

How Firms Can Prep For A More 'Aggressive' SEC

By **Al Barbarino**

Law360 (November 24, 2020, 6:41 PM EST) -- With a Joe Biden presidency around the corner and U.S. Securities and Exchange Commission Chairman Jay Clayton officially announcing he'll depart by year-end, industry attorneys believe in-house legal and compliance professionals at financial firms should expect a more aggressive incoming enforcement regime.

Clayton and his enforcement division's focus has been on protecting Main Street investors from malevolent schemes and frauds, noted Matthew C. Solomon, a Cleary Gottlieb Steen & Hamilton LLP partner and the SEC's former chief litigation counsel.

The SEC doled out significant corporate penalties over the past four years, exemplified by a high-profile set of actions against Silicon Valley-based Tesla Inc. and its CEO Elon Musk that included a \$40 million fine, he noted.

But Solomon, like other attorneys who spoke with Law360, anticipates "a more aggressive vision" from the incoming chairperson that will likely bring steeper civil penalties against public companies and a renewed emphasis on Wall Street regulation and enforcement.

The past year has been anything but routine, with COVID-19 ushering in an increase in tips and complaints filed with the commission and creating a backlog that the new regime will need to tackle initially, according to Jeffrey Boujoukos, who leads Morgan Lewis & Bockius LLP's securities enforcement practice and was the former regional director of the SEC's Philadelphia regional office.

"But it also creates opportunity for enforcement, because there's going to be a lot of different cases to choose from in terms of where you devote your resources," Boujoukos said.

As those priorities shift, attorneys anticipate a stronger emphasis on civil fines against public companies, a tightening of regulations on private funds and private companies, a clampdown on insider trading and, more broadly, a return to the "broken windows" approach to enforcement carried out under Clayton's predecessor, Mary Jo White.

Here are what those changes could look like and what industry players, including in-house compliance and legal teams, should be on the lookout for:

The 'Broken Windows' Approach

Solomon noted that while the SEC under Clayton was in no way "light" on enforcement, the next SEC may recalibrate its approach to one closer to the "broken windows" philosophy to enforcement prevalent under the previous chair, suggesting more cases addressing negligence, controls and books-and-records violations — even in the absence of fraud or even actual investor losses.

"That creates a bigger playing field for the SEC," Solomon said. "The SEC has a lot of discretion on negligence claims, because they can effectively second-guess decisions companies have made based on what was in their view 'reasonable,' without needing to prove the conduct was intentional or reckless."

Solomon advises that companies carefully document year-end accounting and disclosure judgments while taking stock of their control environments and to aggressively address risks or problems before an SEC inquiry arises.

"Make sure you've documented the difficult judgments that are being made, particularly in view of the global pandemic," he said. "If you're asked to explain why you made them, you want to be able to walk the regulator through your thought process to demonstrate that you made them in good faith and with reasonable inquiry."

Solomon said he thinks the agency will look closely at whether a company's own controls have been followed.

"The SEC will be looking for a paper trail, and they'll be looking for companies to be prepared if they're challenged on certain parts of their financial statements or certain disclosures to explain their rationale based on what they documented at the time," he said.

Civil Penalties

Nicolas Morgan, a partner in Paul Hastings LLP's investigations and white collar defense practice and a former senior trial counsel in the SEC's enforcement division, expects to see higher civil penalties for public companies under Biden's administration.

Morgan weighed in on the ongoing debate regarding the value of penalties for public companies, with the current SEC regime siding with those who argue that the penalties needlessly punish shareholders when the misdeeds are often carried out by members of management who are no longer with the company.

"Over the last few years, the penalties against public companies have not been enormous," Morgan said.

"But I think we [will] see the pendulum swinging in the other direction," he added, noting the flipside of the argument, "that penalties against public companies are an important deterrent and therefore justified. So I think we'll see higher penalties against public companies."

Morgan said the early detection, investigation and reporting of potential violations to auditors, the SEC and, "where appropriate, the public," are crucial for in-house compliance and legal teams seeking to minimize the monetary and reputational damage, as is the prompt remediation of misconduct.

"Companies can reduce the impact of this shift by pursuing 'cooperation credit' with the SEC," he added, noting that the agency's 2001 Seaboard Report, an analytical framework for evaluating cooperation by companies, serves as a good guide.

"When businesses seek out, self-report and rectify illegal conduct, and otherwise cooperate with Commission staff, large expenditures of government and shareholder resources can be avoided and investors can benefit more promptly," the report states.

Private Funds

Jeffrey Boujoukos, the head of Morgan Lewis' securities enforcement practice, believes the SEC will step up its scrutiny of private funds in the new administration, particularly when it comes to valuations.

He advised that "documentation is key" for funds looking to mitigate the risks, noting that, "when firms get themselves in trouble, they're not following, in many cases, their own internal policies and procedures."

"Have the appropriate documentation to explain how you did the valuation and have robust policies and procedures on conflicts of interest," he said. "You need to have an explanation for why you did what you did."

Boujoukos added that firms should heed recent risk alerts on the topic.

A June 23 alert from the SEC's Office of Compliance Inspections and Examinations focused on investment advisers managing private funds, for instance, noted that "staff observed private fund advisers that did not value client assets in accordance with their valuation processes or in accordance with disclosures to clients."

"In some cases, the staff observed that this failure to value a private fund's holdings in accordance with the disclosed valuation process led to overcharging management fees and carried interest because such fees were based on inappropriately overvalued holdings," according to the alert.

Morgan of Paul Hastings suggested that advisers and fund managers reexamine their fund formation and operation documents.

"Compare them to your current practices and make sure they're consistent," he said, adding that advisers also reexamine their insurance policies in the face of elevated regulatory scrutiny.

"Check to see if it covers things like the cost for counsel or the expenses related to SEC investigations or examinations, which I think will become more in-depth and potentially more contentious," Morgan said.

Insider Trading

Boujoukos believes insider trading will be a continued focus of the SEC's enforcement division under Biden's administration, particularly as the commission ramps up its use of data analytics to more effectively detect it.

Market volatility and uncertain economic effects of COVID-19 on companies present "increased opportunities for insider trading," and "that should not change" under the next SEC, he said.

"Companies should revisit insider trading policies, including procedures surrounding trading windows," Boujoukos advised. "For registrants, particular attention should be paid to instances where employees are playing multiple roles and get exposed to material non-public information. Enforcement has recently focused on such situations."

The SEC's recent insider trading efforts include cases against a Swiss businessman tied to Sanofi SA's acquisition of Bioverativ Inc., a former Amazon Inc. finance manager and the former chief financial officer for drugmaker Aceto Corp.

Morgan cautioned that company executives and employees should be taking extra caution before any trading, noting that, "I know most people are already doing that, but do it with a bit more vigor."

From an organizational standpoint, he added that "controlling the information flow is obviously a very important compliance tool to prevent suggestions of, or exposure to insider trading liability."

"Yes, by and large, funds and companies that engage in transactions in the public markets already do that sort of thing ... but it certainly wouldn't hurt to revisit the nature of the information flow on the buy side," Morgan said.

--Editing by Nicole Bleier.

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