February 28, 2018

Leaders of SEC Enforcement Division Discuss Priorities and Recent Developments

On February 23, 2018, at the Practising Law Institute's annual "SEC Speaks" event, senior representatives of the SEC's Enforcement Division, including Co-Directors Stephanie Avakian and Steven Peikin, discussed enforcement priorities, recent developments, and other current issues of interest.

Although greater resources have been allocated to the areas of cybersecurity and cryptocurrency, including the creation last year of a new Cyber Unit, and to the retail investor space, including the creation of a Retail Strategy Task Force, the leadership of the Enforcement Division signaled that the Staff is continuing to pursue a broad range of enforcement actions. According to the leadership of the Division, overall enforcement priorities have not changed.

Other topics addressed were recent cases concerning disgorgement (*Kokesh)* and the constitutionality of Administrative Law Judges (*Lucia*); the nature of assistance required to receive credit for cooperation; and observations regarding arguments by defense counsel that, in the Staff's view, may be conflating elements of the antifraud provisions of the securities laws.

Recent and Pending Supreme Court Decisions

Chief Enforcement Litigation Counsel Bridget Fitzpatrick addressed the effects of the Supreme Court's decision last year in *Kokesh* v. *SEC*,[1] in which the Court held that disgorgement constituted a "penalty" and that, therefore, disgorgement claims are subject to a five-year statute of limitations.

Ms. Fitzpatrick described three principal circumstances in which defendants have asserted arguments on the basis of *Kokesh*. First, defendants in cases that have already been resolved have petitioned to relitigate certain claims in light of *Kokesh*, but Ms. Fitzpatrick expressed confidence that those claims would be unsuccessful. Second, defendants in certain pending cases have argued that because some of the alleged misconduct occurred outside the applicable limitations period, the disgorgement amount should be recalculated. According to Ms. Fitzpatrick, judges and the Commission generally have been willing to do so. Finally, defendants have argued that the reasoning underlying *Kokesh* requires other types of equitable relief to be treated as a penalty as well. Ms. Fitzpatrick expressed the view that *Kokesh* will be limited in scope, however, and will not be extended to other forms of relief. We recently addressed that

1 137 S. Ct. 1635 (2017).

issue in a separate Client Alert (available here), in which we described how lower courts have been grappling with the questions left open by the Court in *Kokesh*.

Mr. Peikin noted that the Enforcement Division is being more judicious in determining whether to initiate an investigation where the underlying conduct is dated, albeit within the five-year limitations period. He stated that the Staff is trying to move with as much "alacrity" as they can and may seek tolling agreements where conduct is older but an investigation still appears to be appropriate from the Staff's perspective.

Ms. Fitzpatrick also briefly touched on *Lucia* v. *SEC*,[2] a case currently pending before the Supreme Court on the constitutionality of the SEC's use of Administrative Law Judges ("ALJs"). Ms. Fitzpatrick noted that the overall number of contested ALJ decisions has decreased and indicated that the decision to proceed with an enforcement action in district court or administratively will be made on a case-by-case basis. Cases where the SEC is seeking the revocation of a professional license, however, will most likely be handled administratively, according to Ms. Fitzpatrick.

New Cyber Unit Focused on Fraud and Registration Issues in the Cryptocurrency Space

The Chief of the Enforcement Division's Cyber Unit, Robert Cohen, discussed the work being handled by the Unit since its creation last year. He noted that the SEC recognizes the use and importance of innovative technology in the securities industry, but that new technology must comply with the securities laws. He highlighted three general areas that the Cyber Unit has been focused on. First, the Cyber Unit has been investigating what Mr. Cohen referred to as "garden variety fraud," such as the use of the word "blockchain" to describe a company or its product when, in fact, neither has any relationship to actual blockchain technology. Second, the Cyber Unit has been investigating material misrepresentations in "initial coin offerings," the cryptocurrency equivalent of an IPO. Finally, the Staff has actively pursued cases against companies for failure to register as brokers or dealers, or for failure to register with a national securities exchange.

On the last point, Mr. Cohen noted that the SEC views many cryptocurrency tokens as "securities"[3] and that additional enforcement actions can be expected now that the market has been put on notice about the need for proper registration. Mr. Cohen and Ms. Avakian also urged investors and innovators in the cryptocurrency space to seek legal advice from reputable law firms, expressing frustration with the advice that certain subjects of enforcement actions have attempted to rely on, such as the conclusion that cryptocurrencies are not "securities."

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2 No. 17-130.

3 Mr. Cohen specifically noted the applicability of the test used in *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946), to the question of whether or not cryptocurrencies constitute "securities."

Increased Focus by Asset Management Unit on Retail Investors

Co-Chief of the Asset Management Unit Anthony Kelly explained that, although the Asset Management Unit continues to focus on the asset management industry broadly, it recently has "turned the dial" slightly more towards a focus on retail investors. In particular, Mr. Kelly commented that the Unit has been thinking about incentives that may cause advisers to lose sight of the fiduciary duty they owe to their retail clients. Mr. Kelly noted that the Staff is focused on ensuring that conflicts of interest are fully and fairly disclosed.

Mr. Peikin and Mr. Kelly highlighted the Enforcement Division's "Share Class Selection Disclosure Initiative." This initiative offers investment advisers a recommendation of favorable settlement terms by the Enforcement Division (including a recommendation of no civil penalty) where the adviser self-discloses violations and disgorges fees (and prejudgment interest) collected as a result of the violation. It appears that the Staff may pay particular attention to the disclosure of conflicts of interest associated with investment advisers who collect fees from proprietary products or invest clients in a higher-cost share class.

Assistance Necessary for Cooperation Credit

Mr. Kelly indicated that the SEC wanted to provide more concrete guidance on when credit will be given for cooperation and what that credit will be. He discussed recent requests for cooperation credit where organizations have sought credit for producing documents in a timely fashion; Mr. Kelly noted, however, that producing documents and otherwise complying with legal obligations are *not* the kind of conduct that the SEC views as warranting cooperation credit. Instead, parties should point to conduct that allows the SEC to reach a resolution in a shorter period of time than it otherwise would have been able to, or that allowed a resolution to be reached using fewer resources than otherwise would have been required. He noted that prompt remediation also is a relevant factor in the SEC's consideration as to whether or not to grant cooperation credit.

Ms. Avakian pointed to the SEC's recent resolution with Munchee, Inc. as an example of the type of assistance that will result in cooperation credit. In that case, Munchee halted its initial coin offering immediately after being contacted by the SEC and immediately returned to investors any proceeds of the offering. As a result, no penalty was imposed.

Chief Counsel Shares Observations on Defense Arguments Potentially Conflating Elements of Antifraud Provisions

Chief Enforcement Counsel Joseph Brenner described his observation that some defense counsel have been conflating the various antifraud provisions of the securities laws and collapsing them into general "scheme liability." Mr. Brenner cautioned that generalized advocacy about scheme liability "paints with too broad a brush" and does not reflect the Staff's view of how liability attaches under the antifraud provisions.

As an example, Mr. Brenner compared Rule 10b-5(a),[4] which prohibits the use of "any device, scheme, or artifice to defraud . . . in connection with the purchase or sale of any security," and Rule 10b-5(c),[5] which makes it unlawful to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person," and does not mention "schemes" of any sort. Mr. Brenner urged defense counsel not to ignore the words "device" and "artifice" in Rule 10b-5(a), and not to inject a "scheme" requirement into Rule 10b-5(c).

Mr. Brenner pointed to *Lorenzo* v. *SEC*[6] as an example of the importance of careful scrutiny of the language of each subdivision of the antifraud statutes. At issue was the difference between Rule 10b-5(b)—which makes it unlawful "[t]o make any untrue statement of a material fact . . . in connection with the purchase or sale of any security"—and Rules 10b-5(a) and (c) as well as Section 17(a)(1) of the Securities Act of 1933[7] (which, like Rule 10b-5(a), also deals with devices, schemes, or artifices to defraud). A finding was made during SEC administrative proceedings that the defendant was "the maker" of false statements within the meaning of Rule 10b-5(b).[8] The D.C. Circuit overruled this determination, finding that the defendant did not in fact "make" the misstatements at issue, and the defendant argued that as a result he could not be liable under Rules 10b-5(a) or (c) or Section 17(a)(1) either. The Court disagreed, however, relying on a finding that "the maker" of false statements is not a requirement for liability under either rule or Section 17(a)(1).[9]

Mr. Brenner also noted the SEC's skepticism of arguments asserting that, for the purposes of Rule 10b-5(b), the SEC is required to prove "deceptive misconduct" above and beyond the false statement. He noted that a (non-comprehensive) survey of cases from the past eighteen months showed that the SEC generally prevails on issues concerning deceptive misconduct at the motion to dismiss stage.

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4 17 C.F.R. § 240.10b-5(a).

5 *Id.* § 240.10b-5(c).

6 872 F.3d 578 (D.C. Cir. 2017).

7 15 U.S.C. § 77q(a)(1).

8 17 C.F.R. § 240.10b-5(b).

9 *Lorenzo*, 872 F.3d at 588.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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