Practical Implications Of SEC's Enforcement Policy Shift

By Harris Fischman and Daniel Sinnreich (February 17, 2022)

Harris Fischman

Daniel Sinnreich

On Oct. 13, 2021, U.S. Securities and Exchange Commission Director of Enforcement Gurbir Grewal announced in a speech that he intended to recommend "aggressive" use of available remedies in enforcement actions, including requiring admissions of wrongdoing in certain cases.[1]

Grewal and Deputy Director Sanjay Wadhwa explained that the agency would seek admissions in cases involving "egregious misconduct," a large number of harmed investors, defendants who obstruct SEC investigations, and where "heightened accountability and acceptance of responsibility are in the public interest."[2]

Grewal also explained that, unlike prior Enforcement Division directors, neither he nor the deputy director expected to participate in Wells meetings unless the matters "present novel legal or factual questions, or raise significant programmatic issues."[3]

In this memorandum we discuss both policy shifts and likely implications for practitioners and clients.

The SEC's Policy on Requiring Admissions of Wrongdoing

Background

As former SEC Chair Mary Jo White explained, prior to 2012 the SEC "settled virtually all of its cases on a no-admit-no deny basis," in which the defendant or respondent would agree to the imposition of certain penalties without admitting or denying the alleged conduct.[4]

The SEC's settlement policy shifted under the Obama administration. In 2012 the SEC announced that it would require admissions of wrongdoing in cases involving parallel criminal conduct or nonprosecution or deferred prosecution agreements that included admissions of criminal conduct.[5]

In 2013, White announced that the SEC would begin requiring admissions in additional cases, including those involving large numbers of investors, egregious conduct and significant market risk.[6] She explained that this approach gave the SEC a "powerful tool to use in appropriate cases, which has strengthened the program by increasing accountability."[7]

Following these announcements, there was an uptick in SEC enforcement actions involving admissions of wrongdoing. Between 2010 and 2013, the SEC settled only 12 enforcement actions with admissions; between 2014 and 2017, by contrast, the SEC settled 84 enforcement actions with admissions.[8]

Admissions of wrongdoing, however, remained the exception: These 84 settlements with admissions accounted for only 2.9% of the SEC's total settlements between the fiscal years 2014 and 2017.[9]

In settlements that did include admissions between 2010 and 2017, approximately half included general admissions that the defendant violated the law, typically taking the form of the defendant acknowledging that its conduct violated the federal securities laws;[10] a smaller number went further, including admissions that the defendant violated specific legal provisions.[11]

Approximately half included admissions that the defendant acted with a specific state of mind, although the state of mind admissions varied significantly between cases. In these 50 settlements, defendants most frequently admitted to knowledge or awareness of certain facts; a smaller number of defendants admitted to acting negligently, recklessly, or willfully or intentionally.[12]

Approximately one-quarter of the SEC's settlements with admissions during this period involved persons or entities that were criminally charged for the same or similar conduct.[13] Only about 10% of those who admitted to wrongdoing in SEC settlements during this period were named as defendants in private securities class action lawsuits involving the same underlying conduct.[14]

It is unclear why so few settling defendants faced follow-on private civil class actions, although it is worth noting that most settlements involving admissions during this period did not include admissions that defendants acted with recklessness or willfulness, as required to plead a private cause of action for securities fraud under Section 10(b) of the Securities Exchange Act.

Several settlements also contained language intended to limit the use of the admissions in follow-on actions, including language that all admissions were made "[s]olely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party."

Former SEC Chair Jay Clayton and Co-Directors of Enforcement Steven Peikin and Stephanie Avakian shifted the SEC away from the practice of requiring admissions. Clayton cited the agency's interest in "avoiding drawn-out proceedings that strain the resources of the Enforcement Division staff and lengthen the time it would take for resolution, including for investors to receive restitution."[15]

The SEC's Use of the New Admission of Wrongdoing Policy Thus Far

The SEC has required an admission in at least one high-profile settlement since the policy shift **was announced** in October 2021. On Dec. 17, 2021, the SEC announced that JPMorgan Securities LLC, a registered broker-dealer and subsidiary of JPMorgan Chase & Co., admitted to failing to preserve communications about securities business on personal devices, including those via text messaging applications, like WhatsApp, and personal email accounts.

JPMS admitted to the SEC's factual findings, as well as its conclusion that JPMS' conduct violated Section 17(a) of the Exchange Act and Rules 17a-4(b)(4) and 17a-4(j) thereunder, thereby also violating Section 15(b)(4)(e) of the Exchange Act.[16]

The order does not contain language, present in some previous admission settlements under White, stating that the admissions are "[s]olely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or in which the Commission is a party."

The Risks of Admissions and Implications of the New Policy

Companies and individuals that admit to wrongdoing in SEC settlements risk certain collateral consequences. Chief among the collateral consequences, in particular for public companies, is the risk that any admission of wrongdoing in an SEC settlement could be used to bolster a private civil class action arising out of the same events.

The exposure for public companies in private securities class actions are often significant, and plaintiffs lawyers could cite public admissions of securities violations in their pleadings, and leverage admissions in motion practice, settlement negotiations and trial.

Admitting wrongdoing may also lead to reputational damage and negative business consequences, and, in some circumstances, could trigger conduct exclusions in directors and officers insurance policies that bar coverage for fraudulent conduct or intentional violations of the law. And, in particular for individuals, admitting wrongdoing could have dire consequences in parallel criminal proceedings.

Accordingly, some companies and individuals may consider litigating against the SEC rather than admitting to wrongdoing in an SEC settlement. A willingness to litigate if necessary will likely provide an important negotiation point, as the SEC has limited resources and will have to carefully select the enforcement actions worth taking to trial.

Additionally, those who do admit to certain wrongdoing in an SEC settlement will want to carefully negotiate the language used in the settlement document to mitigate the extent of the collateral consequences. For example, admissions to non-scienter-based claims will be less impactful on private securities class action than admitting to engaging in a violation of Rule 10b-5 or Section 17(a)(1).

Carefully crafted language may also ameliorate the impact of the admissions on parallel litigation or perhaps avoid triggering an exclusion under a D&O policy.

Nonetheless, it remains to be seen just how aggressive the SEC's policy shift on admissions will be. Grewal's intent to pursue admissions in cases involving large numbers of investors and egregious misconduct echoes a similar policy under the Obama administration, that led only to a modest uptick in settlements involving admissions.

Indeed, the SEC has released approximately 170 notices and orders concerning the institution and/or settlement of administrative proceedings since the Oct. 13, 2021, announcement, and only one — the JPMorgan settlement — included an admission of wrongdoing.[17]

The SEC's Policy on Wells Meetings

Background

A Wells notice is a formal communication informing individuals or companies that the staff intends to recommend that the SEC bring an enforcement action against them. Recipients of Wells notices are typically invited to present their side of the story to the SEC through a Wells submission prior to being formally charged.

Before 1972, companies and individuals were generally not advised that they could submit a statement advocating their position to the SEC, although the SEC would often consider such submissions on request.[18] In 1972, the SEC convened a committee, chaired by attorney

John Wells, to review the SEC's enforcement policies and practices.

The Wells committee recommended that the SEC make known the practice of advising prospective defendants or respondents of the opportunity to make a submission to the staff. The committee's recommendation was motivated in part out of a concern for fairness; prior to the recommendation, only those with experienced securities counsel knew to take advantage of the submissions process.

Following this recommendation, the SEC issued a release notifying the public for the first time of the SEC's practice of receiving submissions before initiating enforcement proceedings.[19]

Interaction between defense counsel and the SEC staff typically continues after the Wells submission through a one or more Wells meetings. Wells meetings can be extremely important, as they provide counsel with an opportunity for continued dialogue with the staff. Defense counsel can use a Wells meeting to gain insight into the staff's approach to the case and ensure the SEC staff understands the facts and its view of the case.[20]

Traditionally, the director of enforcement or his or her deputy has afforded defense counsel an opportunity to meet with them directly to try and persuade the staff not to pursue claims or to settle to lesser claims. Peikin described the Wells process as "one of the most significant opportunities for communication" between defense counsel and the SEC.[21]

The SEC's Fall 2021 Statements Regarding the Wells Process

In October 2021, Grewal discussed potential changes to make the Wells process "more streamlined and efficient."[22] Grewal indicated that he and Wadhwa would not attend all Wells meetings — particularly those that do not "present novel legal and factual questions, or raise significant programmatic issues" — and that those under investigation should not "expect a meeting in each and every case."

Gensler later added that he "asked staff to cut back on meetings with entities that want to discuss arguments in their Wells submissions."[23]

In November 2021, several former Enforcement Division directors questioned Grewal on his recent remarks during a securities enforcement forum. When the moderator, former SEC counsel Bradley Bondi, mentioned there had been "rumblings" among defense attorneys about Grewal's reference to streamlining the Wells process, Grewal explained that he expected to be present at some Wells meetings, but that front-line staff would handle more routine cases.

When another former director of enforcement, William McLucas, suggested that Grewal should not create the impression that he is closing the door to the Wells process, Grewal clarified that he was "talking about reducing maybe 5 percent or 10 percent of the meetings that don't make sense."[24]

Implications of the New Wells Policy

With respect to Grewal's comments about changes to the Wells process, by not having the director or deputy director regularly participate in Wells meetings there is an increased risk that similar matters reach inconsistent results, and outcome that is not optimal from a policy or fairness standpoint.

Decentralizing the process may reduce programmatic consistency, increase the risk that similar matters may reach inconsistent results, and reduce opportunities for discussion about the practical significance and consequences of enforcement actions. Nonetheless, it is too early to know with certainty the practical significance of Grewal's comments about the Wells process.

Grewal's comments could be interpreted as a signal that this Enforcement Division will recommend to the commission that claims be brought whenever a Wells notice is issued unless there are novel or programmatic issues. Similarly, Grewal's comments could be interpreted to suggest that Wells meetings will not result in settlements on terms more favorable than those set forth in a Wells notice except in unique circumstances.

Either interpretation would reflect a significant shift from the SEC's more traditional view that the Wells process is one of the most significant opportunities for communication between defendants and the commission. Reduced director and deputy director participation in Wells meetings also signals increased deference to less senior members of the staff, who at times have been viewed as more aggressive in pursuing enforcement actions than more seasoned and senior leadership of the division.

On the other hand, in practice, Grewal could empower associate directors and unit chiefs that will conduct Wells meetings in his absence to reach compromises with defense counsel as has often been the result of Wells meetings in the past.

The announced Wells policy shift, coupled with Gensler's statement signaling a cutback on meetings to discuss arguments in Wells submissions, underscore the importance of beginning an early dialogue and maintaining an open line of communication with the SEC enforcement attorney handling an investigation.

Subjects of SEC investigations should ensure they are well positioned to take advantage of opportunities to communicate their position and arguments to the staff, including in circumstances beyond, and less formal than, the Wells process.

Conclusion

In sum, these are aggressive statements and signals indicating policy shifts, but it remains to be seen how aggressively the Enforcement Division will pursue them in practice.

Harris Fischman is a partner and Daniel S. Sinnreich is an associate at Paul Weiss Rifkind Wharton & Garrison LLP.

Paul Weiss associate Briana Sheridan contributed to this article.

[1] https://www.sec.gov/news/speech/grewal-sec-speaks-101321.

[2] Id.; https://www.wsj.com/articles/sec-to-seek-admissions-of-wrongdoing-in-some-enforcement-actions-11634139229.

[3] https://www.sec.gov/news/speech/grewal-sec-speaks-101321.

[4] https://www.sec.gov/news/speech/spch092613mjw.

[5] https://www.sec.gov/news/public-statement/2012-spch010712rskhtm.

[6] https://www.sec.gov/news/speech/spch092613mjw.

[7] https://www.sec.gov/news/speech/chair-white-speech-new-york-university-111816.html.

[8] https://arizonalawreview.org/pdf/60-1/60arizlrev1.pdf at 21.

[9] Id. at 27.

[10] Id. at 29; see, e.g., https://www.sec.gov/litigation/admin/2017/33-10281.pdf ("Respondent admits the facts set forth . . . below, acknowledges that its conduct violated the federal securities laws, admits the Commission's jurisdiction over it and the subject matter of these proceedings, and consents to the entry of this Order Instituting Cease-and-Desist[.]").

[11] https://arizonalawreview.org/pdf/60-1/60arizlrev1.pdf at 30.

[12] Id. at 30-33.

[13] Id. at 36.

[14] Id. at 40.

[15] https://www.congress.gov/115/chrg/CHRG-115shrg24998/CHRG-115shrg24998.htm.

[16] https://www.sec.gov/news/press-release/2021-262; https://www.sec.gov/litigation/admin/2021/34-93807.pdf.

[17] https://www.sec.gov/litigation/admin.htm.

[18] https://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.25580.17.pdf at 6-2.

[19] Id. at 6-3.

[20] Id. at 6-18.

[21] https://www.sec.gov/news/speech/speech-peikin-050918.

[22] https://www.sec.gov/news/speech/grewal-sec-speaks-101321.

[23] https://www.sec.gov/news/speech/gensler-securities-enforcement-forum-20211104.

[24] https://www.vitallaw.com/news/top-story-former-enforcement-directors-challenge-grewal-s-wells-remarks/sld01b904fae87e031000b2ec000d3a8abb4e02.