Top 5 SEC Enforcement Developments

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In order to provide an overview for busy in-house counsel and compliance professionals, we summarize below some of the most important SEC enforcement developments from the past month, with links to primary sources. The past month has been another busy one for both SEC enforcement and regulation, including record-breaking penalties and the first Reg BI enforcement action. Here, we examine the following:

- The SEC's clawback of profits under SOX Section 304 absent allegations of misconduct;
- The SEC's crackdown on allegedly hidden robo-advisor fees;
- How the SEC is enforcing the "best interest" standard under Reg BI;
- The SEC's imposition of penalties for allegedly failing to include a whistleblower carve-out in employment agreements; and
- Whether there exists a duty to correct a response to a voluntary SEC information request.

1. The SEC Claws Back Profits from a CEO Without Charging Individual Misconduct

On June 7, 2022, the SEC filed charges against New Jersey-based Synchronoss Technologies, Inc. and seven employees, including the former CFO and General Counsel, over long-running accounting improprieties from 2013 to 2017. The company settled scienter-based fraud charges and agreed to pay a civil penalty of $12.5 million. The former General Counsel settled charges for misleading auditors in two transactions and causing the company's violations of certain reporting provisions under Sections 13(a) and 13(b)(2)(A) of the Securities Exchange Act of 1934 ("Exchange Act"). Although several former and current employees of the company settled with the SEC, the former CFO and Controller are litigating in federal district court in the Southern District of New York.

The SEC also took the somewhat unusual step of pursuing clawbacks from the company's former CEO for violations of Section 304 of the Sarbanes-Oxley Act of 2022 ("SOX"), despite not charging him with misconduct. Section 304 does not require that the CEO engage in misconduct to trigger its reimbursement requirement. Under this section, CEOs and CFOs can be required to reimburse the company for certain compensation received in years which the issuer was required to prepare an accounting restatement due to the issuer's "material noncompliance" with its financial reporting requirements under the federal securities laws. The former Synchronoss CEO agreed to reimburse the company for more than $1.3 million in stock sale profits and bonuses and to return previously granted shares of company stock.

This is not the first time the SEC has pursued no-fault clawbacks against an issuer's CEO or CFO. Several courts have held that Section 304's disgorgement remedy applies regardless of whether a restatement was caused by the CEO's or CFO's personal misconduct. [1] According to Enforcement Director Gurbir Grewal, this case should put "public company executives on notice that even when they are not charged with having a role in the misconduct at issue, [the SEC] will still pursue clawbacks of compensation under [the Sarbanes-Oxley Act] to ensure they do not financially benefit from their company's improper accounting."

2. The SEC Charged Three Schwab Subsidiaries for Hidden Robo-Adviser Fees

On June 12, 2022, the SEC brought a settled administrative proceeding against three Charles Schwab subsidiaries for $187 million in civil penalties over their alleged failure to disclose "that they were allocating client funds in a manner that their own internal analyses showed would be less profitable for their clients under most market conditions." According to the settled order, from 2015 through 2018, Schwab investment advisor subsidiaries made false and misleading statements in their Form ADV filings by representing that the amount of cash in robo-advisers' portfolios was determined through a "disciplined portfolio construction methodology" that would seek "optimal returns" for customers, when in reality, Schwab's own data showed that under most market conditions, the cash in the portfolios would cause investors to make less money even while taking the same risk.

The SEC claimed Schwab advertised the robo-adviser as having neither advisory nor hidden fees but didn't tell clients about the "cash drag" on their investment. The SEC alleged that Schwab profited by loaning out the cash at higher interest rates than it paid to the robo-adviser clients. The order further alleges that Schwab's disclosures contained false and misleading statements about Schwab's conflict of interest in setting the cash allocation at a certain level and the effect of the cash allocations on investor returns.

"Schwab claimed that the amount of cash in its robo-adviser portfolios was decided by sophisticated economic algorithms meant to optimize its clients' returns when in reality it was decided by how much money the company wanted to make," said Grewal. This echoes SEC Chair Gary Gensler's statements last year during his Prepared Remarks at DC Fintech Week, where he questioned whether robo-advisor "platforms [are] solely optimizing for our returns as investors . . . [o]r are they also optimizing for other factors, including their revenues?"

3. The SEC Brings Its First Reg BI Enforcement Action

On June 16, 2022, the SEC brought its first Reg BI action, charging Pasadena, California-based registered broker-dealer Western International Securities, Inc. and five of its brokers with violating the Best Interest Obligation under Rule 15*l*-1(a) of the Exchange Act. In its complaint, the SEC

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[1] *See, e.g.*, *SEC v. Jensen*, 835 F.3d 1100 (9th Cir. 2016); *SEC v. Jenkins*, 718 F. Supp. 2d 1070 (D. Ariz. 2010).

alleges that the defendants sold $13.3 million of high-risk and illiquid “L bonds” to retirees and other retail investors with conservative risk tolerances who lacked substantial financial resources. This case was brought in federal district court in the Central District of California and is unresolved.

First adopted in June 2019, Reg BI requires broker-dealers and their reps to act in the best interest of retail customers when recommending a security. To fulfill its Reg BI obligations, a firm must meet four component obligations: the “Disclosure Obligation,” the “Care Obligation,” the “Conflict of Interest Obligation,” and the “Compliance Obligation.”

The SEC alleges Western failed to comply with its Care and Compliance Obligations. Specifically, the SEC alleges Western did not meet its Care Obligation by failing to exercise reasonable diligence to understand the risks associated with the L Bonds and by recommending these allegedly risky, illiquid securities, which were described in their prospectus as suitable only for persons with “substantial financial resources and with no need for liquidity in this investment,” to at least seven retail customers without a reasonable basis to believe the bonds were in its customers’ best interest.

The SEC also claims Western failed to meet its Compliance Obligation because its written policies and procedures on Reg BI merely regurgitated “almost verbatim” Reg BI’s objectives, rather than providing its reps with bespoke guidance tailored to Western’s operations. For example, the SEC alleges that a subsection of Western’s policies instructs its reps to take “particular care” in fulfilling their “Care Obligation” as to risky bonds, but provides no guidance as to which investments are risky or which registered representatives should exercise this “particular care[.]” This action follows an earlier commitment by Chair Gensler to “rigorously get the most out of” Reg BI during a May 6, 2022 hearing before the U.S. House Committee on Financial Services.

4. The SEC Continues to Enforce Whistleblower Protections

On June 22, 2022, the SEC brought a settled administrative proceeding against the Brink’s Company (“Brinks”) for violating Exchange Act Rule 21F-17, which prohibits impeding whistleblower communications with the SEC. The SEC alleged that Brinks required employees to sign a non-disclosure agreement that prohibited divulging confidential company information to third parties without written company authorization but, importantly, lacked an exemption for protected whistleblowing activity. Brinks used the non-disclosure agreement for employees on-boarded between 2015 and 2019, and modified the agreement to add a $75,000 liquidated damages provision *after* the SEC brought its first enforcement action against other companies for violations of Rule 21F-17. Brinks agreed to pay a $400,000 civil penalty, include a new provision in all employment agreements outlining employees’ rights under Rule 21F-17(a), and provide all current and former employees who signed the allegedly violative agreements with a copy of the SEC’s order and a statement outlining their rights.

This action follows last year’s $208,912 fine to Guggenheim Securities LLC over its compliance manual and training materials containing language prohibiting employees from initiating contact with any regulator, including the SEC, without prior company approval. These cases highlight the need for companies to be vigilant in ensuring employee onboarding documents and other agreements, manuals, and training materials contain exceptions for whistleblowing activity. For more on recent developments concerning the SEC's whistleblower program, see our previous client alerts here and here.

5. SEC Imposes Significant Fine on Accounting Firm for Cheating on Licensing Exams and Failing to Correct Response to Voluntary Information Request from Enforcement Division

On June 28, 2022, the SEC brought a settled administrative proceeding against Ernst & Young LLP (EY) for cheating by its audit professionals during exams required to obtain and maintain Certified Public Accountant (CPA) licenses and misleading the SEC's Enforcement Division during the SEC's investigation. In a departure from the more usual "neither admit nor deny" settlements, EY admitted to the facts underlying the charges, agreed to enact remedial measures, including the hiring of independent consultants to examine its ethics policies and make recommendations as to "employment actions and other remedial steps," and agreed to pay a $100 million fine, the largest penalty imposed by the SEC against an audit firm.

According to the settled order, from 2017 through 2021, 49 EY audit professionals sent or received answer keys to the ethics portion of the CPA exams, while hundreds of others cheated on continuing professional education courses. In addition, the settled order sets forth that EY materially misled the Enforcement Division in a voluntary submission that conveyed that the firm's personnel were not cheating on exams despite receiving an employee's tip, on the same day EY received the Division's information request, that an audit professional had shared an answer key to a CPA ethics exam. The order noted that EY failed to correct the misleading submission even after EY was made aware of the tip, concluded an internal investigation into the matter confirming instances of cheating, and held discussions between EY's senior lawyers and senior management on the issue.

Commissioner Peirce issued a dissent, writing that while she could have supported an enforcement action focused on EY's cheating on various exams, the settlement "quietly sets the precedent that failing to correct a response to a voluntary information request received from the SEC might be a strict liability offense punishable with outsized penalties and other costly remedial measures . . . and the source and scope of this purported duty to correct . . . is altogether unclear." She further noted that the senior attorneys who reviewed the EY submission were not apprised of the employee's tip until the day after the submission was sent to the SEC. She then points out that EY "did not simply sit on its hands" after receiving the tip. Rather, it commenced an internal investigation that uncovered misconduct, and, nine months after it completed its investigation, developed a plan to address the problem and reported the results of the investigation to its primary regulator, which in turn notified the SEC. Commissioner Peirce was particularly troubled by the order's vesting the independent consultants "with non-appealable authority to discipline or fire any EY personnel involved with responding [to] the SEC's . . . request," describing it as an "implicit directive to find attorneys and compliance personnel to blame for not complying with a non-existent obligation to correct the . . . submission."