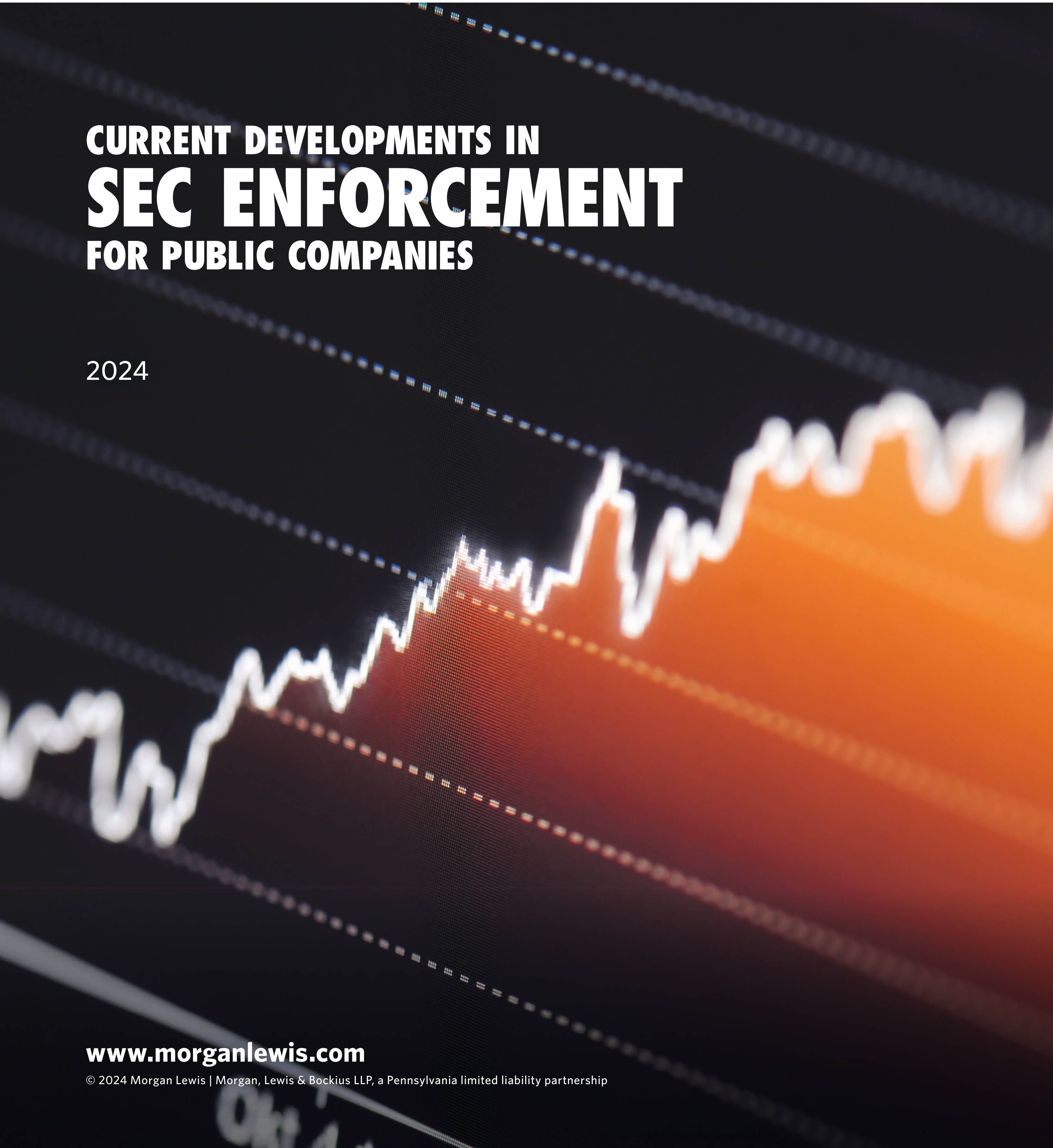
Morgan Lewis

REPORT

CURRENT DEVELOPMENTS IN SEC ENFORCEMENT FOR PUBLIC COMPANIES

2024



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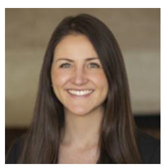

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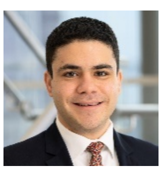

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CURRENT DEVELOPMENTS IN SEC ENFORCEMENT FOR PUBLIC COMPANIES

The US Securities and Exchange Commission (SEC) continued its significant focus on public companies in 2023 with its enforcement and rulemaking programs, and this heightened level of attention will continue throughout 2024.

Recent enforcement activity points to several areas of interest for the SEC—and provides a valuable window for public companies into the SEC's priorities—including the following:

- Civil penalties and disgorgement
- Whistleblowers
- Environmental, social, and governance
- Cybersecurity
- Executive perks
- Rule 10b5-1
- Insider trading
- Reporting of insider stock holdings and transactions
- Section 304(a) clawbacks
- Self-reporting and cooperation
- Crypto
- Disclosure of non-GAAP metrics

Everything Everywhere All at Once

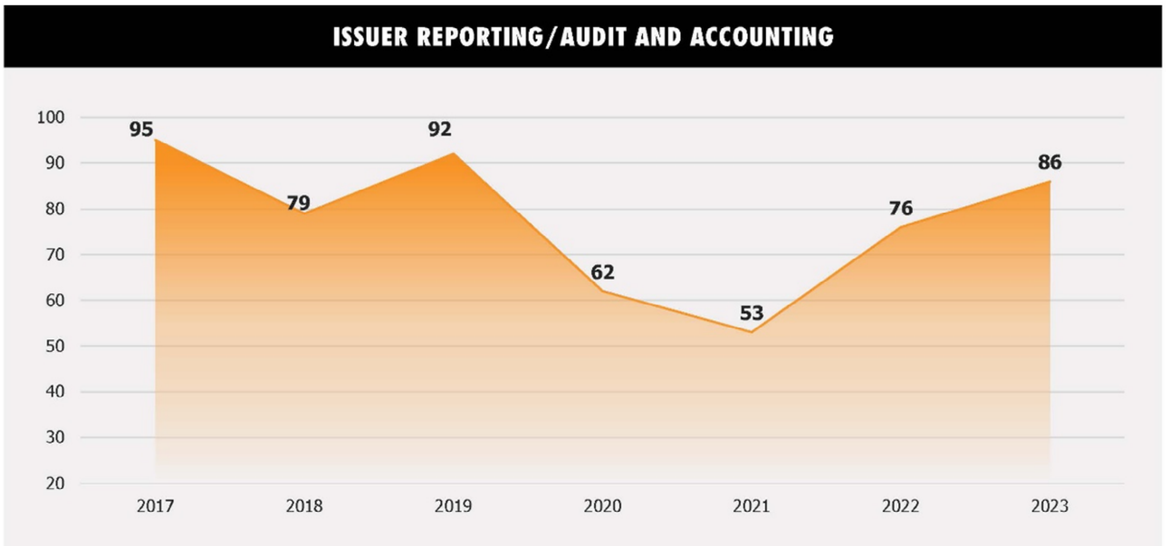
Not unlike the title of the 2023 Best Picture winner, "Everything Everywhere All at Once" is an apt description of the current Enforcement program at the SEC. There does not appear to be an area of the market that the SEC will not attempt to regulate "aggressively." Over the last few years, we have seen the SEC willing to pursue and penalize routine violations.[1] The 2023 statistics released by the SEC's Division of Enforcement continue to reflect aggressive enforcement and outsized civil penalties untethered, in many instances, to past precedent.[2]

While we expect to continue seeing "more of the same" throughout 2024, as the SEC moves assertively, we are seeing an increase in market participants willing to litigate against the agency rather than agree to the SEC's settlement demands. This will likely tie up some of the agency's limited resources in hotly contested litigation and could negatively impact the program, as the SEC risks losing key battles where it has staked a claim. Indeed, the US Supreme Court is currently deciding a case that could greatly limit the SEC's ability to litigate cases in its own administrative forum.

As part of its efforts to be everything, everywhere, all at once, we expect the SEC to continue focusing on its public company enforcement program throughout 2024. This report highlights some of the key cases from the last year as well as our takeaways for the coming year.

Continued Public Company Enforcement Focus

Enforcement actions against public companies jumped significantly in FY 2023 as compared to FY 2022.[3] In FY 2023, the SEC filed 86 actions against public companies, which represents a 13% increase from the prior year and 17% of all enforcement actions brought by the SEC in FY 2023. In September 2023 alone (the final month of the SEC's fiscal year), the SEC filed more than two dozen actions against public companies, which is more than one-third of all cases that it filed in FY 2023. Looking ahead, we expect public companies to continue to be a significant focus of the SEC's enforcement and rulemaking programs throughout FY 2024.



Civil Penalties and Disgorgement

In FY 2023, the SEC obtained more than $4.9 billion in financial remedies, down from the record-setting approximately $6.4 billion in FY 2022, but still the second-highest amount of financial remedies obtained in SEC history. The FY 2023 figure includes nearly $1.6 billion in civil penalties, a 37% decrease from the year prior, and more than $3.3 billion in disgorgement. The civil penalties and disgorgement were also the second-highest amounts on record for the SEC.

TOTAL MONEY ORDERED (IN MILLIONS)*

	FY 2023	FY 2022	FY 2021	FY 2020	FY 2019	FY 2018
Penalties	**$1,580**	$4,194	$1,456	$1,091	$1,101	$1,439
Disgorgement	**$3,369**	$2,245	$2,395	$3,588	$3,248	$2,506
Total	**$4,949**	**$6,439**	**$3,852**	**$4,680**	**$4,349**	**$3,945**

> **Disgorgement totals for 2020 and 2021 have been adjusted to exclude amounts ordered but waived. The currently reported 2020 figure of $3,588 (in millions) was previously reported as $3,589 (in millions). The currently reported 2021 figure of $2,395 (in millions) was previously reported as $2,396 (in millions). No other years were adjusted.*

Despite a year-over-year drop in civil penalties, the SEC continued to impose significant penalties in the hundreds of millions of dollars,[4] untethered to precedent. This more punitive approach is consistent with the Commission's position that higher penalties will deter future wrongdoing, as Director of Enforcement Gurbir Grewal has cautioned that "[m]arket participants must realize that complying with securities laws is cheaper than violating those laws."[5] At the same time, the SEC repeatedly touted instances where it rewarded public companies and registrants for "cooperation" by either reducing or forgoing civil money penalties altogether.

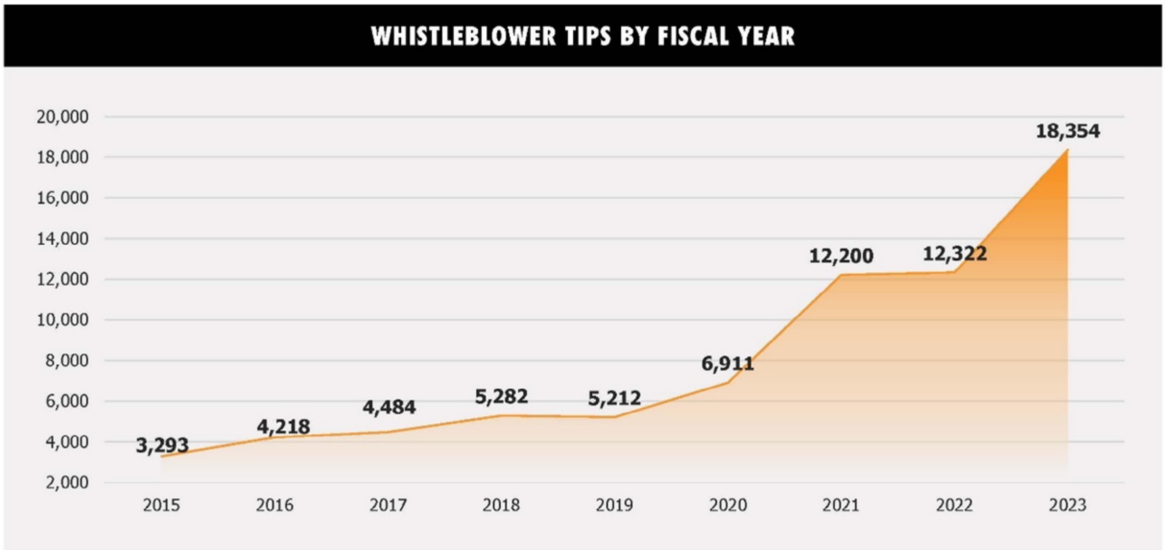
Reinforcing this sentiment in a recent interview with *The Wall Street Journal*, Director Grewal recognized the Commission's "conscious effort over the last two years to make sure the penalties [sought] were having that deterrent effect" and were more than the cost of doing business. However, "moving forward," Director Grewal said that the SEC will be "recalibrating penalties to identify and reward cooperation and remediation."[6] As discussed below, it remains to be seen whether public companies are truly rewarded for the level of cooperation they provide in SEC investigations.

Whistleblower Tips and Awards Continue at Record Levels[7]

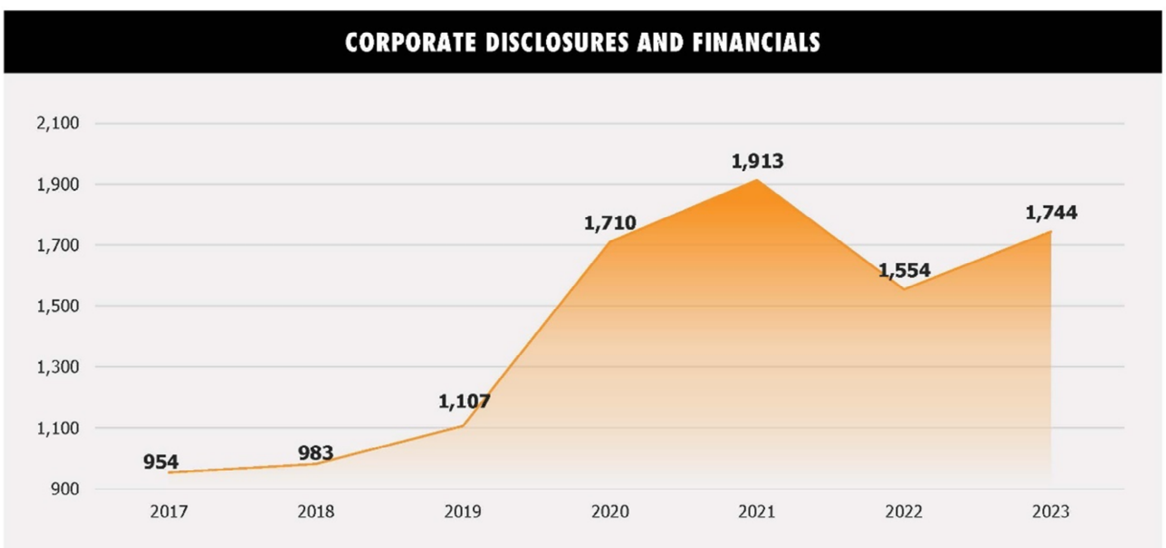
FY 2023 was another record-breaking year for the SEC's whistleblower program. The SEC received 18,000 whistleblower tips—the highest number ever recorded and up significantly from the 12,300 tips the Commission received in 2022. The SEC issued whistleblower awards totaling nearly $600 million, including its largest-ever whistleblower award in May 2023 of nearly $279 million, outstripping the entire prior year's awards and more than doubling the now second-largest award of $114 million from October 2020.[8] It has been publicly reported that the $279 million award related to a whistleblower for a public company/issuer.[9]

Such increased incentives for whistleblowers to come forward was highlighted in the press release announcing the May 2023 award and stated the obvious: the SEC intends such awards to be "a significant incentive for whistleblowers to come forward with accurate information about potential securities law violations." The uptick in whistleblower tips and awards reflects the continued effects of SEC promotion and press releases as well as the substantial financial benefits for whistleblowers and their counsel.

These increases are also reflected in the number of whistleblower allegations categorized by the SEC as relating to corporate disclosures and financial statements.



As a corollary to increased tips and awards, the SEC has aggressively protected the whistleblower process. Over the last year the SEC brought, and will likely continue to bring, enforcement actions to protect whistleblowers' rights and ability to report violations, including those where the SEC believes a company's agreements with employees (e.g., separation agreements or confidentiality agreements) or internal policies impede an employee's ability to report violations. Companies should carefully review their agreements with employees and others to ensure that they are not potentially disincentivizing communications with the SEC about potential securities law violations.[10]



PUBLIC COMPANY AREAS OF FOCUS AND A LOOK AHEAD

Continued Focus on Environmental, Social, and Governance

Environmental, social, and governance (ESG) issues and disclosures were, and continue to be, a leading area of interest for the SEC. The SEC has emphasized that it is neither an environmental regulator nor does it seek to determine what a company's ESG policies should be—instead, the SEC is focused on ensuring companies are truthful in their disclosures on these topics.[11]

With the swift rise in the number of companies disclosing ESG information to investors (who increasingly seek this information), the SEC recently identified two likely risks in making ESG disclosures.[12] In response to increased attention/pressure from investors, companies might (1) exaggerate or make misleading statements about positive ESG developments and/or (2) improperly downplay or omit information about negative ESG developments.[13] The SEC explained that it will evaluate ESG disclosures just as it evaluates all other disclosures: applying "long-standing principles to evaluate whether disclosures or statements are materially false or misleading under the general anti-fraud and other provisions of the federal securities laws."[14]

To that end, in recent remarks Director Grewal highlighted charges against a Brazilian mining company in which the SEC alleged the company made regular representations that one of its dams (which collapsed in 2019) was safe and stable and concealed evidence that it was not causing its public statements to be materially false and misleading.[15] Director Grewal also pointed to disclosures by another company that disclosed its former CEO was terminated "without cause" when in fact the CEO was terminated for poor judgment and an inappropriate personal relationship with an employee. The company exercised its discretion in terminating the CEO "without cause," which allowed the former CEO to retain stock-based compensation.[16]

In addition to exercising caution in making ESG-related statements about company operations, companies must also be careful in the creation and maintenance of ESG-branded investment products. Last fall, the SEC charged a bank subsidiary with making materially misleading statements when it had advertised specific ESG-branded products in marketing materials when the firm did not actually follow all aspects of the ESG investment processes marketed.[17]

SEC Final Rules on Climate-Related Disclosures: Scaled Back But Still Significant

More than two years after the SEC first proposed the rules, the Commission adopted rules to enhance and standardize public companies' climate-related disclosures on March 6, 2024.[18] While the final rules are less aggressive than the proposed rules, there are still not insubstantial requirements that public companies will be required to follow. For a more detailed comparison of the proposed and final rules, refer to our March 2024 LawFlash SEC Adopts Climate-Related Disclosure Rules.

Under the final rules, public companies will be required to make the following disclosures:

- **Climate-Related Risk Disclosures**: Public companies must now disclose (1) climate-related risks that materially impact (or are reasonably likely to have a material impact on) the company's strategy, results of operations, and financial condition; (2) the actual or potential material impacts of those risks on its strategy, business model, and outlook; (3) any activities to mitigate or adapt to material climate-related risks or use of transition plans, scenario analyses, or internal carbon prices to manage material climate-related risks; (4) any oversight of climate-related risks by the board of directors; (5) any role by management in assessing and managing material climate-related risks; (6) any processes used to assess or manage material climate-related risks;

and (7) any targets or goals that have materially affected or are reasonably likely to materially affect the business, results of operations, or financial condition.[19]

- **Greenhouse Gas (GHG) Emissions Disclosures**: Larger public companies must disclose material Scope 1 emissions (emissions directly produced from business operations) and material Scope 2 emissions (energy purchased to run the business).[20]
- **Financial Statement Disclosures**: Public companies' financial statements will need to include the costs, expenses, and losses incurred as a result of severe weather and other natural conditions. Companies must also disclose if estimates and assumptions used to produce financial statements were materially impacted by risks and uncertainties associated with severe weather and other natural conditions. Companies will also need to disclose the costs, expenses, and losses related to carbon offsets and renewable energy credits or certificates if used as a material component of plans to reach disclosed climate-related targets or goals.[21]

The financial statement disclosures will be subject to existing financial statement audit requirements. For GHG emission disclosures, limited assurance review checks will be permitted for the first few years, after which time companies will need to provide a more thorough review (a reasonable assurance) in the accuracy of the reported emissions.[22]

While the final rules become effective 60 days after publication in the *Federal Register*, compliance will be phased in based on company size. For large accelerated filers, the first disclosure requirements will be in effect for Forms 10-K for the fiscal year ended December 31, 2025. Accelerated filers will have certain disclosure requirements beginning in 2026, while smaller reporting companies, emerging growth companies, and nonaccelerated filers will have until 2027 before any disclosure requirements are triggered.

The SEC's new rules passed on a 3-2 vote with dissents from the two Republican Commissioners. Within hours of being passed, the rules were challenged by multiple state attorneys general.[23] As such, it remains to be seen whether the rules will survive legal challenge.

Cybersecurity: New Rules Will Lead to Increased Enforcement Attention

The SEC's increasing focus on cybersecurity controls and disclosures continued throughout FY 2023, and with the new disclosure rules now in place, we expect to see a further uptick in cybersecurity-related enforcement activity in the coming year.

SEC Adopts Wide-Ranging Cybersecurity Disclosure Rule

In July 2023, the SEC adopted final rules and amendments (the Final Rule) for mandating disclosure regarding cybersecurity risk management, strategy, governance, and incident reporting, including amendments to Forms 8-K, 6-K, 10-K, and 20-F. Among other things, the Final Rule requires current reporting about material cybersecurity incidents on Form 8-K and certain expanded standardized cybersecurity-related disclosures and assessments in annual reports.[24] For a robust discussion of the Final Rule, refer to our August 2023 LawFlash SEC Adopts Rules on Mandatory Cybersecurity Disclosures.

Some key features of the Final Rule include

- a requirement that there be prompt assessment of materiality from a disclosure perspective;
- a requirement that disclosure be made within four business days of the intrusion, if the intrusion is deemed by the company to be material; and
- a requirement to disclose annually information regarding cybersecurity risk management, strategy, and governance.

Companies can avail themselves of an extremely limited exception to the four business-day deadline under the new Form 8-K requirement: disclosure may be delayed if the US Attorney General determines that immediate disclosure would pose a substantial risk to national security or public safety and notifies the SEC of such determination in writing. On December 12, 2023, the US Department of Justice (DOJ) issued departmental guidelines on material cybersecurity incident delay determinations.[25]

Notably, the DOJ's view is that "[t]ypically[] registrants will be able to publicly disclose this material information at a level of generality that does not pose a substantial risk to national security or public safety," but the guidance does provide examples of where a delay in reporting may be warranted.[26] Companies are to direct their requests to delay reporting to the FBI, which agency also recently issued a Policy Notice describing the process it will follow for handling such requests.[27]

Internal Controls over Reporting: Cybersecurity Incidents

Similar to efforts in the ESG space, the SEC has advanced internal controls charges in an effort to regulate by enforcement the disclosure of cybersecurity incidents.

In March 2023, the SEC filed a settled case against a public company for alleged misleading statements and disclosures about a 2020 ransomware attack.[28] The SEC identified statements posted on the company's website, and communications sent to customers after the breach, disclosing that the ransomware attacker did not access donor bank account information or social security numbers. However, the SEC alleged that, within days, the company's technology and customer relations personnel learned that the attacker had in fact accessed this sensitive information. The SEC focused on the alleged failure of employees to communicate this information to senior management responsible for its public disclosure and alleged the failure was due to inadequate disclosure controls and procedures. The company agreed to pay a $3 million civil penalty without admitting or denying the SEC's allegations.[29]

In October 2023 the SEC filed a federal court action against a public company and its Chief Information Security Officer (CISO) for intentional (not negligence-based) fraud and internal control failures.[30] The SEC alleges that from at least its initial public offering in October 2018 until December 2020, when the company announced that it was the target of a massive cyberattack, the company and its CISO defrauded investors by overstating the company's cybersecurity practices and understating or failing to disclose known risks.[31]

According to the SEC, employees were internally identifying key vulnerabilities for critical assets and questioning the company's ability to protect its critical assets, but publicly the company misled investors by disclosing only generic and hypothetical cybersecurity risks.[32] Director Grewal warned that this action "underscores [the SEC's] message to issuers: implement strong controls calibrated to your risk environments and level with investors about known concerns."[33]

To prepare for the SEC's heightened scrutiny of cybersecurity incidents and the newly adopted SEC rules, public companies should consider the following proactive steps:

- Review, assess, and update existing cybersecurity-related policies and procedures to ensure that they provide effective protection against cybersecurity breaches and identify gaps that should be remediated.
- Review and assess the company's corporate governance structure and risk management framework to identify areas of focus and improvement.
- Review and implement disclosure control procedures to ensure that cybersecurity incidents can be identified and communicated quickly to appropriate personnel who can make disclosure decisions to mitigate enforcement risk in the event of delayed disclosure.

The SEC's Ongoing and Aggressive Investigation of a Law Firm Hack

In January 2023, the SEC filed a subpoena enforcement action against a law firm seeking the names of its clients affected by a cybersecurity intrusion at the firm, demonstrating one of the many securities law issues that can surround such an event. The SEC investigation involved a cyberattack that the SEC contended began around November 2020 and continued into at least March 2021.[34] The law firm, unquestionably a victim of the hack, conceded that certain clients' information was compromised. The SEC demanded the affected client names from the law firm, arguing that the information was necessary to "understand the nature and scope of the attack," "assess and identify potential illegal trading based on information gathered during the attack," and "determine relevant disclosure obligations for public companies impacted by the attack."[35]

The insider trading aspect of the investigation is interesting, but companies should pay particular attention to the SEC's emphasis on the disclosure obligations, which are further reflected in the new rules described above.

On May 9, 2023, the US District Court for the District of Columbia heard argument on the SEC's motion to compel and 83 law firms filed amici in opposition to the SEC's request. The court gave the SEC a partial victory on July 24, 2023, ordering the law firm to "disclose the names of the seven clients as to whom it has not been able to rule out the threat actor accessed material nonpublic information."[36] The law firm agreed to share six of the seven client names, but the seventh client objected to the release of its name and indicated plans to intervene to pursue an appeal before dropping its challenge.[37]

Executive Perquisites: A Point of Enforcement Emphasis

As part of a continued focus on "gatekeepers" by the SEC, perquisites and perquisite disclosure remain a priority for enforcement. In recent cases, the SEC has found that use of a company car, personal services provided by company personnel, personal security, and certain travel expenses are perquisites that must be disclosed.

- In March 2023, the SEC filed a settled administrative action against a company and its founder and former CEO for failing to disclose perks provided to the CEO and other executives.[38] The CEO owned a private aircraft that he leased through a management company. The company leased the aircraft from the management company, resulting in $3 million in payments of which an undisclosed $1.6 million went to the CEO. The SEC also identified several categories of undisclosed perquisites and personal benefits such as use of a company car, financial advisors, club dues, a one-time medical expense, spousal travel expenses, and expenses for personal security that "was not directly and integrally related to the performance of [the CEO's] and certain other [executives'] duties." The SEC alleged that the company made material misstatements in public filings and lacked necessary internal controls. The company neither admitted nor denied the SEC's allegations and agreed to pay a $1 million civil penalty.
- In a June 2023 settled administrative proceeding, the SEC charged a public company with the failure to properly disclose executive compensation in definitive proxy statements.[39] The action focused on expenses associated with executives' use of the corporate aircraft. Without admitting or denying the allegations, the company agreed to a cease-and-desist order relating to violations of Section 14(a) of the Securities Exchange Act of 1934 (the Exchange Act) regarding proxy solicitation, Section 13(a) of the Exchange Act concerning the filing of periodic reports with the SEC, and Rule 12b-20 under the Exchange Act regarding the disclosure of material information. Because the company self-reported the issues and cooperated with the investigation, the SEC declined to seek a civil penalty.

However, one executive recipient of the perks was separately charged with violations of Section 14(a) of the Exchange Act and for causing the company to violate Section 13(b)(2)(A) of the Exchange Act regarding accurate books and records.[40] The SEC alleged that the executive failed to disclose perquisites that included chauffer services, meals, apparel, car repair services, use of the corporate aircraft, and other authorized items, such as personal services provided by company employees and certain gifts and products. Without admitting or denying the allegations, and despite reimbursing the company for personal expenses, the executive settled the action and paid a civil penalty of $75,000.

10b5-1 Plans – New Rules and Increased Scrutiny

Amendments to Rule 10b5-1: SEC Focus on Perceived Loopholes

In December 2022, the SEC adopted amendments to Rule 10b5-1.[41] Chief among the changes was the addition of lengthy "cooling-off" periods before any trading may begin under a plan. The rule's good-faith requirement also was modified to require plan participants to certify that they are acting in good faith and have no material nonpublic information (MNPI). The amendments also set forth additional public disclosures for issuers, directors, officers, and Form 4 and 5 filers. Among the new requirements, issuers must disclose quarterly whether any 10b5-1 plans or other trading arrangements have been adopted, modified, or terminated in the prior period as well as the material terms of each such plan.[42]

Increased Enforcement Activity

With the new rules there was also enforcement activity, and we expect this to continue.

10b5-1 Plans Are Not Absolute Safe Havens: The SEC charged the executive chairman of a healthcare treatment company with insider trading for selling more than $20 million of company stock while in possession of negative MNPI relating to the company's largest customer.[43] In this previously rare action stemming from an alleged improperly established 10b5-1 trading plan, the SEC claimed that the chairman improperly set up his trading plan, while aware of a likely termination by a large customer, and avoided more than $12 million in losses. Particularly in light of the recent amendments to Rule 10b5-1, we expect increased scrutiny of preset trading plans and an expanding view of what constitutes MNPI. We will continue to monitor this case throughout the litigation to see if the SEC can prove its allegations.

Internal Controls Surrounding Buybacks and 10b5-1 Plans: The SEC announced a settled action in November 2023 regarding a company's use of a Rule 10b5-1 trading plan for stock buybacks, assessing a $25 million penalty against the company.[44] In the administrative order, the SEC asserted that the company's board of directors had authorized stock buybacks in accordance with Rule 10b5-1. However, the SEC contended that the trading plans improperly "included 'accordion' provisions, which company personnel described as giving [the entity] flexibility, that allowed [the entity] to change the total dollar amounts available to buy back stock and to change the timing of buybacks after the plans took effect."[45] This led the SEC to conclude that the plans did not satisfy Rule 10b5-1 and were effectively unauthorized because the company acted inconsistently with the board's authorization.

That is where the action gets interesting. The SEC did not allege insider trading or a fraud in connection with the offer, purchase, or sale of a security. Continuing a trend that we have seen in cyber and ESG-related cases, among others, the SEC once again relied on an internal controls theory pursuant to Section 13(b)(2)(B) of the Exchange Act. The company allegedly failed to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that its repurchases were executed and access to its assets was permitted only in accordance with the Board's authorizations." The board's authorizations for these buybacks were predicated on the company's use of trading plans that comport with Rule 10b5-1. According to the SEC, the company did not have controls that reasonably assured that the company used trading plans in accordance with these authorizations. Melissa Hodgman, Associate Director in the SEC's Division of Enforcement, stated that "[c]ompanies whose boards authorize buybacks using Rule 10b5-1 plans must have controls that reasonably assure that their trading plans meet all of the rule's conditions. . . . This includes the fundamental requirement that, to benefit from the protection of Rule 10b5-1, traders have to relinquish their ability to influence the amount or timing of trades after their trading plans go into effect."

The SEC's settlement was controversial within the ranks of the Commission. The two Republican Commissioners issued a statement criticizing the settlement and the apparent expansion of the internal control provision at issue in the case. Per that statement, the settlement is "the latest example of the Commission's unmooring of Section 13(b)(2)(B) from its statutory text and context to extend the reach of its jurisdiction."[46] The two Commissioners further criticized the settlement because of "its failure to distinguish between internal *accounting* controls and other types of internal controls. . . . Controls designed to answer a *legal* question—compliance with the regulatory conditions necessary to qualify for an affirmative defense—are simply not internal *accounting* controls within Section 13(b)(2)(B)'s scope."[47]

Insider Trading Continues to Be a Focus

Insider trading continued to be a priority for the SEC during 2023 and the first part of FY 2024. Recent cases only add to a growing list of actions, including those against senior executives and public company officers, aimed at holding alleged bad actors accountable for the misuse of MNPI. The SEC filed 23 insider trading civil actions and nine standalone administrative proceedings in FY 2023, which included 11 cases focused on ownership reports that company insiders are required to file regarding their holdings of company stock and five matters involving publicly traded companies contributing to the filing failures by insiders or failing to report their insiders' filing delinquencies.

- **Data Analytics and Technology Used to Identify Unusual and Suspicious Trading Patterns for "Gatekeepers":** The SEC filed four civil complaints in the US District Court for the Southern District of New York alleging insider trading by 13 defendants who collectively made more than $30 million dollars from their allegedly illegal trading.[48] Simultaneously, the US Attorney's Office for the Southern District of New York announced charges in four criminal actions arising from the same conduct. According to the SEC and DOJ, the cases targeted "gatekeepers" whom the SEC has previously described as those individuals who "are often the first lines of defense against misconduct."[49] The named defendants included a chief compliance officer, a board member, a veteran registered broker-dealer, and a police chief—all gatekeepers in various public sectors. These cases reinforce the SEC's focus on gatekeepers, and by filing them all on the same day (akin to a sweep) and in coordination with the DOJ, the government was sending a message that it remains committed to pursuing insider trading charges wherever they may exist (and sweeps and coordinated actions where appropriate). Director Grewal also specifically referenced the Commission's use of "data analytics initiatives" and "leveraging all the tools at [its] disposal . . . to investigate [] abusive trading practices" in the press release announcing the four insider trading actions, reinforcing the SEC's continued prioritization and use of data analytics to identify unusual and suspicious trading patterns for potential misconduct.[50]
- **Tippee Liability Without a Tipper:** While tippee liability is generally derivative of claims against a tipper, a January 2023 jury verdict in the Northern District of Illinois found an alleged tipper **not guilty** while simultaneously finding the alleged tippee **guilty** of insider trading.[51] We provide a more in-depth analysis of this in our March 2023 LawFlash.[52] The tippee defendant filed a motion that he also be acquitted or alternatively afforded a new trial.[53] Recently, the court agreed with the tippee and dismissed the case against him.[54] In the meantime, this case further demonstrates the government's continued aggressive pursuit of alleged insider traders, even those who did not profit significantly from their conduct.

Going Forward

Insider trading will continue to be a priority for the SEC going forward, and public companies should consider the following actions:

- Revisiting insider trading policies and procedures, particularly in light of the amendments to Rule 10b5-1 and in consideration of the fact that it is often a company's policies and procedures that the SEC will cite as evidence that defendant insiders misused MNPI.
- Conducting routine training to educate insiders and employees on the nuances of insider trading policies and monitoring for potential violations.
- Reviewing policies regarding chats and text messages, as these "off-channel" platforms are not immune from SEC collection and review during investigations and are often key evidence for the government.

Timely Reporting of Insider Stock Holdings and Transactions

In what was described as an "ongoing investigation of potential beneficial ownership violations," the SEC announced in September 2023 a series of enforcement actions against five public companies and six insiders in connection with failures to timely file Forms 4 and Schedules 13D and 13G reports related to stock transactions by executives, directors, and beneficial owners.[55]

Corporate officers, directors, and certain beneficial owners of more than 10% of a company's stock are required to use Form 4 to report their company stock transactions. Beneficial owners of more than 5% of a company's stock must use Schedule 13D and 13G reports to report their holdings and intentions with respect to the company. In these actions, the SEC further alleged that "[r]eporting issuers are required to disclose in the proxy statement for the issuer's annual meeting, or its annual report, Section 16 reporting delinquencies by its insiders."[56]

According to the SEC, the Staff used "data analytics to identify the charged insiders as repeatedly filing these reports late," with some filings being "delayed by weeks, months, or even years."[57] The actions documented a number of instances where reports were untimely, leaving the impression that the companies viewed the reporting as unimportant. The SEC sent a clear message that late filings, and the alleged deficient processes that caused the late filings, will not be tolerated with both the insiders and their public companies held responsible.

Further, while the individual insider "retains legal responsibility for compliance with the filing requirements, including the obligation to assure that the filing is timely and accurately made," the Director of Enforcement emphasized that "[t]hese enforcement actions also make clear that [the SEC] will not hesitate to charge companies *for causing* their insiders' disclosure violations where the companies took on the responsibility for making relevant filings for their insiders, and then acted negligently" (emphasis added).[58]

For example, in one of these matters, the SEC alleged that the issuer had voluntarily agreed with its officers and directors to perform certain tasks such as the preparation and filing of Section 16(a) reports. However, the SEC alleged that "for virtually all of the[] late-reported transactions, [the issuer] had received timely notification of or otherwise possessed the necessary information for such filings but failed to prepare and file the reports within the required time frame."

Accordingly, the SEC concluded that the issuer acted negligently, and its "procedures and practices . . . were insufficient to the extent that those practices resulted in the recurrent failure to meet the two-business-day filing deadline."[59]

SOX 304 Clawbacks

Aggressive Approach to Clawbacks of Executive Compensation

Section 304 of Sarbanes-Oxley (SOX 304) allows an issuer that has filed a restatement as the result of misconduct to seek reimbursement of any bonus or other incentive-based or equity-based compensation received by a CEO or CFO. The SEC has been invoking this provision more aggressively to force reimbursement where companies are charged with securities law violations but neither the CEO nor CFO are "charged under any additional provisions."[60]

According to the SEC, clawbacks "provide a form of public accountability for senior executives" by incentivizing them to prevent and detect misconduct that would require a financial restatement.[61] Further, the SEC will seek the "full amount of the reimbursement that is required by the statute" and not just the amount of additional compensation the CEO or CFO may have received as a result of the misconduct.[62] In the past, the financial remedy was often just the so-called "fraud delta" and not the entire amount of the executive's compensation.

For example, a final judgment was entered in which the SEC brought charges against a company and four former company executives, including the former CEO, alleging that the defendants falsely inflated the company's revenue by approximately $100 million and concealed their theft of millions of dollars from the company.[63] The final judgment ordered the former CEO to pay $1,116,987.27 in disgorgement plus $194,835.52 in prejudgment interest, for a total of $1,311,822.79, as well as to reimburse the company $1,206,626 pursuant to SOX 304. The SEC's ongoing litigation against the other defendants remains pending.

The SEC's New Rule 10D-1 Imposes Clawback Obligations on Companies

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act added Section 10D to the Exchange Act, requiring the SEC to adopt rules for national securities exchanges directing issuers to adopt and comply with a clawback policy. In October 2022, the SEC announced Rule 10D-1, which would significantly alter the corporate landscape on clawbacks.[64] Rule 10D-1 became effective on January 27, 2023.

The new rule is significantly broader in scope than SOX 304 in many ways:

- It provides for company enforcement, whereas only the SEC has enforcement power under SOX 304.
- It encompasses all executive officers (not just the CEO and CFO as under SOX 304) and requires the clawback of incentive-based compensation in the event of any type of restatement, regardless of misconduct, received during the three-year period preceding the date the issuer is required to prepare the accounting restatement.
- It mandates that issuers develop, implement, and disclose a clawback policy as well as disclose all clawbacks that occur as a result of violations of that policy.
- Noncompliance may result in an issuer being delisted from its national securities exchange as well as a potential SEC enforcement action.[65] In this regard, Director Grewal recently warned "[e]xecutives should be on notice that we view SOX 304 as broad authority in seeking all forms of compensation that should be reimbursed to the company."[66]

Notably, the amounts recovered under SOX 304 may be credited to reduce the amount required to be recovered under Rule 10D-1; however, the adopting release clarifies that recovery under Rule 10D-1 does not preclude recovery under SOX 304 to the extent any applicable amounts have not been reimbursed to the issuer. Indeed, SEC Chairman Gary Gensler has reiterated that Rule 10D-1 "will strengthen the transparency and quality of corporate financial statements, investor confidence in those statements, and the accountability of corporate executives to investors."[67]

Self-Reporting and Cooperation

While only 3% of public companies subject to SEC enforcement actions in FY 2023 avoided the imposition of a civil penalty, the Division of Enforcement has continued to reiterate the importance of cooperation, self-reporting, and self-policing as well as the positive outcomes such acts can bring.[68] In the past, Director Grewal has not precisely articulated what benefits self-reporters will receive from the Commission other than vague notions of "something less" than a respondent that did not self-report or meaningfully cooperate.[69] However, in a flurry of cases filed during FY 2023, the SEC is making attempts to provide more concrete insight into what type of cooperation may be required to either reduce or avoid a civil money penalty.

Enforcement Actions Crediting Self-Reporting and Cooperation

In June 2023, the SEC alleged that a company had failed to disclose $1.3 million worth of perquisites it provided to certain executives, but ultimately settled the matter without requiring the company to pay a monetary penalty, remarking that the company had self-reported the conduct, implemented remedial measures, and cooperated with the SEC's investigation. Shortly after the settlement, the SEC similarly did not impose a penalty against several additional settling respondents in other actions because those companies also cooperated with the SEC's investigation.[70] The SEC credited these companies for:

- "After learning of potential misconduct . . . [acting] to ensure that outside counsel conducted an internal investigation under the direction and oversight of a Special Committee of independent directors";
- "Providing [SEC] staff with detailed explanations and summaries of specific factual issues at all stages of the staff's investigation";
- Before finishing the internal investigation, self-reporting its failure to disclose perquisites to the SEC and providing the SEC with findings from its internal investigation and other relevant documents;
- Identifying documents and making witnesses available for both informal interviews and subpoenaed testimony; and
- Implementing "remedial measures designed to ensure compliance with Item 402 of Regulation S-K and Commission guidance" and making disclosures about the previously undisclosed perquisites.

SEC Checklist for Cooperation

One of the most difficult decisions a company under investigation must make is whether, and to what extent, cooperation is appropriate. When making that decision, it is important to understand what the SEC is seeking.

Recent settlements have identified a number of steps that merited cooperation credit, including the following actions:

- Identifying documents and making witnesses available for both informal interviews and subpoenaed testimony
- Promptly retaining outside counsel to conduct internal investigations

- Maintaining the independence of any investigation by having a board committee or other designated committee oversee the investigation
- Self-reporting the underlying issues and presenting the results of the internal investigation to the SEC
- Cooperating fully with the SEC's investigation and affirmatively indicating a desire to cooperate
- Furnishing SEC Staff with analyses and/or findings of any outside consultants retained to assist with the company's investigation
- Providing SEC Staff with summaries of specific factual issues during the staff's investigation while also taking steps to preserve any applicable privileges
- Proactively identifying key documents and witnesses for SEC Staff and making those witnesses available for interviews/testimony
- Promptly following up on the SEC's requests and keeping the staff informed of the company's progress in responding to those requests
- Periodically asking SEC Staff whether they believe the company is being cooperative

Notably, however, SEC Staff still has a tremendous amount of discretion in determining whether to seek a penalty and how to credit cooperation, which may be, at least in part, why a significant perception gap in the value of cooperation still seems to exist between the Commission and companies considering the benefits of significant cooperation.

Cryptoassets: Emphasis on Disclosures

In the beginning of FY 2023, only about a month after a prominent centralized cryptocurrency exchange specializing in derivatives and leveraged products filed for bankruptcy, the SEC's Division of Corporation Finance published informal guidance[71] on how public companies may be asked to address the possible impact of financial distress in the cryptoasset market. The guidance includes a "sample" crypto-specific comment letter focused on disclosure that public companies should consider providing in filings made under the Securities Act of 1933 and the Exchange Act.[72]

While the guidance does not create new disclosure requirements, the sample letter provides insight into the Staff's scrutiny of the cryptoasset market and outlines its significant concerns about the possible impact of crypto market volatility on investors and reporting companies.[73] For a more fulsome discussion of the sample letter guidance, see our December 2022 blog post Public Companies: Consider Updating Disclosures to Reflect Risks Posed by Cryptoasset Markets.

To meet their disclosure requirements, companies must address cryptoasset market developments and their material impact on the company's business in company filings, including in business descriptions, risk factors, and management discussions and analyses.[74] Examples of potential areas that may be impacted materially by volatility in the cryptoasset market include companies' liquidity, ability to obtain financing, and legal and litigation risks.

Companies must proactively assess exposure and risks in these and other areas and issue appropriate disclosures, including about the potential risks to their investors. Failure to make adequate disclosures can land companies in hot water,[75] and the recently issued guidance is an indicator that there will be increased regulatory scrutiny and potential enforcement in this area.

Crypto continued to remain a top priority for the SEC throughout FY 2023. In March 2023, the SEC's Office of Investor Education and Advocacy released an Investor Alert, *Exercise Caution with Crypto Asset Securities*, warning investors of the volatile and speculative nature of crypto asset securities investments and explaining that the offerings may not be compliant with the applicable securities laws, which could potentially deprive investors of key information or other protections that are associated with other investments subject to SEC enforcement.[76]

Disclosure of Non-GAAP Metrics

The SEC's increased use of data analytics and the prevalence of industry sweeps will likely lead to more enforcement actions based on allegedly misleading disclosures of non-GAAP metrics, that is, numerical measures of performance, financial position, or cash flows that are not calculated in accordance with generally accepted accounting principles (GAAP).[77]

In December 2022, the SEC's Division of Corporation Finance updated its Compliance & Disclosure Interpretations related to rules and regulations governing the use of non-GAAP financial measures, including those related to public companies' use of potentially misleading non-GAAP financial measures.[78] The guidance explains factors the SEC will consider when evaluating whether a non-GAAP measure is misleading including, for example, the nature and effect of the non-GAAP adjustment and how it relates to the company's operations, revenue-generating activities, business strategy, industry, and regulatory environment.[79]

Only three months after the updated guidance was issued, the SEC settled an enforcement action involving an $8 million penalty against an IT services company that allegedly made misleading disclosures about its non-GAAP financial performance that the SEC viewed as inconsistent with the company's public description of the costs that were subject to those non-GAAP adjustments.[80] More recently, the SEC announced a $12.5 million penalty against a consumer products company and a $110,000 penalty against its former CEO in connection with misleading investors about the company's core sales growth, a non-GAAP financial measure. [81]

According to the SEC, the disclosure was misleading because the company did not also disclose that the core sales growth rate was higher because of actions taken by the company that were unrelated to its actual underlying sales trends. Such actions allegedly included approving plans to pull forward sales from future quarters, asking employees to examine accruals established for customer promotions in order to determine if they could be reduced, and agreeing with decisions to reclassify consideration payable to customers that resulted in the value of that consideration not being deducted as required under GAAP.[82]

CONCLUSION

As noted above, we expect the SEC to continue to take an aggressive approach to enforcement as the year progresses. The SEC has increased resources and at least a majority of commissioners apparently are willing to take more aggressive approaches on legal theories and remedies.

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