management learns of "yellow flags" or "red flags" (including complaints or reports from regulators), the board should be told, and the board should address these issues.

- *Need for heightened focus on regulatory mandates and risks to health.* As was articulated in another Delaware decision issued last year (*In re Facebook Section 220 Litigation*), there is heightened risk under *Caremark* where a board fails to oversee the company's obligations to comply with "positive law" (including regulatory mandates) as opposed to the company's efforts generally to avoid business risk. Also, there appears to be heightened risk of *Caremark* liability when human life or health is involved; thus, directors of companies in businesses such as food, pharmaceuticals, medical devices, transportation, and the like, may face a heightened risk of *Caremark* liability as compared to directors of other companies.

ENDNOTES:

[1] *Teamsters Local 443 Health Services & Insurance Plan v. Chou*, 2020 WL 5028065 (Del. Ch. 2020).

[2] *In re Clovis Oncology, Inc. Derivative Litigation*, 2019 WL 4850188 (Del. Ch. 2019).

[3] *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019).

[4] *In re GoPro, Inc.*, 2020 WL 2036602 (Del. Ch. 2020).

[5] *Owens on Behalf of Esperion Therapeutics, Inc. v. Mayleben*, 2020 WL 748023 (Del. Ch. 2020), judgment aff'd, 2020 WL 6373169 (Del. 2020).

[6] *In re LendingClub Corp. Derivative Litigation*, 2019 WL 5678578 (Del. Ch. 2019).

[7] *Rojas on behalf of J.C. Penney Company, Inc. v. Ellison*, 2019 WL 3408812 (Del. Ch. 2019).

SEC ENFORCEMENT'S THIRD QUARTER: MORE CASES, BROADER REACH

By Thomas O. Gorman

Thomas Gorman is a partner in the Washington, D.C. office of Dorsey & Whitney LLP. He also publishes SEC Actions (www.secactions.com), a blog that focuses on the Securities and Exchange Commission. This article is based on blog posts that he published on October 7 and 8, 2020. He is also a member of the Editorial Advisory Board of ***Wall Street Lawyer****.*
Contact: gorman.tom@dorsey.com.

The Securities and Exchange Commission fre-

quently increases the rate at which enforcement actions are filed in advance of the September 30 fiscal year-end. That fiscal year-end is followed by Congressional budget hearings where statistics are at least one measure of performance. Filing over 120 enforcement actions as the Government fiscal year-end approached far eclipsed the number of cases brought in each of the earlier quarters, clearly suggesting a push to increase the number of filings.

The push and number of cases may, however, also reflect a possible shift in the enforcement program focus. During the third quarter, for the first time in years, more administrative proceedings were filed than federal court cases. In addition, a review of the cases suggests that the focus was broader with, for example, more financial fraud actions and cases involving market professionals being filed. These points will have to be carefully assessed by compliance professionals to ensure a proper focus.

Statistics

The following table depicts the leading categories of cases as a percentage of the total actions filed during the period.

- Offering fraud 33.6%
- Manipulation 16%
- Insider trading 9%
- Unregistered broker 8%
- Misappropriation 7%

Grouping the actions by defendant/respondent provides a different assessment, as shown below.

- Microcap fraud 30%
- Investment advisers 23%
- Broker-dealers 21%
- Financial fraud 11%
- Insider trading 9%
- Crypto assets 5%
- FCPA 3%

Select Cases

Examples of the cases are set forth below, grouped by category.

Offering Fraud

SEC v. Karlsson, Civil Action No. 20-civ-04615 (E.D.N.Y. Filed Sept. 29, 2020), names as defendant Roger Nils-Jonas Karlsson who describes himself as a System Analysis Manager. Over a period of about seven years, beginning in late 2012, Defendant marketed an investment called a Pre Funded Reversed Pension Plan that claimed to be the first such instrument. The instrument was supposedly developed by world-class economists and had "huge" payouts tied to the value of gold. At least 2,200 investors acquired interests in Eastern Metals. The initial payment was $99. In the last 18 months about $3.5 million in digital assets were transferred to Defendant. The complaint alleges violations of Securities Act Sections 5(a), 5(c) and 17(a)(1) & (3) and Exchange Act Section 10(b). The case is pending. *See* Lit. Rel. No. 24932 (Sept. 30, 2020).

SEC v. Rogas, Civil Action No. 20 cv 7628 (S.D.N.Y. Filed Sept. 17, 2020), is an action which names the founder of NS8 FP, LLC as a defendant. NS8 is a privately-held high tech company founded by Adam Rogas. In 2019, and again in 2020, Mr. Rogas allegedly defrauded investors purchasing shares of the firm. The scheme was implemented by altering the firm's bank records to show millions of dollars in revenue. Those records were then furnished to the company which used them to prepare financial statements for the offerings. Mr.

© 2020 Thomson Reuters

Rogas took steps to conceal his allegedly fraudulent acts but was persistent. In 2019, he allegedly continued the fraud after being questioned by a representative for an investor. He also continued to furnish purportedly false information to the company after being contacted by the staff. About $123 million was raised in the two offerings. The complaint alleges violations of Securities Act Section 17(a) and Exchange Act Section 10(b). The case is pending. *See* Lit. Rel. No. 24905 (Sept. 18, 2020).

SEC v. Coggins, Civil Action No. 70-cv-23444 (S.D. Fla. Unsealed August 26, 2020) is an action which names as defendants David C. Coggins and Coral Gables Asset Management LLC, an investment adviser he controlled. Beginning in 2015, Defendants solicited investors using a series of alleged lies about the nature of the investments, how the money would be invested and the performance of the funds. While about $1.85 million was raised, a substantial portion of the investor money was allegedly misappropriated. The portion that was invested performed poorly. The complaint alleges violations of Securities Act Section 17(a), Exchange Act Section 10)(b), and Advisers Act Sections 201(1), 206(2) and 206(4). The case is pending. *See* Lit. Rel. No. 24877 (August 26, 2020).

Disclosure

In the Matter of Fiat Chrysler Automobiles N.V., Adm. Proc. File No. 3-20092 (Sept. 28, 2020), is a proceeding naming the auto manufacturer as a respondent. In early 2016, following the action brought against a German auto firm for circumventing environmental limitations on emissions with a "defeat mechanism," the firm disclosed the results of an internal inquiry focused on the same issue. While the disclosures stated the findings of the inquiry that no defeat mechanism was used, it failed to state that the investigation was limited and that the EPA and California Air Resources Board engineers had raised concerns about certain of its engines. The Order alleges violations of Exchange Act Section 13(a). To resolve the proceedings Respondent consented to the entry of a cease and desist order based on the section cited. The firm will also pay a penalty of $9.5 million. A fair fund will be created.

Internal Controls

In the Matter of Kroll Bond Rating Agency, LLC, Adm. Proc. File No. 3-20096 (Sept. 29, 2020), names the rating agency as a respondent. The firm's internal controls relating to its rating of conduit/fusion commercial mortgage backed securities had deficiencies. Those issues resulted in material weaknesses in its internal control structure. The firm established procedures to determine credit ratings for the instruments which permitted the use of professional judgment to make adjustment. Unfortunately, the system failed to include any analytical method for determining the applicability of, the magnitude of, or recording the rationale for the adjustments. The firm failed to detect or prevent the omissions. Kroll's written procedures from 2012 to 2017 also permitted the adjustments made to be done on a portfolio basis rather than by property. The Order alleges violations of Exchange Act Section 15E(e)(3)(A). To resolve the proceedings the firm consented to the entry of a cease and desist order based on the section cited and a censure. The firm will also pay a penalty of $1,250,000 which will be transferred to the U.S. Treasury. *See also In the Matter of Kroll Bond Rating Agency, LLC*, Adm. Proc. File No. 3-20097 (Sept. 29, 2020) (based on a failure to establish and maintain policies and procedures, re: if CLO combination notes will default; resolved with a cease and desist order based on Rule 17g-8(b)(1) of Exchange Act, a censure, a series of undertakings, payment of $160,000 in disgorgement, $4,836.33 in prejudgment interest and a penalty of $600,000). A fair fund was created.

© 2020 Thomson Reuters

Manipulation

In the Matter of J.P. Morgan Securities LLC, Adm. Proc. File No. 3-20094 (Sept. 29, 2020). The Order alleges that over series of months from April 2015 to January 2016 certain traders at the firm engaged in manipulative trading in the secondary market of U.S. Treasury cash securities. On one side of a trade, orders would be entered that were bona fide. On the other, trades were placed that were not bona fide but were designed to either raise or depress the price. The non-bona fide trades were generally cancelled. The Order alleges violations of Securities Act Section 17(a)(3). To resolve the proceedings the firm acknowledged that its conduct violated the federal securities laws, consented to the entry of a cease and desist order based on the section cited in the order, and to a censure. The firm will pay a civil penalty of $25 million and disgorgement of $10 million. The penalty and disgorgement will be satisfied by amounts paid in the parallel DOJ and CFTC actions.

Insider Trading

SEC v. Sheinfeld, Civil Action No. 20-civ-01692 (M.D. Pa. Filed Sept. 17, 2020) is an action which names as a defendant Steven J. Sheinfeld, a 20-year employee of Rite Aid Corp. who implements their code of ethics. The case centers around a planned merger of Rite Aid and Walgreens Boots Alliance, Inc., which was scheduled to close on January 17, 2017. Prior to that date Defendant learned, while working on a special project at work, that the deal would likely not close on time. In fact, the deal did not close and the stock dropped about 13%. Just prior to the announcement that it would not close, Defendant reportedly sold all of his shares, avoiding a loss of about $140,000. He also allegedly sold firm shares held in the accounts of relatives, avowing over $15,000 in losses. The complaint alleges violations of Exchange Act Section 10(b). The case is pending. *See* Lit. Rel. No. 24903 (Sept. 17, 2020).

SEC v. Kelly, Civil Action No. 1:20-cv-04479 (E.D.N.Y. Filed Sept. 23, 2020), is an action which names as a defendant Edward T. Kelly, the retired controller of Aceto Corporation. After Mr. Kelly retired, the firm had financial difficulties. In March 2018, Mr. Kelly was brought in to aid the firm. After determining that the company had financial issues, he sold all of his firm shares and exercised his stock options and sold those shares. By trading while in possession of inside information, and after the facts were disclosed, he avoided losses of over $85,000. The complaint alleges violations of Exchange Act Section 10(b). To resolve the action Mr. Kelly consented to the entry of a permanent injunction based on the section cited in the complaint. He also agreed to the entry of an order that bars him from serving as an officer or director of a public company and to pay a penalty of $170,228. *See* Lit. Rel. No. 24912 (Sept. 23, 2020).

SEC v. Yang, Civil Action No. 1:29-cv-4427 (E.D.N.Y. Filed Sept. 21, 2020). Yinghang "James" Yang and Yuanbiao Chen, respectively, the Senior Index Manager of "Company" and his friend, a manager at a sushi restaurant, are defendants in the action. Mr. Yang has held his position since September 2018. In that position he helped manage the firm's Indexes. He also served on the Index Committee during which there were discussions regarding the components of the various Indexes. The firm had confidentiality procedures in place to protect their information, as Mr. Yang knew. Prior to the commencement of the scheme, Mr. Chen opened a Brokerage Account at Broker. Mr. Chen informed the brokerage that he had five years of experience in trading options. He executed an agreement that would permit trading options through the new account. As per the complaint, over a period of just over four months, beginning on June 24, 2019, Defendants purchased options in the shares of 14 stocks shortly prior to the time the Company made

© 2020 Thomson Reuters

additions or deletions from those Indexes. Following the announcement by Company of either the addition or deletion of stocks from an Index, Defendants closed the transactions. The trades were placed while in possession of material, non-public information about the actions to be taken for various securities with regard to being added or deleted from the Indexes of Company. Defendants placed the trades in Brokerage Account with computers using IP addresses at three locations. One was Mr. Yang's home. A second was the Company. A third was at Mr. Chen's place of employment. According to the complaint, the transactions netted illegal trading profits of $912,082. The profits were divided by the two men. The complaint alleges violation of Exchange Act Section 10(b). The case is pending. *See* Lit. Rel. No. 24909 (Sept. 22, 2020).

False Statements

In the Matter of Alan J. Kau, Adm. Proc. File No. 3-20052 (Sept. 23, 2020) is an action centered on the bankruptcy of the firm for which Mr. Kau once served as President, Worthington Energy, Inc. In 2018, Mr. Lau signed off on an allegedly fraudulent Disclosure Statement Describing Debtor's Joint Plan of Reorganization and Debtor's Joint Plan of Reorganization as a Chapter 11 prepackaged plan. The materials were filed with the U.S. Bankruptcy Court for the Southern District of California. The materials were included in the plan of reorganization. The Order alleges violations of Securities Act Section 17(a) and Exchange Act Section 10(b). To resolve the proceedings Respondent consented to the entry of a cease and desist order based on the sections cited in the Order. He also agreed to the entry of an officer-director bar and a penny stock bar with a right to apply for reentry after two years. In addition, he will pay a penalty of $15,000 that will be forwarded to the U.S. Treasury. *See also In the Matter of Daniel C. Masters*, Adm. Proc. File No. 3-20051 (Sept. 23, 2020) (action based on the same facts against the attorney involved; resolved with a cease and desist order based on the same sections and an officer and director bar, a penny stock bar and the revocation of his right to appear and practice before the Commission as an attorney; he will also pay a penalty of $50,000 that will be transferred to the U.S. Treasury).

In the Matter of BorgWarner Inc., Adm. Proc. File No. 3-19932 (August 26, 2020), is an action which names the firm as a defendant. Over the years the firm has been named as a defendant in asbestos-related personal injury suits. From 2012 through the fourth quarter of 2016 the company failed to estimate its incurred but not reported liabilities for future asbestos claims. The company did note that future claims were probable but claimed the amount could not be estimated. In fact, the firm allegedly made little effort and failed to conduct the proper analysis. In the fourth quarter of 2016, however, it recorded a pre-tax $703.6 million charge for those claims but identified the amount as a charge resulting from a change of estimate. In 2018, the firm acknowledged that was an error and did a restatement. The firm noted that it had failed to report a material weakness in its internal controls over financial reporting. The Order alleges violations of Exchange Act Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B). To resolve the proceedings the firm consented to the entry of a cease and desist order based on the sections cited in the Order. It also agreed to pay a penalty of $950,000 which will be transferred to the Treasury subject to Exchange Act Section 21F(g)(3).

In the Matter of Valeant Pharmaceuticals International, Inc., Adm. Proc. File No. 3-19899 (July 31, 2020). The Quebec-based pharmaceutical firm has shares listed on the TSX in Toronto and the NYS. In 2014 and 2015 the firm was pursuing a growth by acquisition strategy. Part of the firm's

© 2020 Thomson Reuters

strategy centered on its relation with Philidor Rx Services LLC, a licensed pharmacy formed in early 2013. Valent acquired an option to purchase the pharmacy in mid-December 2014. The relationship was terminated on October 30, 2015 following extensive media reports discussing the relation. By the end of the third quarter of 2014, Valeant obtained a $75 million order from Philidor. The order included a one-time special pricing deal and exceeded Philidor's credit limit. Valeant then approved a $70 million credit increase despite the fact that a large receivable with an overdue balance was outstanding. In early December 2014, Valeant received a $130 million order from Philidor which required another credit increase that was granted without following the usual procedures. When Valeant reported its results for the quarters ended September 30, 2014 through September 30, 2015, the disclosures were allegedly misleading since the impact of the Philidor arrangements was not disclosed. Indeed, Valeant did not disclose the requisite information about Philidor in the MD&A section of its quarterly reports on Form 10Q and annual report on Form 10K. In the second quarter of 2015, the firm recorded revenue for price appreciation credits received under its Distribution Service Agreements with wholesalers. Under these agreements, Valeant offset distribution fees owed to wholesalers with credits for price increases on its products held by wholesales in inventory. In June 2015, Valeant recorded about $110 million in net price appreciation revenue through a 500% price increase on one drug. The entire amount of the increase was erroneously attributed as revenue to numerous products. Four months later the firm made an investor presentation regarding Philidor following which the firm restated its financial statements. The firm also disclosed the existence of the price appreciation agreements for the first time. It did not disclose the impact from those clauses earned in 2015 on certain GAAP and non-GAAP measures. The Order alleges violations of Securities Act Sections 17(a)(2) and (3), and Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) and certain related rules. Respondent resolved the proceedings, consenting to the entry of a cease and desist order based on the sections and rules cited in the Order. The firm cooperated with the investigation and engaged in certain remedial acts. Respondent agreed to pay a penalty of $45 million. The money will go to a fair fund. *See also In the Matter of J. Michael Pearson*, Adm. Proc. File No. 3-19900 (July 31, 2020) (CEO and COB of the firm; resolved similar charges with consent to a cease and desist order based on the same sections and, in addition, SOX Section 304(a); paid penalty of $250,000); *In the Matter of Howard B. Schiller*, Adm. Proc. File No. 3-19901 (July 31, 2020) (Ex. V.P. and CFO; resolved with a consent to a cease and desist order based on same sections as in the forgoing proceeding; and payment of $100,000 penalty); *In the Matter of Tanya R. Carro, CPA*, Adm. Proc. File No. 3-19902 (July 31, 2020) (controller of firm; resolved with a consent to a cease and desist order based on the same sections as above (Order include Rule 102(e)), an order denying her the privilege of appearing and practicing before the Commission as an accountant with the right to reapply after one year; and the payment of a penalty in the amount of $75,000).

Investment Advisers

SEC v. Boucher, Civil Action No. 20CV1650 (S.D.Ca. Filed August 25, 2020), is an action which names as defendants Mark J. Boucher and his firm, Strategic Wealth Advisor Group Services Inc. Mr. Boucher worked for Investment Adviser A from 2010 through 2016 and Investment Adviser B from 2016 through 2019. The firm was a state registered investment adviser in 2019. The complaint is based on three multi-year frauds in which Mr. Boucher misappropriated over $2 million in client funds. It

© 2020 Thomson Reuters

alleges that while working for Advisers A and B, Defendant Boucher defrauded Client A by misappropriating almost $700,000 from her advisory accounts. A variety of deceptive conduct was used including forging checks and even withdrawing funds on margin where he wanted more cash than was available. In addition, about $60,000 was misappropriated from Client B's advisory accounts by wiring sale proceeds from the account using a phone call in which Mr. Boucher allegedly impersonated the client. After Client C passed away Mr. Boucher allegedly misappropriated about $1.5 million from the trust accounts by moving the funds to his personal accounts. He also took steps to conceal his actions from the firms and later the staff during the investigation. The complaint alleges violations of Securities Act Section 17(a), Exchange Act Section 10(b) and Advisers Act Sections 206(1) and 206(2). The case is pending. *See* Lit. Rel. No. 24875 (August 25, 2020).

In the Matter of Hancock Whitney Investment Services, Inc., Adm. Proc. File No. 3-20074 (Sept. 25, 2020), is a proceeding which names as a respondent the registered investment adviser. This action centers on the failure of the adviser to properly inform its clients about the conflict that arise from the payment of certain fees on some shares acquired, held or sold for clients. First, over a three-year period the firm failed to advise its clients when buying, recommending a hold or selling fund shares that paid 12b-1 fees. Second, the same conflict arose with respect to certain money fund interests. Neither conflict was properly disclosed. The firm agreed to implement certain undertakings and took a series of remedial actions. The Order alleges violations of Advisers Act Section 206(2) and 206(4). Respondent consented to the entry of a cease and desist order based on the sections cited in the Order and to a censure. Respondent will also pay disgorgement, prejudgment interest and a civil penalty totaling $2,337,792.08 as follows: disgorgement of $1,651,686.59, prejudgment interest of $286,105.79, and a penalty of $400,000. A fair fund is created.

Brokers

In the Matter of Interactive Brokers LLC, Adm. Proc. File No. 3-19907 (August 10, 2020). Interactive Brokers is a Greenwich, Connecticut Commission registered broker-dealer whose ultimate parent is a public company. The firm acts as a retail and clearing broker. The firm does not engage in proprietary trading. The firm's clients did engage in a number of transactions involving microcap securities. For example, Interactive Brokers accepted deposits for about 3,800 microcap securities during the period here. Yet the firm's business in this area involved only a small number of customers. Ten customers, for example, had net sales of over 4.7 billion shares of U.S. microcap securities involving about $27.6 million. Personnel at the firm were trained to monitor for "red flags" that might indicate money laundering or terrorist-financing activities as part of its AML compliance program. Nevertheless, the firm failed to investigate or file a SAR in connection with a number of suspicious transactions involving the deposit, sale and withdrawal of funds over a short period of time. Specifically, the firm failed to investigate 78 such transactions even when they represented a substantial percentage of the daily trading volume for a particular security or the shares had been subject previously to a trading suspension. These transactions involved at least $100,000. The firm also ignored other red flags. For example, a sample of 309 issuers found 58 instances where customer sales represented at least 90% of the daily trading volume. In addition, 126 instances were identified where the customer sales constitute at least 70% of the daily trading volume. Interactive Brokers took no action. Finally, in three instances during the period the bro-

© 2020 Thomson Reuters

ker failed to timely file a SAR where it identified red flags, which included the fact that the customers had previously violated the securities or other criminal laws. While the firm did restrict the trading of those customers, no SAR was filed. The Order concluded that the firm violated Section 17(a) of the Exchange Act and Rule 17a-8 which requires broker-dealers registered with the Commission to comply with the reporting, record-keeping requirements of the Bank Secrecy Act and the related regulations promulgated by the Financial Crimes Enforcement Network or FinCEN. In resolving the action here Interactive Brokers took certain remedial steps. The firm consented to the entry of a cease and desist order based on the section and rule cited and to a censure. The firm also agreed to pay a civil penalty of $11.5 million. *See also In the Matter of: Interactive Brokers LLC*, CFTC Docket. 20-25 (August 10, 2020) (Interactive Brokers agreed to pay a penalty of $12 million for AML violations). The firm also agreed to pay $15 million to settle similar charges with FINRA.

In the Matter of Franklin Advisers, Inc., Adm. Proc. File No. 3-19854 (July 2, 2020). Two firms are named as Respondents in the Order, Franklin Advisers, Inc., or FAV, and Franklin Templeton Investments Corp., or FTIC. The former is a registered investment adviser. The latter is a subsidiary of Franklin Resources, Inc., Toronto, and is also a registered investment adviser. The proceedings here center on Section 12(d)(1)(A) of the Investment Company Act which, generally, limits an investment firm's ownership interests in other investment companies. Over an 11-month period, beginning in December 2014, the Allocation Funds (a particular series of Templeton funds) and eight LifeSmart Retirement Target Date Funds (another series) purchased shares of three ETFs, each of which is a registered unaffiliated investment company. FAV sought to rely on Section 12(d)(1)(F) to exceed the limits of Section 12(d)(1)(A)(iii). The former permits a registered investment company to invest in unaffiliated investment companies in excess of certain limits if the acquiring company and its affiliates do not own more than 3% of the outstanding shares of the acquired company. The latter prohibits the purchase when the "acquisitions results in the acquired company and all other investment companies having an aggregate value of more than 10% of the total assets of the acquiring company"—a pyramiding limitation. The provisions of 12(d)(1)(F) could not be relied on, however, since FAV's aggregate purchases of the three ETFs caused the Franklin Funds to exceed the firm wide 3% ownership limits of Section 12(d)(1)(F) for each ETF. At the time of the transactions FAV was responsible for implementing written policies and procedures designed to ensure compliance with the sections cited above. In late November 2015 the compliance department discovered the breach of the statutory limits. The client positions were reduced, generating losses of over $2.1 million for ETF No. 1 and gains of over $3.7 and $4.7 million for ETFS Nos. 2 and 3 respectively. FAV assessed the situation and decided not to reimburse the losses. That determination created an undisclosed conflict and was contrary to its disclosed policies and procedures that required reimbursement. There was no disclosure until mid-2016. The Order alleged violations of Investment Company Act Section 12(d)(1)(A) and Advisers Act Sections 206(2) and 206(4). After the Commission's investigation began, Franklin Funds' board fully reimbursed the losses of the Allocation Funds, including interest. Respondents each resolved the proceedings following certain remedial steps. FAV consented to the entry of a cease and desist order based on the sections cited and a censure. FTIC also consented to the entry of a cease and desist order but only one based on the Investment Company Section cited.

© 2020 Thomson Reuters

FAV also agreed to pay a penalty of $250,000 while FTIC will pay $75,000.

Auditors

In the Matter of Brian Dee Matlock, CPA, Adm. Proc. File No. 3-19914 (August 13, 2020) is a proceeding which names as a respondent the engagement partner from audit firm Rothstein, Kass & Co., P.C. on the audit of Breitling Energy Corp., Inc. During the audit of a two-year period ended December 31, 2013, Respondent became aware that Breitling's predecessor, Breitling Oil and Gas Corporation, was misrepresenting its business model to investors who were purchasing oil and gas interests sold by the firm and inflating the returns. Respondent also became aware that certain procedures designed to safeguard investor funds were not being implemented. No action was taken. The order alleges violations of Exchange Act Section 10A(b)(1)(A)(i) and Rule 2-02(b)(1) of Regulation X. To resolve the proceedings Respondent consented to the entry of a cease and desist order based on the section and rule cited in the Order. He is also denied the privilege of appearing and practicing before the Commission as an accountant but may apply for re-instatement after one year.

Municipal Bonds

In the Matter of William W. Welsh, Adm. Proc. File No. 3-19998 (Sept. 14, 2020) is a proceeding which names Mr. Welsh, a registered representative at a municipal bond firm, Roosevelt & Cross, Inc. Over a three-year period, beginning in March 2020, Respondent violated the purchase and sale rules for new issue municipal bond offering by selling to those who were "flippers," who bought the bonds out of the required order and then immediately resold them. In addition, over a two-year period, beginning in January 2014, Respondent purchased bonds from a flipper for the account of Roosevelt. The Order alleges violations of Exchange Act Sections 15(a)(1), 15B(c)(1) and MSRB Rules G-11 and G-17. To resolve the proceedings Respondent consented to the entry of a cease and desist order based on the Sections and Rules cited and to a censure. The firm was also suspended for a period of six months. In addition it will pay a penalty of $25,000, of which $5,000 will be transferred to the MSRB and $20,000 to the U.S. Treasury. *See also In the Matter of Thomas Vigorito*, Adm. Proc. File No. 3-19997 (Sept. 14, 2020) (proceeding against representative at Roosevelt based on conduct similar to that detailed above; resolved with a cease and desist order based on same Sections and Rules as above; a suspension from the securities business and from any penny stock offering for 12 months; and the payment of a penalty of $40,000, of which $8,571.43 will be transferred to the MSRB and the balance to the U.S. Treasury).

The Foreign Corrupt Practices Act

In the Matter of World Acceptance Corporation, Adm. Proc. File No. 3-19905 (August 6, 2020). World Acceptance Corporation is a consumer loan firm based in Greenville, South Carolina. The firm sold its one wholly-owned subsidiary, WAC Mexico, effective July 1, 2018. The subsidiary had two lines of business. One focused on small loans made directly to consumers. The other centered on loans to federal government employees. Prior to that sale the subsidiary WAC Mexico reportedly engaged in a bribery scheme that began in late 2010 and ended in mid-2017. It involved loans to government employees. There were advantages to these loans for the firm which included a reduced collection risk and greater job security for the borrower. The loan contracts were extended to government and union officials. Alleged bribes were paid to induce the officials to enter into the loan agreements. During the term of the agreements additional payments were made. Approximately $4.1 million in alleged bribe payments were made to

© 2020 Thomson Reuters

government officials and union officials in cash and by depositing the funds in a bank account or into an account of a friend. About $1.5 million was paid to government and union officials while $480,000 went to third party intermediaries who used the funds to pay government and union officials. The records are insufficient to determine how the remaining $1.5 million was distributed. The firm reportedly also had inaccurate books and records and insufficient internal controls to detect or prevent the bribery. The Order alleges violations of Exchange Act Sections 30A, 13(b)(2)(A) and 13(b)(2)(B). To resolve the proceedings the firm consented to the entry of a cease and desist order based on the sections cited in the Order. In addition, WAC agreed to pay disgorgement of $17,826,000, prejudgment interest of $1,900,000 and penalties of $2 million. The funds will be transferred to the general fund of the U.S. Treasury subject to Exchange Act section 21F(g)(3).

Conclusion

The Commission filed a large number of cases in the third quarter of the calendar year, or the fourth quarter of the Government fiscal year. That number, coupled with the shift in venue and the increased variety of actions as illustrated by the select cases cited above, presents a challenge for those seeking to establish an effective compliance program.

Nevertheless, it is clear that can be done. Establishing an effective compliance program begins with a careful risk assessment. For those who might be in the path of the SEC—public companies, private firms and registered entities, to cite a few—that might begin with analyzing the type of actions brought by the enforcement division and carefully considering the risks of the business. Coupling that analysis with a proactive approach and a careful evaluation of the factors cited in the U.S. Sentencing Guidelines can create for the firm the predicate for an effective compliance program. That program can help the firm avoid a call or subpoena from the Commission's Enforcement Division. And, if that program is properly established and a call or subpoena still arrives, it should be the first line of defense.

NEW GUIDANCE ON PPP LOANS PROVIDES A ROUTE TO AVOID SBA APPROVAL OF A BORROWER'S CHANGE-IN-OWNERSHIP

By Gail Weinstein, Matthew V. Soran, Michael T. Gershberg, Randi Lally, and Maxwell Yim

Gail Weinstein is a senior counsel, and Matthew Soran, Randi Lally and Maxwell Yim are partners, in the New York office of Fried, Frank, Harris, Shriver & Jacobson LLP. Michael Gershberg is a partner in Fried Frank's Washington, D.C. office. Contact: gail.weinstein@friedfrank.com or michael.gershberg@friedfrank.com or matthew.soran@friedfrank.com or randi.lally@friedfrank.com or maxwell.yim@friedfrank.com.

The Small Business Administration ("SBA") issued guidance on October 2, 2020 relating to "changes in ownership" of companies that have obtained Paycheck Protection Program ("PPP") loans under the federal CARES Act. Most critically, the guidance provides that prior approval by the SBA will *not* be required for such a transaction if the borrower has completed its forgiveness application and, pending the SBA's determination of forgiveness, an amount equal to the outstanding balance on the PPP loan is deposited into an escrow account under the control of the PPP lender or the lender servicing the loan (the "PPP Lender").

Key Observations

We expect that:

© 2020 Thomson Reuters

- ***Most PPP borrowers will want to avoid the process of seeking SBA approval of a change of ownership transaction***. Although the new guidance states that the SBA will provide a determination within 60 calendar days after receiving a request for approval of a change of ownership transaction involving a PPP borrower, we would note that, given the general backlog at the SBA, the timeframe could be longer. For this and other reasons, we expect that, in most cases, a PPP borrower, at or prior to closing of a change of ownership transaction, will either (a) if the forgiveness process for the loan has been completed, repay any amount not forgiven, or (b) complete and submit the forgiveness application for the loan to its PPP Lender and establish the required escrow account. Of note, in our experience, to date many PPP Lenders are not yet equipped to accept forgiveness applications—thus, currently, it may often be the case that a PPP borrower will not be able to avoid the SBA approval requirement for a change of ownership transaction.

- ***A buyer of a PPP borrower likely will seek indemnification from the PPP borrower for liability relating to its obtaining the PPP loan and any non-compliance with the PPP requirements***. The guidance states that, irrespective of a change of ownership transaction, the PPP borrower will remain responsible for all requirements relating to the PPP loan, including with respect to liability for its certifications made at the time of obtaining the loan relating to the economic necessity therefor. We note that the SBA has a six-year timeframe for bringing claims with respect to noncompliance with PPP requirements.

Background

Under the PPP program, which was launched in April 2020 and permitted applications for loans through early August 2020, approximately 5.2 million loans, totaling about $525 billion, were issued. The average loan size was just over $100,000. There remains about $130 billion in funding that was appropriated for PPP loans and is unused—although it is uncertain whether Congress will authorize a second round of PPP loan issuances. A Goldman Sachs survey released in early October reflects that 88% of PPP borrowers had fully used the proceeds of their PPP loans and 30% expected to deplete their cash reserves by the end of 2020. PPP loans are forgivable if the proceeds were used for certain purposes (primarily payroll expenses). Many PPP borrowers are currently engaged in the process of applying for forgiveness of the loans; however, some PPP Lenders have not yet begun to accept forgiveness applications.

The new guidance provides as follows:

Definition of a "change of ownership." A change of ownership of a borrower is defined as (i) a sale or transfer of at least 20% of the PPP borrower's common stock or other ownership interest (whether in one or more transactions and including transfers to affiliates or existing owners); (ii) a sale or transfer of at least 50% of the PPP borrower's assets (measured by fair market value, and whether in one or more transactions); or (iii) a merger of the PPP borrower with or into another entity. To determine if the relevant threshold has been met, all sales and other transfers occurring since the date of approval of the PPP loan must be aggregated. For publicly-traded borrowers, only sales or transfers that result in one person or entity holding or owning at least 20% of the common stock (or other ownership interest) of the PPP borrower must be aggregated.

© 2020 Thomson Reuters

Notice of any change of ownership transaction is required. Prior to the closing of a change in ownership transaction, the PPP borrower must notify the PPP Lender in writing of the contemplated transaction and provide the PPP Lender with "a copy of the proposed agreements or other documents that would effectuate the proposed transaction." (The PPP Lender will have to continue to submit the required monthly reports ("1502 reports") until the PPP loan is fully satisfied.)

Under certain circumstances, prior approval by the SBA will not be required for a change of ownership transaction involving a borrower with an outstanding PPP loan. The guidance newly provides that, if there is an outstanding balance under a PPP loan, prior approval by the SBA of a change of ownership transaction involving the borrower will not be required (and the PPP Lender unilaterally can provide such approval) if, prior to the closing of the transaction, (i) the PPP borrower submits to the PPP Lender a completed application for forgiveness of the PPP loan, together with all required supporting documentation, and (ii) an amount equal to the outstanding balance of the PPP loan is deposited into an escrow account for the purpose of fully satisfying the loan. The escrow account must be interest-bearing and controlled by the PPP Lender; and, after the forgiveness process is completed (including any appeal of the SBA's decision), the escrow funds must be disbursed to repay any remaining PPP loan balance plus interest before being disbursed to the PPP borrower. We expect that in most cases the PPP borrower will, at the closing of the change of ownership transaction, have the buyer divert part of its payment of the purchase price in order to fund the escrow account. The guidance states that only a change of ownership transaction involving the sale or transfer of more than 50% of the PPP borrower's common stock (or other ownership interest), or the sale or transfer of 50% or more of the PPP borrower's assets (by fair market value), is subject to prior approval by the SBA.

The SBA will make a determination within 60 calendar days of receiving a request from the PPP Lender for approval of the borrower's change of ownership transaction. To obtain approval for a PPP borrower's change of ownership transaction, the PPP Lender must submit the request to the appropriate SBA Loan Servicing Center. The request must include (i) the reason the PPP borrower cannot fully satisfy the PPP loan or have the escrow account established (either of which would eliminate the need for the SBA's prior approval); (ii) the "details" of the proposed change of ownership transaction; (iii) a copy of the executed PPP Note; (iv) any letter of intent and the purchase or sale agreement setting forth the responsibilities of the PPP borrower, the seller (if different from the PPP borrower), and the buyer; (v) disclosure as to whether the buyer has an existing PPP loan (and, if so, the loan number); and (vi) a list of all owners of 20% or more of the buyer. Further, the guidance states that, if the SBA deems it appropriate, it may require "additional risk mitigation measures" as a condition of its approval. Also, the guidance states that approval of an asset sale will be conditioned on the purchasing entity assuming all of the PPP borrower's obligations under the PPP loan.

The following requirements apply to all sales or transfers of common stock (or other ownership interest) or mergers, whether or not prior SBA approval is required:

- ***Segregation of any PPP loan of the buyer***. If any new owner(s) or the successor in a merger has a separate PPP loan, then, after closing of the change of ownership transaction, the PPP loans must be "segregated" and documentation submitted demonstrating compliance

© 2020 Thomson Reuters

with PPP requirements with respect to each PPP loan.

- ***Continuing responsibility of the PPP borrower.*** Notwithstanding a change of ownership transaction involving a PPP borrower, the PPP borrower (and, in the event of a merger of the PPP borrower into another entity, the successor to the PPP borrower) "will remain subject to all obligations under the PPP loan." In addition, "[i]f the new owner(s) use PPP funds for unauthorized purposes, SBA will have recourse against the new owner(s) for the unauthorized use."

- ***Post-closing notice to Servicing Center.*** Within five days of "completion" of a change of ownership transaction, the PPP Lender must notify the appropriate SBA Servicing Center of (i) "the identity of the new owner(s) of the common stock or other ownership interest" and the new owner(s)' ownership percentage(s), (ii) the tax identification numbers for any owner(s) holding 20% or more of "the equity in the business," and (iii) the location of and amount of funds in an escrow account if one is required.

Prior approval of a borrower's change of ownership transaction will not be required if the PPP loan has been fully satisfied. Prior approval (by the SBA or the PPP Lender) will not be required if the PPP loan has been fully repaid or if the forgiveness process has been completed and any unforgiven amount has been fully paid.

SEC SPEAKS: A ROUNDUP

By Jay Clayton and Elad Roisman

The following are excerpts from speeches given by SEC Chairman Clayton and Commissioner Roisman on October 8, 2020, as part of "The SEC Speaks" event.

Jay Clayton: An Update on Fiscal Year 2020 Results

At last year's SEC Speaks, I spoke about our goals and accomplishments through the "eyes of management," similar to what public companies do in the "Management's Discussion and Analysis," or "MD&A" section of SEC filings. During those remarks, I identified several factors that could cause the Commission's actual results to differ from expected results. One of those factors was "[t]he need to divert resources to respond to major or unexpected events." One year later, of course, we faced a "major and unexpected event" in the form of the COVID-19 global pandemic. In addition to first, and promptly, doing everything practicable to protect the health and safety of the SEC staff, we were faced with responding to severe operational and performance stresses in our markets and the economy more broadly.

In spite of these stresses and our rapid move to a mandatory telework environment in early March, the SEC remained fully operational and met each challenge presented head on. We were able to do so, in short, because of our people. I could go on and on about the caliber of our people and how they rose to the occasion time and time again. The superlatives are not necessary because their work—which I highlight—speaks for itself. On a personal level, I want to acknowledge how proud I am to work with such dedicated public servants.

So, how did we do in FY 2020? I am pleased to report that while the pandemic significantly impacted how we do our work, it did not negatively impact the work itself. Our planned oversight, examination, rulemaking, and enforcement work continued with vigor, rigor and transparency. At the same time, we added to our workload. We (1) provided targeted regulatory relief to ensure the

© 2020 Thomson Reuters

continued operation of our markets, (2) worked continuously with our domestic and foreign regulatory counterparts to monitor and mitigate the impacts of COVID-19, and (3) increased oversight and engagement in key areas of stress.

FY 2020 Commission Operations

To elaborate on the "results speak for themselves" point, I would like to summarize some recent statistics I shared with our staff.

Starting with the Division of Enforcement, the Commission brought over 700 actions in FY 2020, a significant percentage of which were brought after March 15. The Commission obtained financial remedies of more than $4 billion; an amount above that of last year. The Division's activities during the pandemic have included three dozen trading suspensions, six COVID-related fraud actions, and over 150 newly opened COVID-related investigations and inquiries. What's more, the Commission awarded a record 39 individual whistleblowers approximately $175 million—more, much more, than in any prior fiscal year.

In FY 2020, the Office of Compliance Inspections and Examinations conducted examinations that covered 15 percent of all SEC-registered investment advisers. OCIE also continued its complementary and highly effective asset verification program—in the same time period of FY 2020, OCIE verified 4.8 million investor accounts totaling $3.4 trillion in assets. In FY 2020 OCIE conducted over 300 outreach events, issued a report on Cybersecurity and Resiliency Observations, and published eight risk alerts. I am a firm believer that OCIE's engagement, including their highly informative risk alerts, stops problems before they start. There are no statistics for "problems prevented." Yet, we all know the most effective regulatory environment is one that drives a culture of compliance. That is just what OCIE does.

On maintaining, improving and modernizing our time-tested regulatory framework, overall, in FY 2020, the Commission issued 20 proposals and 25 final rules from across all divisions and offices. I know of no other agency—of any size—that does so much to maintain its effectiveness and efficiency in the face of change. The figures are impressive in their own right, but when you consider the complexity of the issues and examine the quality of the product, they are truly remarkable.

Diving in more deeply, in FY 2020, Trading and Markets executed its responsibility for maintaining fair, orderly, and efficient markets by engaging in 10 rulemaking initiatives addressing, among other things, (1) retail investor fraud in the "penny stock" market, (2) standing up the Dodd-Frank Act Title VII regime, (3) modernizing the National Market System, and (4) enhancing transparency and oversight for ATSs that trade government securities. Additionally, the Division processed over 2,000 self-regulatory organization rule filings, issued 25 exemptive orders and 12 no-action letters, and published or updated over 75 Frequently Asked Questions & Answers.

Turning to Investment Management, on the disclosure review front, in FY 2020 the Division reviewed disclosures relating to more than 10,700 funds, including more than 1,200 new funds—an increase of 7% over last year. Investment Management staff also took the lead on a total of 14 rulemaking-related releases, including proposals, final rules, a request for comment, and Commission guidance, in FY 2020. And with respect to COVID-related relief specifically, Investment Management staff contributed to more than 20 temporary rules, exemptive orders, no-action letters, and staff guidance statements. Those actions have been relied upon by an estimate of close to 700 investment advisers and investment companies—I expect the actual number is much higher.

© 2020 Thomson Reuters

And, as we have seen in the financial news just about every day, Corporation Finance has remained committed as ever to promoting the high-quality corporate disclosure that is at the heart of our mission. Corporation Finance staff continued to maintain an engaged, rigorous and investment decision-oriented review presence. In FY 2020, the Division reviewed the filings of more than 3,500 reporting companies and the registration statements of more than 800 IPOs and initial registrations. In addition, Division staff assessed the filings of the more than 1,000 companies that sought to take advantage of the Commission's extension of certain filing deadlines. Importantly, the Division issued proactive COVID-19-related disclosure guidance which has substantially contributed to the quality and breadth of current and periodic reporting.

Further, in FY 2020, Corporation Finance took the lead on 19 rulemaking-related releases, including proposals, final rules, and Commission guidance, to modernize current rules, adopt new rules, and provide important disclosure guidance as well as temporary relief to companies relying on Regulation A and Regulation Crowdfunding to raise capital during the COVID-19 crisis.

And, going back to quality, for analysis and insight into the work of the Commission and staff, we rely on the work of our colleagues in the Division of Economic and Risk Analysis. They have been tireless. DERA has provided more than 3,650 responses to requests from nearly every office and division within the Commission. DERA economists, lawyers, and data specialists completed over 145 policy-related projects, including economic analyses of rulemakings, as well as analyses of SRO rule filings, new products and 10-year retrospective rule reviews. DERA also contributed to the Commission's enforcement mission, conducting economic analyses for more than 175 new enforcement matters and 80 distributions. In addition, DERA staff published three editions of the DERA Economic and Risk Outlook and conducted analysis of substantial amounts of data, including in connection with 12 risk-related projects related to the COVID-19 economic shock. Also, I would be remiss not to mention staff's recent report on our credit markets and the impact of COVID-19. It is a remarkable piece of insightful work, and I will return to this topic at the end of my remarks.

None of this or our other work would go into effect or reach the public without the work of the Office of the Secretary. They are essential to our success, and have continued their exemplary work in the face of incredible logistical obstacles and an enormous workload. FY 2020 set a record in terms of the number of unique comment letters, processing more than 13,000 this year, which is the most since we started tracking them. For comparison purposes, ten years ago, we received 589. OS also processed nearly 2,000 Federal Register submissions and 6,000 releases and orders, and that's only a portion of their work. The Office of the Secretary also completed an important modernization effort this fiscal year. On March 9, just days before the Commission began full-time telework, the Office of the Secretary instituted a new paperless voting system for Commission actions. For those of you who previously worked at the Commission, you likely remember that all Commissioner votes were recorded in paper—multiple copies of the rule or enforcement action were printed and delivered to each Commissioner's office and each Commissioner recorded their vote by manual signature. The Commission's transition to electronic voting, meticulously planned and executed, couldn't have come a better time.

As we are well aware, our agency does not do its work in a vacuum. As I often say, "independent"

© 2020 Thomson Reuters

does not mean "isolated." In fact, I firmly believe that engagement, broad engagement, enhances independence, quality and efficiency. In this regard, our Office of Legislative and Intergovernmental Affairs and our Office of International Affairs helped us maintain strong relationships and engagement with Congress and other regulators, domestic and international.

The Office of Legislative and Intergovernmental Affairs helped secure funding in FY 2020 to support new positions in key areas. I relied on them to prepare for hearings before the House Financial Services Committee and Senate Banking Committee, as did OMWI Director Pam Gibbs for a hearing before the House Financial Services Committee. OLIA also successfully guided two SEC Commissioners—Commissioners Crenshaw and Peirce—through a Senate nomination hearing and the confirmation process. The office responded to 58 congressional letters and over 175 technical assistance and briefing requests from Congress and other federal agencies and worked with colleagues across the agency to help ensure the SEC had tools and flexibility to navigate the COVID-19 pandemic.

More globally, the Office of International Affairs observed a significant increase in requests from foreign authorities for Commission assistance (nearly 700 of them) and requests for Commission staff to assist (approximately 1,684) this year, clearly showing that the SEC staff's expertise is becoming increasingly recognized on a global scale.

How was the Commission able to adapt so quickly in response to COVID-19, both in terms of our operations (transitioning quickly to a remote workforce) and in terms of our market engagement and oversight (providing timely and impactful regulatory relief, analysis and oversight)? The answer is simple—our focus on risk planning and operational flexibility, outlined in last year's remarks, coupled with the Commission's most important asset, our human capital, meant we have been able to meet these new challenges head on. That said, we must remain vigilant as I am certain the current challenges will present additional surprises and there will be new challenges ahead.

Engagement with Domestic and International Regulatory Partners

I'd also highlight another facet of our response to COVID-19 that I briefly touched on earlier. As I have explained publicly throughout the pandemic, from a systemic risk point of view, the Commission's primary responsibilities during this time of market stress are three-fold:

- **Market function**. This involves using our authority, expertise and experience to help ensure the continuing fair, orderly and efficient functioning of the securities markets—including with respect to equities, fixed income securities, funds and other products;

- **Market monitoring**. This involves monitoring market prices and price movements, flows of capital and the availability of credit to assess the functionality and resiliency of our capital markets, This also involves taking action, including providing regulatory relief and guidance, as appropriate; and

- **Facilitating high-quality corporate and other issuer disclosure**. This involves monitoring and providing guidance concerning, and emphasizing, timely and accurate issuer and other disclosures, recognizing that transparency and broad disclosure of material information are fundamental to market function and resiliency.

An important component of ensuring that we are meeting these responsibilities is our external en-

© 2020 Thomson Reuters

gagement with domestic and international regulatory partners focusing on market and systemic risks. For a number of reasons, at a personal level, our world may seem smaller—many of us are working remotely, travel is curtailed, children are at home. But our country's recovery from the economic effects of COVID-19 is inextricably linked to the broader domestic and global economy. The Commission's external engagement at this time, including with our international counterparts, is a fundamental component of our efforts to support investors, policy makers and our markets, as we strive to recover from the economic effects of COVID-19.

Much of this work has occurred through the Financial Stability Oversight Council, the President's Working Group on Financial Markets, the International Organization of Securities Commissions, and the Financial Stability Board. I'll start first with our domestic regulatory partners.

Financial Stability Oversight Council

The Dodd-Frank Act established the Financial Stability Oversight Council ("FSOC") to bring together financial regulators in the United States to, among other things, respond to emerging risks to the stability of our nation's financial system.

Since the start of the pandemic, the FSOC principals have met four times. At those meetings, we discussed and shared information about the actions that our respective agencies have been taking and considering to respond to the impacts of COVID-19. We also discussed specific markets in detail, including the treasury market and secondary mortgage markets. In addition, there have been numerous meetings of the FSOC deputies—senior staff at the various agencies—as well as staff working groups and committees. This does not take into account the innumerable bi-lateral discussions among my counterparts and me, as well as our key staff, over the course of the COVID-19 economic shock.

President's Working Group on Financial Markets

Next, let's talk about some of our work with the President's Working Group on Financial Markets (or the "PWG"). The PWG consists of the Chairs of the SEC, the Federal Reserve, and the CFTC, as well as the Treasury Secretary, and our meetings often also include the heads of the OCC and the FDIC. We have worked collaboratively during this time of market stress, both in connection with regulatory responses to COVID-19, as well as in formulating a series of recommendations focused on the risks of investing in emerging markets, including China. With respect to emerging markets, the PWG has recommended, among other things, (1) that there be enhanced listing standards at U.S. exchanges that would require as a condition to initial and continued exchange listing, sufficient PCAOB access to audit workpapers; and (2) enhanced issuer and fund disclosures regarding investing in emerging markets.[1]

To this end, I have directed Commission staff to actively consider the PWG recommendations that seek to strengthen protections for investors and promote the integrity of our capital markets by (1) leveling the playing field for all companies listed on U.S exchanges; and (2) improving disclosure regarding, and consideration by fiduciaries and other market professionals of, the risks of investing in emerging markets, including China.[2]

We have also worked with our fellow PWG agencies to discuss important issues related to cybersecurity and incident response coordination. As cyber threats have increased over the years, including from threat actors backed by significant resources, the PWG has been an important focal point for information sharing and response coordination.

© 2020 Thomson Reuters

Financial Stability Board and International Organization of Securities Commissions

We also work closely with our international regulatory partners on systemic risk issues, namely through the Financial Stability Board ("FSB") and the International Organization of Securities Commissions ("IOSCO"). Since the start of the COVID-19 pandemic, other Commissioners, staff, or I have participated in over 50 meetings of the FSB and IOSCO. Indeed, earlier this morning, I participated in a teleconference of the FSB's steering committee on non-bank financial intermediation to discuss further market stress in March of this year. SEC staff are active in numerous FSB and IOSCO work streams, including multiple COVID-19 initiatives coordinated by the FSB's Standing Committee on Assessment of Vulnerabilities and Standing Committee on Supervisory and Regulatory Cooperation, as well as IOSCO's Financial Stability Engagement Group.

An important part of our engagement here is also through IOSCO's Monitoring Group, which is co-chaired by our own Chief Accountant, Sagar Teotia. Through the Monitoring Group, we work with our foreign counterparts to advance the public interest in areas related to international audit standard setting and audit quality. Earlier this year, as the result of a review effort that began in 2015, the Monitoring Group published a number of recommendations to strengthen the international audit and ethics standard-setting system.[3] Yes, again, our staff, our people, brought a long-standing review to a high-quality, principles-oriented conclusion.

Additional Engagement

These are just a few examples of the ways in which we work with other domestic and foreign regulators. We are also engaged in a large number of bilateral discussions and workstreams around various issues. For example, we have been actively working with a number of key jurisdictions on substituted compliance applications in connection with our standing up of the Title VII regime for the regulation of security-based swaps. We also continue to work with foreign regulators on enforcement matters and to provide technical assistance where we can be helpful.

The Credit Market Interconnectedness Project

Finally, I'd like to close with a short discussion of an important recent initiative. Earlier this year, and informed by our discussions with these domestic and international partners, Commission staff undertook an ambitious and important project. The staff sought to bring greater understanding to the character and dynamics of our $54 trillion credit markets. Staff mapped credit from its creation, through its distribution and secondary trading, with an eye toward identifying areas of both vulnerability and stability. Earlier this week [October 5], the staff debuted its report on Interconnectedness and Risk in U.S. Credit Markets.[4] This report analyzes the interconnectedness among markets and market participants—e.g., banks, non-bank financial intermediaries and investors of various types—in the U.S. credit markets. The report focuses on risk distribution and transmission, including in particular, during the spring 2020 COVID-19 market turmoil.

Elad Roisman: Thoughts on Securities Law Enforcement

Today, I will focus my remarks on a topic that brings together so many of my SEC colleagues: enforcement of the securities laws and regulations. As you probably know, each week, the Commission gathers in closed session, where we are presented with recommendations from staff in the agency's Division of Enforcement ("Enforcement"). Generally, Enforcement recom-

© 2020 Thomson Reuters

mends that the Commission institute or settle a lawsuit under the securities laws, either in federal court or in the agency's administrative forum. Recommendations may have multiple charged violations, multiple defendants or respondents, and various remedies and, as a result, Commissioners may vote to approve the entire recommendation or select parts of it. And, in order for a recommendation to move forward, a majority of the Commission must vote in favor of it.

Since I joined the Commission a little over two years ago, I have participated in the decisions of over 2,000 individual enforcement recommendations. I have always recognized that the enforcement of our securities laws is one of the SEC's most important responsibilities. It is how we protect and compensate harmed investors; hold wrongdoers accountable; and deter would-be wrongdoers from harming investors in the future. Our actions have far-reaching effects on the well-being of the individuals or companies involved in every case. The weight of this responsibility never lets up. As a consequence, I spend most of my days each week reading and thinking about new enforcement cases, and have lost sleep reflecting on pending and prior ones.

Enforcement is not a partisan matter. The vast majority of the Commission's votes on enforcement matters are unanimous, bringing together those of us who may have stark disagreements on particular policy issues. Yet, each Commissioner approaches consideration of enforcement cases differently, and we do not always agree on every aspect of every case. So I thought that this year at SEC Speaks, I would share with you how I deliberate about the cases I review and how I envision the responsibilities of our Enforcement Division.

Beginning With the End

When I review a recommendation from our Enforcement staff, I begin at the end. No, it is not a riddle: I focus my attention first on the outcome. Specifically, does the recommended outcome of the case meaningfully support the SEC's mission? Everyone here should be familiar with the SEC's tri-partite mission: To protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation. All three of these tenets are important to ensuring that our capital markets remain healthy and robust, so that they can create wealth and improve the well-being of everyone in society.

Enforcement of the federal securities laws is essential to all three parts of the SEC's mission. First and foremost, enforcement protects investors by identifying, stopping, and penalizing those who take advantage of them. Second, enforcement promotes market integrity by removing these bad actors from our markets. Third, I believe that the vigorous enforcement of securities laws, by remedying violations, and by publicizing how we have remedied violations, increases trust and confidence in our markets. Trust and confidence are prerequisites of capital formation; without them, companies and investors would be reluctant to enter our markets.

I always start with the mission, because circumstances sometimes conspire to divert our attention away from these fundamental objectives. For example, around the end of the SEC's fiscal year, which was just about a week ago, the press often focuses on the number of cases we have brought and the number and amounts of penalties we have imposed.[5] A frequent implication is that rising numbers reflect more effective enforcement, and falling numbers reflect less effective enforcement. The number of cases, and the aggregate penalty amounts, and other statistics can be informative, and I think many of us are attracted to the idea of

© 2020 Thomson Reuters

measuring our success in an objective, quantitative way. However, in the SEC's enforcement program, I do not equate high numbers with success. In fact, when I review an enforcement recommendation, I want to be sure that it is not just a number. I want to be sure that it is advancing our mission in a meaningful way and that, as much as possible, the proposed remedies address the wrongdoing and make harmed investors whole.

Enforcing Law or Forcing Policy?

Another consideration for me as I review enforcement recommendations is whether the alleged violation is based on a novel interpretation of a rule or law. The vast majority of enforcement recommendations I receive are based on straightforward interpretations of our laws and rules. But, because markets evolve, new business practices can arise that implicate our rules in new ways. Sometimes, these are nefarious and clearly bad for investors or markets; other times the intent, outcomes, and future policy implications are not so clear.

I am wary of the Commission addressing these matters of first impression through enforcement actions. When I am presented with such a recommendation that is based on and sets forth a new interpretation of existing rules—particularly a recommended settlement where the Commission itself acts as prosecutor and final arbiter—I believe it is my responsibility to question whether the matter would be better handled in a different way.

The Commission has both a regulatory and an enforcement role. So while our enforcement job is to pursue violations of the laws that already exist, our job as regulators is to be clear in our expectations of market participants. I believe all market participants deserve to know what the law is before they are informed that they are breaking it. We have plenty of tools at our disposal to make this happen. If we see practices that concern us, but are not clear violations of our rules, we can launch examinations to better understand the practices and publicly explain our concerns, such as through OCIE's Priorities, Risk Alerts to registrants, or bulletins for investors.[6] We can issue guidance, addressing how a specific rule should be interpreted in a particular novel context. Of course, we can promulgate new rules too.

I believe that, despite our understandable desire to stop conduct we view as improper, we should not use our enforcement powers to promulgate and set new legal standards. This has been called "regulation by enforcement" and I believe wholeheartedly that it should be avoided. Not only is it unfair to market participants, but it also subverts the rulemaking process Congress established in the Administrative Procedure Act, which generally requires public notice and comment before the Commission can issue rules that carry the force of law.[7] While that process surely is less efficient and more time consuming than a single-respondent settlement, it has certain benefits. It ensures that market participants and others with a stake in changes to the law have a chance to comment, and it gives us an opportunity to learn from those comments to improve our own rules. Commenters often identify nuances we may not have considered or market realities we may not have discerned on our own, and this input can be enormously helpful in improving the effectiveness of our rules. Even the act of proposing a rule can be helpful: alerting market participants—and compliance departments—to issues that may require additional attention.

Enforcement can and does still play an important role in matters that concern new or novel interpretations of law, even in the absence of rulemaking. If an Enforcement investigation identifies practices that are problematic, but there is understandable

© 2020 Thomson Reuters

uncertainty about how the law applies to the facts at hand, Enforcement can recommend that the Commission resolve the investigation by issuing a Report of Investigation pursuant to Section 21(a) of the Exchange Act.[8] Section 21(a) reports allow the Commission to set forth its views on the practices at issue without sanctioning the actor. The most memorable recent example of such a report is the 2017 DAO report, which set forth the Commission's view on how the securities laws apply to Initial Coin Offerings.[9] The Commission has exercised its authority to issue 21(a) reports somewhat infrequently—less than once a year—but I think this is a missed opportunity to put marketplace actors on notice of how the Commission believes the law should be understood and applied.

Compliance Is the Goal

While I have been primarily discussing enforcement, I do want to note the efforts of the divisions and offices at the SEC that often address issues with non-compliant registrants before and sometimes without the help of Enforcement. Where market participants are making a good faith effort to comply with our myriad requirements—which, given the complexity of the securities landscape, can indeed be unclear, confusing, and overwhelming—enforcement should be the last resort, not a first resort.

Fortunately, there are indeed some "first resorts" at the Commission, and as I mentioned, these are the traditional divisions and offices that handle such issues when they first arise. As just a few examples, the Division of Corporation Finance engages with potential and existing issuers with the goal of ensuring that these businesses provide materially complete and accurate disclosure. The Office of Compliance Inspections and Examinations regularly inspects broker, dealer, and investment adviser registrants. The SEC also has an Office of Credit Ratings, which, among other things, examines nationally recognized statistical rating organizations. Our lawyers, accountants, and experts in all of these (and other relevant) divisions and offices are eminently qualified to identify compliance issues, explain regulatory requirements, and guide market participants toward compliance. And, where conduct appears harmful to investors or driven by a desire to defraud, referrals from these divisions and offices to our Enforcement attorneys are invaluable.

Now, none of this is to say that we should be "light" on enforcement. The Commission plays a critical role in identifying, stopping, deterring, and punishing wrongdoers. I am merely stating that we need to use our agency's resources wisely and pick the right tool for each job, aiming in instances to improve compliance amongst our registrants—a goal which will benefit all investors.

Differentiating Culture and Compliance

Before I go on, I want to draw briefly a distinction between my belief that we should use agency resources (including enforcement tools) to improve compliance versus the idea that the SEC should define and set a "culture" of compliance at the firms we regulate.

"Culture" has been a topic of increasing focus for registrants and regulators. I have seen cases regarding registrants where inadequate controls or oversight in place enabled violations of our rules. Sometimes, these entities have been previously sanctioned by us for similar or other violations. In these instances, one of the things I think about is whether this bad conduct is limited to a few bad apples or whether it reflects a more widespread breakdown in compliance and supervision within a firm. I am not alone in asking such questions, and the scenarios I just set forth have appropriately led

© 2020 Thomson Reuters

to greater scrutiny of registrants' controls, procedures, and practices, including whether employees understand and follow internal rules. However, some say that the SEC should go further and work to define and set a "culture of compliance" within such firms, as though an unsatisfactory "culture" itself is a securities law violation. Although interconnected, I see a distinction between the SEC's role in making rules and enforcing compliance with those rules, on the one hand, and dictating culture, on the other hand.

To me, direct attempts to define and fix a registrant's culture could go too far, and I worry about the potential for overreach. Changing an organization's culture is not straightforward. Regulators are not experts in day-to-day business operations, and every organization has its own incentives, personalities, ideals, and idiosyncrasies. Setting and maintaining an organization's culture seems to me to be squarely in the remit of the management and leadership of the organization itself. If the leadership and individuals fail to have an effective compliance system, rest assured we will find out and address violations that occur. But we should focus more on remedying concrete problems like that, rather than on vaguer notions of "culture."

I worry about the Commission, or any regulator, trying to define the appropriate culture of an organization, including how and what is sufficient to stress compliance in the day-to-day operation of its business. Questions about how much training is needed, what topics must be stressed over others, and what constitutes sufficient employee engagement or incentives are different for each market, registrant, and workforce. If we were to set such bright lines on an ad hoc basis, through enforcement cases, for example, I do not see how the agency (over time) could be consistent and clear in our actions as they are perceived by the marketplace and even by our own staff who is charged with overseeing and regulating registrants or bringing enforcement actions.

In sum, I am generally hesitant to state that there has been a failure in a firm's culture in the enforcement setting and impose remedies aimed at improving the firm's culture. I would prefer that we focus our attention on the specific statutes or rules that have been violated.

Shareholder-Funded Civil Penalties

Finally, I would be remiss if I did not address another area often of interest to people both on the inside and on the outside of the SEC: civil penalties—particularly corporate civil penalties. I will not break too much new ground in this area, because many have already articulated the same principles and reasons I share regarding why I do not always view such penalties as being appropriate. I will note that I view penalties against publicly-traded companies differently from penalties against closely-held regulated entities. My greatest concern is that civil penalties against corporate entities—especially public companies—penalize innocent shareholders for the conduct of others whose actions they could not foresee or control. And those innocent shareholders are often the victims of fraud by corporate insiders, meaning that shareholders are harmed twice over—once by the fraud, and again by the penalty. In such cases, and particularly where the individual wrongdoers somehow manage to escape accountability, civil penalties add insult to injury.

I am not dogmatic, however. I always analyze recommended civil penalties on a "facts and circumstances" basis, with investor welfare as my North Star. In this, I am informed by the framework set forth in the Commission's 2006 Statement Concerning Financial Penalties (the 2006 Statement).[10] This unanimous statement lists sev-

© 2020 Thomson Reuters

eral factors to consider when determining whether to levy a civil penalty against a corporation, giving primacy to "the presence or absence of a direct benefit to the corporation as a result of the violation," or "corporate benefit" for short. While the 2006 Statement cannot be used to determine a particular outcome in every case, I do find it to be persuasive and to be a useful starting place.

Accordingly, my review of corporate civil penalties brings corporate benefit to the fore. And fortunately, our colleagues in the Department of Economic Risk and Analysis ("DERA") have become experts at quantifying the benefit a corporate entity has derived from violative conduct such as disclosure violations. In cases where they are able to provide me with the supportive analysis, I typically approve a proposed penalty that is commensurate with the corporate benefit.

Where there is little or no corporate benefit, I have a harder time seeing a shareholder-funded penalty as an appropriate remedy. Yet, there are times when, despite the lack of a quantifiable corporate benefit, I (have been and) may nevertheless be persuaded by particular facts or circumstances to support a civil penalty against a public company. For example, there are cases in which the corporate benefit of the violation is clear—and clearly large—even if not precisely quantifiable. As another example, if a company has repeatedly committed the same securities violations, I generally believe that investors are on notice about the potential for violations at the company, and can determine whether they want to bear that risk by continuing to hold the stock. A third example is if the resulting penalty can be used to reimburse harmed investors (one of the factors in the 2006 Statement) by, for instance, using a Fair Fund,[11] I will be more likely to support it.

ENDNOTES:

[1]*See* President's Working Group on Financial Markets, Report on Protecting United States Investors from Significant Risks from Chinese Companies (July 24, 2020), *available at* https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf.

[2]Additional information is *available at* https://www.sec.gov/news/public-statement/statement-presidents-working-group-financial-markets.

[3]*See* IOSCO Monitoring Group, Monitoring Group Publishes its Recommendations to Strengthen the International Audit and Ethics Standard-Setting System (July 14, 2020), *available at* https://www.iosco.org/about/monitoring_group/pdf/2020-07-Monitoring-Group-Recommendations-to-Strengthen-the-International-Audit-and-Ethics-Standard-Setting-System.pdf.

[4]SEC Staff Releases Report on U.S. Credit Market Interconnectedness and the Effects of the COVID-19 Economic Shock (Oct. 5, 2020), *available at* https://www.sec.gov/news/press-release/2020-245-0.

[5]*See*, in this issue, Thomas Gorman, "SEC Enforcement's Third Quarter: More Cases, Broader Reach." *See also, e.g.,* Jean Eaglesham, "SEC Breaks Record for Number of Enforcement Cases," Wall St. J. (Oct. 11, 2016, 11:56 AM), https://www.wsj.com/articles/sec-on-track-to-break-record-for-number-of-enforcement-cases-1476198436; Jean Eaglesham, et al., "Regulators' Penalties Against Wall Street Are Down Sharply in 2017," Wall St. J (Aug. 6, 2017 4:33 PM), https://www.wsj.com/articles/regulators-penalties-against-wall-street-are-down-sharply-in-2017-1502028001; Dave Michaels, "SEC Says Don't Judge Its Enforcement Strength Solely on Volume of Cases, Fines," Wall St. J. (Sept. 20, 2018, 9:49 AM), https://wsj.com/articles/sec-says-dont-judge-enforcement-strength-solely-on-volume-fines-1537451398.

[6]Office of Compliance Inspections and Examinations, OCIE's 2016 Share Class Initiative, National Exam Program Risk Alert, Vol. V, Issue 2 (July 13, 2016), *available at* https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf.

[7]5 U.S.C.A. § 551 et seq.

© 2020 Thomson Reuters

[8]15 U.S.C.A. § 78u.

[9]*See, e.g.*, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Rel. No. 34-81207 (July 25, 2017).

[10]Press Release, U.S. Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* http://www.sec.gov/news/press/2006-4.htm.

[11]15 U.S.C.A. § 7246 (establishing the Fair Fund mechanism).

© 2020 Thomson Reuters

FROM THE EDITOR

Change Ahead?

This issue of *Wall Street Lawyer* goes to press on the day before Election Day, 2020. By the time you're reading this, the outcome of the presidential election will have been decided (well, with hope). Regardless of who wins the election, there are certain to be substantial after-effects on Wall Street. The more pronounced ones will, of course, be if Joe Biden becomes the 46th president in January 2021—and particularly if he has a Democratic Congress ready to go to work.

In the latter case, expect swift action on several fronts, political analysts say. A Biden Administration and Democratic Congress could try to use the Congressional Review Act to nullify any regulations passed after June 1, 2020. So for example, they could nullify amendments to the SEC's whistleblower program (see the lead article in our October issue) and a recent loosening of conflict-of-interest rules for independent auditors (see this issue's lead article). Congress could also use the CRA to nullify a Volcker Rule amendment in which banks gained the limited ability to invest in or sponsor hedge funds and private equity funds.

There's also the strong potential that a Biden Administration Department of Labor would no longer seek exemptions to its fiduciary rules for brokers that advise on certain types of retirement plans. After all, Sen. Kamala Harris, who stands to become Vice President, signed a comment letter in August attacking the proposed changes, which the letter described as having the potential to enable unscrupulous "financial advisors to evade their fiduciary responsibilities and den[y] retirement savers meaningful remedies when they have been harmed."

A Biden Administration also means a reinvigorated Consumer Financial Protection Bureau, towards which the Trump Administration has been aggressive in its attitude. (Should President Trump be reelected, he could decide to remove current CFPB head Kathy Kraninger, whom he appointed and who was confirmed to a five-year term in December 2018; as per a June 2020 Supreme Court ruling, the CFPB director can now be removed by the president "at will.") In a policy document on his website, Biden said his plan is to "reinvigorate the Consumer Financial Protection Bureau to ensure that banks and lenders cannot prey on consumers."

Perhaps the biggest prize will be the SEC. Chairman Jay Clayton's term expires in June 2021, and he's been expected to leave before then any in case—this past summer, he was nominated to become the next U.S. Attorney for the Southern District of New York (in the event of a Biden victory, this nomination could well be revoked; Clayton is expected to return to private practice in that case). Should Biden appoint Clayton's replacement, that could mean the SEC's two Democratic appointees will gain a third, controlling vote in many key decisions over the next four years.

Chris O'Leary

Managing Editor

© 2020 Thomson Reuters

EDITORIAL BOARD

MANAGING EDITOR:
CHRIS O'LEARY

CHAIRMAN:
JOHN F. OLSON
Gibson, Dunn & Crutcher
Washington, DC

ADVISORY BOARD:
THOMAS O. GORMAN
Dorsey & Whitney
Washington, D.C.

BLAKE A. BELL
Simpson Thacher & Bartlett
New York, NY

STEVEN E. BOCHNER
Wilson Sonsini Goodrich & Rosati
Palo Alto, CA

JORDAN ETH
Morrison & Foerster LLP
San Francisco, CA

EDWARD H. FLEISCHMAN
Former SEC Commissioner
New York, NY

ALEXANDER C. GAVIS
Senior VP & Deputy GC
Fidelity Investments

JAY B. GOULD
Winston & Strawn LLP
San Francisco, CA

PROF. JOSEPH A. GRUNDFEST
Professor of Law
Stanford Law School

MICALYN S. HARRIS
ADR Services
Ridgewood, NJ

PROF. THOMAS LEE HAZEN
University of North Carolina — Chapel Hill

ALLAN HORWICH
Schiff Hardin LLP
Chicago, IL

TERESA IANNACONI
Retired Partner
KPMG LLP

MICHAEL P. JAMROZ
Partner, Financial Services
Deloitte & Touche

STANLEY KELLER
Locke Lord LLP
Boston, MA

BRUCE W. LEPPLA
Lieff Cabraser Heiman & Berstein LLP
San Francisco, CA

SIMON M. LORNE
Vice Chairman and Chief Legal Officer at Millennium Partners, L.P.

MICHAEL D. MANN
Richards Kibbe & Orbe
Washington, DC

JOSEPH MCLAUGHLIN
Sidley Austin, LLP
New York, NY

WILLIAM MCLUCAS
WilmerHale LLP
Washington, DC

JOHN F. SAVARESE
Wachtell, Lipton, Rosen & Katz
New York, NY

JOEL MICHAEL SCHWARZ
Attorney, U.S. Government

STEVEN W. STONE
Morgan Lewis LLP
Washington, DC

LAURA S. UNGER
Former SEC Commissioner & Acting Chairman

ERIC S. WAXMAN
Retired Partner
Skadden, Arps, Slate, Meagher & Flom LLP
Los Angeles, CA

JOHN C. WILCOX
Chairman, Morrow Sodali
New York, NY

JOEL ROTHSTEIN WOLFSON
BofA Securities
New York, NY

© 2020 Thomson Reuters

Wall Street LAWYER

West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

FIRST CLASS
MAIL
U.S.POSTAGE
PAID
WEST

Wall Street LAWYER

West LegalEdcenter
610 Opperman Drive, Eagan, MN 55123
Phone: 1-800-344-5009 or 1-800-328-4880
Fax: 1-800-340-9378
Web: http://westlegaledcenter.com

THOMSON REUTERS

YES! Rush me ***Wall Street Lawyer*** and enter my one-year trial subscription (12 issues) at the price of $1,092.00. After 30 days, I will honor your invoice or cancel without obligation.

Name _____

Company _____

Street Address _____

City/State/Zip _____

Phone _____

Fax _____

E-mail _____

METHOD OF PAYMENT

❑ BILL ME

❑ VISA ❑ MASTERCARD ❑ AMEX

Account # _____

Exp. Date _____

Signature _____

Postage charged separately. All prices are subject to sales tax where applicable.