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SEC Brings First-Ever Enforcement Action Against Non-Fungible Cryptocurrency Tokens

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Introduction

The Securities and Exchange Commission ("SEC") issued a cease-and-desist order on August 28, 2023, charging Impact Theory, LLC ("Impact Theory") with conducting an unregistered offering of crypto asset securities in violation of the Securities Act of 1933 ("Securities Act").[1] Without admitting or denying the SEC's findings, Impact Theory accepted the order and agreed to pay more than US$6.1 million in civil penalties, disgorgement and prejudgment interest.[2] The order marks the first time that the SEC has applied the seminal "Howey test" to non-fungible cryptocurrency tokens ("NFTs"). In a dissenting opinion two SEC Commissioners rejected the SEC's application of the Howey test and raised several questions for future cases involving NFTs.

Background

Courts generally apply the "Howey test" to determine whether a digital asset constitutes an "investment contract," and consequently a security under U.S. securities laws.[3] Under the Howey test, a digital asset is an investment contract if the following elements are present: (i) an investment of money (ii) in a common enterprise (iii) with the expectation of profits to be derived from the efforts of others.

Impact Theory, a Los Angeles-based entertainment media company, offered and sold NFTs, known as Founder's Keys ("KeyNFTs"). NFTs are digital asset tokens similar to cryptocurrency. However, each NFT possesses unique characteristics that distinguish NFTs from each other, such as being tied to ownership of a specific piece of art. Many NFTs operate on the Ethereum ("ETH") blockchain.

KeyNFTs were divided and sold into three classes, titled "Legendary," "Heroic," and "Relentless." Impact Theory raised around US$29.9 million worth of ETH from the sale. As part of the remedial actions Impact Theory undertook, and which the SEC considered in arriving at the resolution, it agreed to revise the KeyNFTs' smart contracts to eliminate royalties that Impact Theory would have received for any future secondary market transactions.

The Order

The SEC analyzed Impact Theory's KeyNFTs under the Howey test and determined that they constituted investment contracts, stating that "[p]urchasers in the KeyNFT offering had a reasonable expectation of obtaining a future profit based on Impact Theory's managerial and entrepreneurial efforts." In arriving at this conclusion, the SEC did not conduct a fact application; instead, it highlighted several key facts that lead to its position.

<u>First</u>, the SEC established that an investment of money was present. Specifically, Impact Theory sold (i) Legendary tier KeyNFTs to investors for between 1.5 to 3 ETH per token; (ii) Heroic tier KeyNFTs for 0.75 to 1.5 ETH per token; and (iii) Relentless tier KeyNFTs for 0.05 to 0.1 ETH per token.

Second, the SEC provided facts purporting to show that the sale of KeyNFTs constituted a "common enterprise" or "scheme" between investors. Specifically, according to the SEC, Impact Theory claimed that a purchase of a KeyNFT constituted an investment in what would be a "thriving community" in Impact Theory's vision.

Last, the SEC claimed that investors possessed an expectation of profits to be derived from the efforts of Impact Theory because the company repeatedly told investors that their money would be put into development efforts and create additional projects to add value to the company. Per the SEC, Impact Theory expressed that such development efforts would enrich investors, including statements that NFTs were the "mechanism by which communities will be able to capture economic value from the growth of the company that they support" as well as claims that investors would be ecstatic that they would be "getting all this value" from their investment.

As a result of these findings, the SEC concluded that investors "understood Impact Theory's statements to mean that the company's development of its projects could translate to appreciation of the KeyNFTs' value over time."

The Dissent

SEC Commissioners Hester M. Peirce and Mark T. Uyeda released a joint dissenting opinion disagreeing with the SEC's application of the Howey test.[4] The dissent acknowledged the matter's routine facts, which are typical of many similar cases. But, importantly, the dissent also contested the SEC's position that the facts provided a sufficient basis for the SEC to bring an enforcement action.

The dissenting Commissioners began by noting that the offer and sale of KeyNFTs were not the sale of shares of a company, did not generate any type of dividend, and did not involve the type of promises on the part of Impact Theory traditionally present in Howey test analyses.

The dissenting Commissioners were sympathetic to the SEC's concern that investors may buy into the "hype" of NFTs without a clear understanding of how to use or profit from such investment, but contended that such concern, though legitimate, does not "pull the matter into our jurisdiction." The dissent further observed that even if the KeyNFTs are investment contracts under the Howey test, Impact Theory already proffered remedial efforts and as such should not be subject to an enforcement action.

The dissent concluded by positing several issues worthy of consideration before the SEC delves into matters relating to the offer and sale of NFTs. We highlight a few of these below and note that in making these observations, the dissenting Commissioners provide a helpful and potentially effective roadmap to push back on the SEC's position on NFTs, should more enforcement actions be in the pipeline.

- Given the nebulous and difficult-to-define characteristics of NFTs as a group, are there useful ways for the SEC to categorize NFTs for purposes of contemplating whether and how the securities laws apply to their offers and sales?
- What regulatory frameworks, including existing cryptocurrency programs and ongoing legislative efforts regarding cryptocurrency, may be helpful to apply to NFTs?
- Does the Impact Theory enforcement action reflect a view that both current and prior NFT offerings and sales fall under the Howey analysis such that issuers of such offers and sales need to come into compliance with the position set forth in this action?
- What impact, if any, will undertakings to destroy NFTs or revise smart contracts have for future NFT cases?
- What is the status of secondary investments in NFTs that are said to be investment contracts? Do such secondary offerings also, by definition, constitute investments?

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Takeaways

The Impact Theory action represents the first shot across the bow by the SEC regarding the world of NFTs. As the dissent highlighted, it also foreshadows that this action might be the SEC's first move towards bringing NFTs into the larger fold of its digital asset enforcement policies. Should the SEC be setting its sights on NFTs more broadly, then it is reasonable to expect more enforcement actions against other varieties of NFTs both past and present.

As the SEC continues its march to gain increasing jurisdiction over the digital asset ecosystem, market participants are increasingly finding themselves in a position of having to make a difficult decision: Push back against the SEC's theories of enforcement or fall into compliance. Pushing back can be done in two ways: Defend against an enforcement action brought by the SEC or initiate a pre-enforcement challenge in federal court that forces the SEC to defend its position and asks a neutral federal judge to endorse or reject the SEC's theory of liability before the SEC brings an enforcement action.

Given the aggressive enforcement climate against digital assets, market participants and observers can expect that the SEC is likely not done with NFTs; instead, the SEC is likely to provide further guidance or other indications regarding its position on NFTs. Of course, entities considering whether to offer and sell NFTs should consider the costs associated with operating in a manner consistent with the Impact Theory order as well as the risks of not doing so. In addition, market participants that have already sold NFTs to investors should consult with counsel to determine the best path forward in light of the SEC's order, including implementing remedial actions such as those undertaken by Impact Theory.

Footnotes

Impact Theory, LLC, Release No. 33-11226 (Aug. 28, 2023).

Press Release, *SEC Charges LA-Based Media and Entertainment Co. Impact Theory for Unregistered Offering of NFTs* (Aug 28, 2023).

SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

NFTs & the SEC: Statement on Impact Theory, LLC, Hester M. Pierce and Mark. T Uyeda, (Aug 2023).

Related Professionals

PARTNER

Andrew S. Boutros

Chicago

+1 312 646 5803

Washington, D.C.

+1 202 261 3465

PARTNER

Timothy Spangler

Los Angeles

+1 949 442 6044

Silicon Valley

+1 650 813 4803

ASSOCIATE

Paul L. Capuano

New York

+1 646 731 6108

ASSOCIATE

Samuel Scarritt-Selman

New York

+1 212 698 3842

PARTNER

Jeffrey A. Brown

New York

+1 212 698 3511

PARTNER

Vincent H. Cohen Jr.

Washington, D.C.

+1 202 261 3432

SEC Releases 2022 Enforcement Division Results

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The Securities and Exchange Commission ("SEC") released an annual summary, on November 15, 2022, of actions brought by the Division of Enforcement ("Division") over fiscal year 2022 ("Enforcement Summary"), providing an overview of its results and priorities over fiscal year 2022, Gurbir Grewal's first full year as the Division's Director.[1] While these summaries, by their nature, always include a focus on the amounts obtained in penalties and disgorgement, and, in recent years the continuing importance of the whistleblower program to the Division's work, the overriding theme of this past year's report is the "breadth of issues" covered by the Division and the expectation of more proactive enforcement sweeps to come.

Overview

In fiscal year 2022, the SEC filed a total of 760 enforcement actions, which represents a nine percent increase over fiscal year 2021. Over the past year, the SEC has generally sought large monetary results, as well as bespoke undertakings depending on the particular allegations in an action. In 2022, the SEC obtained a record $6.436 billion in disgorgement, civil penalties, and prejudgment interest. The increase of almost 70 percent compared to 2021 is largely attributable to the increase in civil penalties, which nearly tripled from $1.456 billion to $4.194 billion. The SEC also returned $937 million to affected investors, compared to $521 million in fiscal year 2021.

The Enforcement Summary emphasized that "individual accountability is a pillar of the SEC's enforcement program." To support this point, the SEC cited cases it had brought against public company senior executives and senior portfolio managers in the financial industry. The SEC also noted enforcement actions brought to compel clawbacks of public company executive compensation under Sarbanes-Oxley Section 304, which Director Grewal addressed in a speech given on the same day that the Enforcement Summary was released.[2]

The SEC has also been more willing to litigate than in past years, which the Enforcement Summary highlighted by noting that the Division litigated a record 15 trials in 2022, the most conducted in a single year over the past decade. The SEC has also been willing to bring actions against market participants notwithstanding potential collateral consequences, such as potential waivers, particularly when cases may send a "message" to the market concerning the Division's priorities. Director Grewal's November 15 speech noted in particular that, "proactive enforcement sweeps that specifically target recurring issues … not only demonstrate[] accountability, but also [have] a more pronounced deterrent effect than if the [SEC] filed separate standalone cases."

The Enforcement Summary drew particular attention to the Division's actions against 17 market participants for what the SEC described as "failures to maintain and preserve work-related text message communications conducted on employees' personal devices." These "off-channel communications" have been a focus of the Division over the past year and have led to $1.235 billion in civil penalties (or almost 30% of the $4.194 billion in total civil penalties for 2022), as well as tailored undertakings, such as the retention of compliance consultants to ensure compliance going forward.

The SEC also identified other areas of focus for the Division, including financial fraud and issuer disclosures, gatekeepers, crypto assets, cybersecurity, ESG, private funds, insider trading and other market abuses, and complex investment products among others.

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Substantive Areas of Focus

The Enforcement Summary highlighted the breadth and depth of the Division's enforcement actions over the past year, specifically naming certain industries and types of violations that the SEC found particularly noteworthy. For example, the SEC routinely brings a significant number of actions against market participants for inadequate or inaccurate disclosures. The Division continued that emphasis this year, with the SEC noting that it "places a high priority on pursuing issuers or their employees who make materially inaccurate disclosures, as well as auditors and their professionals who violate appliable laws and rules in connection with such disclosures." More broadly in this year's summary, the SEC made explicit the Division's focus on bringing actions against gatekeepers, including auditors, lawyers, and transfer agents, when the SEC believes that they "fail[] to live up to their heightened trust and responsibility."

With the continued expansion of the Division's Crypto Assets and Cyber Unit—it is set to nearly double in size—the SEC continues its focus on enforcement in the crypto asset space, as well as on cybersecurity violations broadly. For example, the SEC brought actions against crypto lending platforms, individuals in an alleged "crypto pyramid and Ponzi scheme," and those involved in insider trading related to a crypto asset trading platform. The SEC also brought actions regarding failures to comply with record-keeping and customer data requirements.

The Division continues to address "concerns" by investors regarding environmental, social, and governance ("ESG") issues. The Enforcement Summary noted that the Division will focus on principles of materiality, accuracy of disclosures, and fiduciary duty when evaluating potential enforcement actions against public companies and with regard to investment products and strategies.

The Division has increased its attention to the private funds industry, which it has signaled repeatedly over the past year. The SEC expressed its likely emphasis on the risks associated with the "unique features" of private investment, including "undisclosed conflicts of interest, fees and expenses, valuation, custody, and controls around material nonpublic information." The Division has brought several actions against private fund advisers and associated individuals over the past year, which have included fraud charges in some instances.

The Enforcement Summary also described actions over the past year addressing regulated entities, including broker-dealers and investment advisers,[3] as well as associated individuals, including actions concerning trading restrictions placed on "meme stocks," failures to disclose conflicts of interest regarding SPACs, and the first action enforcing Regulation Best Interest.

As in prior years, the Division highlighted its market abuse actions involving violations such as insider trading, market manipulation, and cherry-picking, as well as actions involving complex products and strategies, and violations of the Foreign Corrupt Practices Act. Last, the Division summarized its activity in bringing actions involving public finance abuse, including actions in the municipal bond sector

Other Areas of Emphasis

In addition to the substantive areas highlighted as part of the Division's work during fiscal year 2022, the Enforcement Summary also highlighted the Division's process and areas of emphasis as it considers, investigates, and adjudicates potential enforcement actions. The SEC places an emphasis on the deterrent effect of its enforcement actions on future misconduct. For example, the Division "recalibrated penalties for certain violations," including using undertakings to require retention of compliance consultants, requiring admissions as part of settlements, and continuing to focus on individual accountability, with more than two-thirds of the SEC's stand-alone actions involving at least one individual defendant or respondent.

The Enforcement Summary also described the Division's continued use of sophisticated data analytics in assisting its work, noting a wide range of types of cases resulting from data analytics, including insider trading, market manipulation and "cherry picking." The Enforcement Summary discussed the SEC's continued support for its whistleblower program, noting its receipt of over 12,300 whistleblower tips that led to 103 awards totaling $229 million. The Enforcement Summary also noted the SEC's reliance on both parallel criminal proceedings and "[t]angible cooperation," including "significant remedial measures" by firms under investigation.

Looking Ahead to 2023

Fiscal year 2023 will likely continue to see an active enforcement climate. Chairman Gary Gensler, as well as Director Grewal and the enforcement staff, have made clear their desire to pursue alleged violations of the securities laws vigorously, including by "push[ing] the pace of investigations" and ensuring that the Division operates with "tremendous breadth." While the SEC is expected to face increased Congressional oversight with a new, Republican-controlled House of Representatives in 2023, we expect enforcement to continue apace, particularly in priority areas such as ESG, private funds, crypto and cybersecurity, and "high-impact" actions.

Conclusion

Fiscal year 2022 brought a significant rise in the number of actions filed by the SEC, as well as a new record in total money ordered to be paid by respondents. The familiar emphasis on actions involving regulated firms, financial fraud and inadequate disclosures was coupled with an increasing number of actions brought as a result of investigations by specialized teams, including the Crypto Assets and Cyber Unit and the Climate and ESG Task Force. Those trends can be expected to continue and, more likely than not, accelerate in the coming year.

Footnotes

1) Beginning last year for fiscal year 2021, the SEC has not published a formal "Annual Report" concerning its enforcement activities. Instead, a press release and related "Addendum" summarize the Division's results.
2) Director Grewal's speech also focused on the SEC's use of disgorgement, penalties, and the Division's use of "proactive enforcement" through sweeps and initiatives.
3) In 2022, 23% of all enforcement actions, and 26% of standalone enforcement actions, concerned investment advisers/investment companies. These were the highest percentages in both categories for all classification groups.

Related Professionals

PARTNER

David P. Bartels

Washington, D.C.

+1 202 261 3375

PARTNER

Catherine Botticelli

Washington, D.C.

+1 202 261 3368

PARTNER

Anthony S. Kelly

Washington, D.C.

+1 202 261 3495

PARTNER

Mark D. Perlow

San Francisco

+1 415 262 4530

COUNSEL

Dennis Lawson

Washington, D.C.

+1 202 261 3343

ASSOCIATE

Eric Auslander

Washington, D.C.

+1 202 261 3319

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Recent SEC Enforcement Actions Highlight SEC Focus on Adviser Fiduciary Duty When Recommending and Reviewing Account Types

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The Securities and Exchange Commission recently brought two enforcement actions[1] that highlight the SEC's focus on the investment adviser fiduciary duties, particularly as applied to recommendations that clients open or remain in certain types of accounts. The cases also reflect the SEC's continued movement toward emphasizing the duty of care and a client's best interest when describing an adviser's fiduciary duties. In these enforcement actions, which the SEC brought in August and September of this year, the SEC alleged that the wrap program sponsors violated the Investment Advisers Act of 1940, either by: failing to review the continued suitability of wrap accounts for certain clients; or failing to take reasonable steps after reviews identified wrap accounts that were no longer in certain clients' best interests. As discussed in more detail below, both advisers were charged with: non-scienter-based violations of the antifraud provisions of the Advisers Act; and failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act.[2]

These orders follow the SEC's release of: a bulletin in March 2022 (Staff Bulletin) in which the Staff expressed its views concerning the standards of conduct for broker-dealers and investment advisers when recommending account types to retail investors;[3] and the Division of Examination's 2022 priorities report (Examination Priorities), which identified the assessment of account types as a priority.[4]

Together, these actions illustrate that the SEC is focusing on how advisers assess and monitor the types of accounts in which their clients participate. The SEC also continues to call out the duty of care, including providing advice in a client's best interest, as a distinct element of an adviser's fiduciary duties. This emphasis suggests a desire to look beyond disclosures when assessing compliance with an adviser's fiduciary duties. At the same time, the SEC's enforcement orders show that clear disclosures, and implementing practices consistent with those disclosures, continue to be essential to demonstrating compliance with the Advisers Act.

Recent Regulatory Background

In March 2022, the SEC Staff issued guidance in a Staff Bulletin highlighting the standard of conduct for broker-dealers and investment advisers when making account type recommendations to retail investors. The Staff Bulletin reflects the staff's views and largely draws from statements that the SEC made in its 2019 interpretation of advisers' fiduciary duties (Fiduciary Interpretation) and in the adopting release for Regulation Best Interest.[5] The Staff Bulletin states that the staff aimed to "assist firms and their financial professionals with considering reasonably available alternatives and cost, addressing conflicts of interest, and adopting and implementing reasonably designed policies and procedures when making account recommendations." As in the Fiduciary Interpretation, the Staff Bulletin stated that an adviser's duty of care encompasses three components: (1) the duty to provide advice that is in a client's best interest (which includes suitability obligations); (2) the duty to seek best execution; and (3) the duty to provide advice and monitoring over the course of the adviser-client relationship.

Also in March 2022, the staff of the SEC's Division of Examinations issued its Examination Priorities. The Division included scrutinizing compliance with the fiduciary duty among its five "Significant Focus Areas." The Division also stated that it would pay particular attention to the adviser's duty of care in connection with wrap fee programs.[6] While the standards of conduct received mention in previous years, this year's priorities suggested greater emphasis in this area.

Enforcement Cases

KAI

Kovack Advisors, Inc. (KAI), a registered investment adviser, offered a wrap fee program to its clients from at least 2015 through August 2018. According to the SEC order, the adviser disclosed in its brochures and certain of its client account agreements that it would review its advisory accounts on a periodic basis in order to monitor whether wrap accounts remained suitable for its clients.[7] Additionally, the adviser's compliance policies and procedures required the adviser to conduct reviews of client accounts, including for "volume of trading."

According to the KAI Order, following an examination by the SEC's Division of Examinations that began in 2017, the adviser conducted account reviews for the first time in almost two years. The SEC also found that the adviser did not monitor such accounts "consistent with its representations to wrap clients" and "did not have policies and procedures in place reasonably designed to determine" when to convert inactive accounts. The SEC alleged that this resulted in certain clients remaining in the wrap fee program despite low volume of trading in the accounts.[8]

Waddell

Waddell & Reed, Inc. (Waddell), a dually registered adviser and broker-dealer, maintained a wrap fee investment advisory program from at least January 2015 through July 2021. According to the SEC order, Waddell maintained certain written compliance policies and procedures for financial advisors (Compliance Policy) to monitor whether its wrap fee program remained suitable for advisory clients.

As described in the Waddell Order, the Compliance Policy provided that accounts enrolled in Waddell's wrap fee program must maintain "an appropriate level of … activity," and that an account with less than four trades over the most recent eight quarters "will be terminated and the account will be converted to a traditional brokerage … account." The firm also had policies and procedures that required compliance and supervisory personnel to: review the wrap program accounts; flag accounts with lower trading activity; and create reports on the same. However, the SEC found that the program "lacked reasonable coordination, oversight and a method of confirming" that accounts with lower levels of trading activity were "addressed appropriately." Although Waddell conducted such reviews and transitioned some accounts out of the wrap fee program, the SEC found that Waddell did not always follow up. The order indicates that Waddell did not, in each case, contact the account's financial advisor and coordinate with operations to transition accounts out of the wrap fee program in accordance with the firm's policies. According to the SEC, the failure to transition those accounts resulted in clients paying $484,645 in wrap fees during the relevant period.

Conclusion

While the SEC issued the KAI and the Waddell Orders addressing similar conduct in successive months, their vocabulary in these orders differs, in potentially significant ways. Both orders highlight the SEC's emphasis on advice that is in a client's "best interest," but only the Waddell Order uses the term "duty of care." In addition, while both orders focus on periodic reviews of account type recommendations, the Waddell order contains additional exposition concerning an adviser's obligation, in general, to provide advice and monitoring over the course of the adviser-client relationship.9 These differences may be explained by the relevant period of the conduct: KAI terminated its wrap fee program before the SEC issued the Fiduciary Interpretation, while Waddell's program continued until 2021. If this is the case, the juxtaposition demonstrates the SEC's growing emphasis on the duty of care and suggests a desire, ultimately, to reduce the SEC's need to point to false or misleading disclosures when enforcing an adviser's fiduciary duties.

The orders also underline the SEC's previously announced focus on account recommendations. Advisers should expect that SEC examiners may ask whether they periodically reassess the suitability of account type recommendations and how they follow through when an account type may no longer fit a client's needs. The SEC's orders indicate that an adviser's policies and procedures with regard to monitoring client accounts should be robust and that an adviser will need to act consistently with those policies, and related disclosures, to demonstrate compliance with the Advisers Act.

Footnotes

1) In the Matter of Kovack Advisors, Inc., SEC Order, SEC Rel. No. IA-6098 (Aug. 26, 2022) (KAI Order); In the Matter of Waddell & Reed, LLC, SEC Order, SEC. Rel. Nos. 34-95828 and IA-6136 (Sept. 19, 2022) (Waddell Order).
2) The SEC explained in the interpretive release that an adviser's fiduciary duties are made enforceable by the antifraud provisions of the Advisers Act. Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Interpretation, SEC Rel. No. IA-5248 at 7 (effective July 12, 2019) (Fiduciary Interpretation). For further information on the standards of conduct releases, please refer to *Dechert Newsflash*, SEC Adopts Enhanced Standard of Conduct for Broker-Dealers and Clarifies Fiduciary Duties of Investment Advisers.
3) Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors (Mar. 30, 2022) (Staff Bulletin). For further information on the Staff Bulletin and its contents, please refer to *Dechert OnPoint*, SEC Publishes Staff Bulletin on the Standards of Conduct for Broker-Dealers and Investment Advisers Making Account Recommendations to Retail Investors.
4) 2022 Examination Priorities, SEC Division of Examination (Mar. 30, 2022) (Examination Priorities).
5) Regulation Best Interest: The Broker-Dealer Standard of Conduct, SEC Final Rule, SEC Rel No. No. 34-86031 (effective Sept. 10, 1991).
6) Examination Priorities at 14 (the "Significant Focus Area" in the 2022 Examination Priorities Report is titled: "Standards of Conduct: Regulation Best Interest, Fiduciary Duty, and Form CRS").
7) According to the KAI Order, KAI stated that such reviews would be "on at least a semi-annual basis" in its 2015 and 2016 brochures. In 2017 and 2018, KAI's brochures stated that the reviews would be periodic.
8) The SEC also found that KAI charged brokerage fees to certain wrap account clients in addition to the wrap fee without appropriate disclosure.
9) As described in the Fiduciary Interpretation, among the fiduciary duties that an adviser owes to its clients is to provide advice regarding selecting an account type in the client's best interest. The SEC asserted in the Waddell Order that, "[a] wrap fee account may not be in the best interest of a client with minimal or no trading activity as compared to a non-wrap fee or brokerage account, where the client would otherwise pay trading costs (commissions) as incurred but lower overall fees than in a wrap account."

Related Professionals

PARTNER

David P. Bartels

Washington, D.C.

+1 202 261 3375

PARTNER

Kevin F. Cahill

Los Angeles

+1 949 442 6051

PARTNER

Anthony S. Kelly

Washington, D.C.

+1 202 261 3495

PARTNER

Mark D. Perlow

San Francisco

+1 415 262 4530

ASSOCIATE

Ashley N. Rodriguez

Washington, D.C.

+1 202 261 3446

ASSOCIATE

Sarah Sennett

New York

+1 212 649 8795

Dechert LLP

Compensation Clawback Crackdowns – an Emerging Enforcement Focus

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Key Takeaways

- DOJ and the SEC Enforcement Division have launched initiatives targeting executive compensation clawbacks.
- The SEC is aggressively pursuing SOX 304 compensation clawbacks from Chief Executive Officers and Chief Financial Officers of public companies that have been required to restate financial reports in connection with misconduct at the company—even when the CEO and CFO are not involved and their compensation is not tied to the misconduct.
- DOJ has announced that compensation clawbacks will be considered as a factor in whether to bring and settle criminal charges against corporations. DOJ will evaluate not only whether companies have adopted clawback provisions in executive compensation packages, but also whether companies have, in practice, actually pursued clawbacks.

Background

After lurking many years in the shadows since the Sarbanes-Oxley Act of 2002 was enacted, prosecutors and regulatory officials have now trained their enforcement sights on corporate compensation clawbacks. Recent public remarks from leaders at the Department of Justice ("DOJ") and the Securities and Exchange Commission's ("SEC") Enforcement Division reveal how the agencies are leveraging (and intend to continue to leverage) clawbacks in carrying out their enforcement mandates. Public companies should take heed. Here we examine the context behind these pronouncements and the planning opportunity they present for the business community.

The SEC's Renewed Focus on Clawbacks

The SEC's enforcement authority related to clawbacks derives from Section 304 of the Sarbanes-Oxley ("SOX 304"). SOX 304 applies where an issuer "is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws."[1] In such cases, SOX 304 requires CEOs and CFOs to "reimburse" the company for (i) "any bonus or other incentive-based or equity-based compensation" paid during the 12-month period following the first public issuance of the restated financial report, and (ii) profits realized from the sale of the issuer's securities during the same 12-month period. The SEC can pursue charges against CEOs and CFOs for violations of SOX 304 where a qualifying restatement occurs, but the executive does not reimburse the company as the statute requires.

Since its enactment 20 years ago, the SEC has pursued SOX 304 charges infrequently—typically when the SEC alleged that the covered executive had a role in the misconduct underlying the restatement. Over the past twelve months, by contrast, the SEC has settled actions or commenced proceedings for SOX 304 violations against 11 different executives. Nine have come in the last four months alone.

Several of the Commission's recent SOX 304 cases are settled actions involving executives with zero alleged culpability. According to SEC Deputy Director of Enforcement Sanjay Wadhwa, featured at Practicing Law Institute's annual "SEC Speaks" conference last month, the Enforcement Division views "the Commission's use of SOX 304 orders against executives who were not charged under any additional provisions" as an "important element" of the recent SOX 304 enforcement actions, with the enforcement theory being that such actions "create[] accountability and establish[] incentives to prevent corporate wrongdoing."[2]

SEC Enforcement Division Chief Counsel Sam Waldon highlighted three key aspects of how this Enforcement Division is applying SOX 304:

It is pursuing these cases regardless of whether the CEO and CFO at issue were culpable for the underlying securities law violation.

It views SOX 304 as not "limited by fraud delta," meaning the SEC intends to seek "the full amount of the reimbursement that is required by the statute" not merely the amount by which the executive's compensation was allegedly inflated due to the reporting problem.

It will seek to prevent director and officer insurance policy proceeds from being used to indemnify covered executives for SOX 304 reimbursements.

The Enforcement Division's increased attention to SOX 304 coincides with the Commission's June 2022 announcement that it was reopening the comment period for a new, broader clawback rule, originally proposed in 2015, to implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[3] If adopted as proposed, that rule would require stock exchanges to establish listing standards, effectively requiring public companies to adopt policies to pursue clawbacks from executives under circumstances even broader than what is required under SOX 304.

DOJ's New Focus on Compensation Clawbacks

Likewise, DOJ recently announced its own initiative to encourage companies to claw back executive compensation. As discussed in another OnPoint last month, when announcing revisions to DOJ policies regarding corporate criminal enforcement, Deputy Attorney General ("DAG") Lisa Monaco highlighted individual accountability as a primary focus for DOJ. Among several policy changes, DAG Monaco announced that when evaluating corporate compliance programs for purposes of making charging and settlement decisions, DOJ will now direct prosecutors to assess whether a company's compensation arrangements promote a culture of compliance. Part of that assessment will evaluate whether a company's compensation program has been "crafted in a way that allows for retroactive discipline, including through the use of clawback measures, partial escrowing of compensation, or equivalent arrangements."[4]

But it will not stop there. DAG Monaco instructed that prosecutors "will evaluate what companies say and what they do, including whether, after learning of misconduct, a company actually claws back compensation or otherwise imposes financial penalties."[5] She also announced that she has directed DOJ's Criminal Division to examine ways that it can further incentivize clawback arrangements.

Shortly after DAG Monaco's announcement, Principal Associate Deputy Attorney General ("PADAG") Marshall Miller offered additional color regarding DOJ's new focus on clawbacks: "[a]ll too often [DOJ] see[s] companies scramble to dust off and implement dormant policies once they are in the crosshairs of an investigation."[6] At that point, PADAG Miller indicated, it may be too late: "A paper policy not acted upon will not move the needle—it is really no better than having no policy at all."[7]

DOJ's suggested use of compensation clawbacks would be broader than SOX 304 in two significant ways: First, companies would be expected to implement and enforce clawback provisions that reach a larger swath of executives beyond just the CEO and CFO. Second, these clawbacks would not be limited to financial restatements; they could apply to any and all acts that contribute to criminal misconduct.

Key Considerations Going Forward

The recent SEC Enforcement Division and DOJ announcements provide an important opportunity for the business community to prepare. As PADAG Miller stressed, "[w]hat [DOJ] expect[s] now, in 2022, is that companies will have robust and regularly deployed clawback programs."

All companies operating in an environment with any meaningful enforcement risk should carefully consider how their own compensation programs and executive employment agreements would fare should the company find itself under DOJ scrutiny. If adjustments are warranted, the recent clawback initiatives could afford employers helpful leverage when dealing with employees whose consent may be necessary to make the change. Separately, for companies seeking to comply with the new guidance, a thornier question may be *when* to pursue clawbacks. Indeed, companies often find that the cost of pursuing a clawback action can exceed the amount the company may hope to recover.

For public companies, the SEC's recommitment to SOX 304 enforcement adds another layer of complexity in the personal financial exposure for company leaders. Particularly with an Enforcement Division taking a hard line on SOX 304's reach, companies will want to reassess their Sarbanes-Oxley controls program to ensure that it is functioning properly, with reasonable risks being addressed in a timely fashion.

Finally, in-house legal and compliance professionals should stay tuned for further developments on clawbacks, which we expect are on the way from both agencies. The SEC's reopened rulemaking may result in even broader clawback requirements for public companies, while the Criminal Division is expected to release new clawback-related guidance before the end of the year.

Footnotes:

15 U.S.C. § 7243.

Sanjay Wadhwa, Deputy Director of Enforcement, Remarks at SEC Speaks (Sept. 9, 2022), https://www.sec.gov/news/speech/wadwah-remarks-sec-speaks-090922.

Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation, Release No. 34-95057 (June 8, 2022); *see also* Listing Standards for Recovery of Erroneously Awarded Compensation, Release No. 34-75342 (July 1, 2015).

Lisa Monaco, Deputy Attorney General, Further Revisions to Corporate Criminal Enforcement Policies Following Discussions with Corporate Crime Advisory Group (Sept. 15, 2022), https://www.justice.gov/opa/speech/file/1535301/download.

Lisa Monaco, Deputy Attorney General, Remarks on Corporate Criminal Enforcement (Sept. 15, 2022), https://www.justice.gov/opa/speech/deputy-attorney-general-lisa-o-monaco-delivers-remarks-corporate-criminal-enforcement.

Marshall Miller, Principal Associate Deputy Attorney General, Keynote Address at Global Investigations Review (Sept. 20, 2022), https://www.justice.gov/opa/speech/principal-associate-deputy-attorney-general-marshall-miller-delivers-live-keynote-address.

Id.

Related Professionals

PARTNER

Hartley M.K. West

San Francisco

+1 415 262 4511

Los Angeles

+1 213 808 5716

PARTNER

Andrew S. Boutros

Chicago

+1 312 646 5803

Washington, D.C.

+1 202 261 3349

PARTNER

Anthony S. Kelly

Washington, D.C.

+1 202 261 3495

PARTNER

David N. Kelley

New York

+1 212 698 3580

ASSOCIATE

D. Brett Kohlhofer

Washington, D.C.

+1 202 261 3349