Practical Guidance

# Capital Markets, Professional Perspective - SEC Enforcement 2024: A Mid-Year Review

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Midway through the SEC's enforcement year, a few key developments stand out. Among the most significant, the SEC punctuated its emphasis on gatekeeper liability by bringing its first case against a chief information security officer (CISO) for allegedly faulty cybersecurity risk disclosures by his employer.

Meanwhile, the SEC seems poised to expand its off-channel communications initiative from broker-dealers to investment advisers, whose document retention obligations are far narrower. The SEC's whistleblower protection efforts likewise have expanded to include charges related to settlement agreements with customers and against alleged Ponzi schemers.

In contrast, ESG enforcement—once high-profile—has receded, perhaps to be supplanted by scrutiny of disclosures about artificial intelligence capabilities. Lastly, the SEC finds itself on the defensive, facing lawsuits before federal courts that seem increasingly receptive to arguments that the SEC is exceeding its enforcement authority.

**_SolarWinds_ Case Heightens Liability Concerns Among Gatekeepers**

Enforcement actions against so-called gatekeepers—which historically included professionals such as auditors, chief compliance officers, and lawyers—have long been an SEC enforcement priority. But the Commission expanded the list of potentially liable gatekeepers in October 2023 when it sued SolarWinds Corporation and its CISO. In 2020, SolarWinds and many of its customers were victimized by a cyberattack that exploited vulnerabilities in SolarWinds' software products. The SEC alleges that for more than two years before its disclosure of the attack, SolarWinds made misleading disclosures about its cybersecurity risks and vulnerability to a cyber breach. The CISO was allegedly complicit in these misrepresentations and pursued "a scheme and course of business to mislead the public about the quality of the Company's cybersecurity practices."

It remains to be seen whether the SEC's allegations survive pending motions to dismiss. The defendants argue that the CISO "simply did his job during the events in question (and did it well)." Other cybersecurity professionals have filed briefs supporting the CISO, cautioning that the charges will discourage cybersecurity professionals from candidly discussing cybersecurity vulnerabilities and identifying potential improvements. Indeed, the SEC's decision to target the CISO is curious given that it did not charge SolarWinds' CEO or CFO, who (unlike the CISO) certified the relevant SolarWinds public filings and who the SEC alleges knew about at least some of the alleged cybersecurity issues.

The SEC's aggressive approach in *SolarWinds* highlights the regulatory risks gatekeepers of all types face—particularly when high-profile issues arise within the scope of their responsibilities—and we expect the agency to continue scrutinizing gatekeeper conduct.

**Investment Advisers in the SEC's the Off-Channel Communication Crosshairs**

Since December 2021, the SEC's well-publicized "recordkeeping initiative" has targeted Wall Street firms for failing to capture and retain employees' "off-channel" electronic communications. To date, the SEC has levied approximately $1.7 billion in penalties against nearly 60 firms for recordkeeping violations.

Before this year, the recordkeeping initiative focused on broker-dealers, whose record-retention obligations are generally more comprehensive than those applicable to investment advisers. But the SEC recently expanded the initiative's focus. In February, the SEC announced settled charges against 16 firms—including 11 investment advisers that are either dually registered or affiliated with broker-dealers—for alleged failures to preserve electronic business communications on employees' personal devices. These firms paid total penalties of $81.25 million and agreed to retain independent compliant consultants.

In April, the SEC went a step farther by bringing its first charges against a stand-alone investment adviser, private fund adviser Senvest Management, LLC. According to the SEC, Senvest personnel "communicated about Senvest-related business internally and externally using personal texting platforms" and other non-approved channels in violation of the firm's policies and procedures. The SEC specifically noted that "three senior Senvest officers" set their personal devices to automatically delete messages after 30 days. As a result, Senvest allegedly did not keep communications it was required to retain under the Advisers Act. The SEC alleged that these failures "likely deprived the Commission of these off-channel communications in response to the Commission's requests and subpoenas" over a three-year period. Without admitting or denying the SEC's charges, Senvest agreed to pay a $6.5 million civil penalty and to engage a compliance consultant.

It is too early to tell whether *Senvest* signals a shift in the SEC's focus to the record retention practices of stand-alone investment advisers. But given the initiative's impact on the SEC's enforcement case numbers and penalty collections, and the increasing use of messaging applications and mobile devices to communicate, off-channel communications in the financial services industry is likely to remain fertile ground for SEC enforcement.

**Whistleblower Protection Remains a Top Priority**

Fiscal 2023 saw the SEC's whistleblower program set new award records, both in the aggregate (nearly $600 million paid out) and individually (a single award of almost $279 million). The SEC also matched its previous high of five whistleblower protection enforcement actions. All of this highlights the critical role whistleblowers now play in the SEC's enforcement efforts.

Fiscal 2024 is not yet on pace to match last year's figures but whistleblower protection clearly remains paramount for the SEC. Notably, the two whistleblower protection cases the SEC has brought so far this year underscore the agency's view that whistleblower protection expands beyond the employment context.

In the first case, the SEC charged a participant in an alleged cryptocurrency Ponzi scheme with impeding reports to the SEC after he told investors that he would help return their money if they retracted statements previously provided to SEC staff. This is a novel application of Rule 21F-17(a)—which prohibits taking "any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation"—because it appears from the SEC's allegations that investors had *already* communicated with the SEC staff. However, rather than signaling an expansion of Rule 21F-17's reach, the SEC may simply be making creative use of existing tools to penalize what it considers to be obstructive behavior.

The SEC's other whistleblower protection case this year is potentially more troubling. The SEC alleged that a financial services firm executed settlement agreements with clients. Requiring the clients to keep the settlement terms underlying facts confidential. But, according to the SEC, while the agreements permitted clients to respond to regulator inquiries, they did not expressly allow clients to affirmatively approach the SEC with information. To the SEC, this "forced certain clients into the untenable position of choosing between receiving settlements … and reporting securities law violations to the SEC." Notably, there are no allegations that anyone was actually dissuaded from reporting to the SEC or that the firm tried to prevent such a report. To the contrary, the SEC acknowledges that the firm reported the client settlements to FINRA in accordance with that organization's rules. Without admitting or denying the SEC's allegations, the firm settled the charges and agreed to pay an $18 million civil penalty.

This case goes beyond the SEC's usual whistleblower protection scope, perhaps signaling expanded enforcement of Rule 21F-17. Indeed, the SEC's order states that the firm rectified the alleged deficiency in its agreements simply by adding "language affirmatively advising clients that they are not prohibited from disclosing information to any governmental or regulatory authority." Since the SEC evidently was content with the remainder of the firm's confidentiality terms, this seemingly harmless drafting oversight seems a thin reed on which to hang a securities law violation and sizable penalty.

**Is AI Enforcement the New ESG?**

In March 2021, the SEC unveiled its ESG Task Force, whose "initial focus" was to "identify any material gaps or misstatements in issuers' disclosures of climate risks under existing rules" and to "analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies." Since then, the SEC has brought a few cases touching on these issues, most of which were filed in the task force's first year of existence. Although the SEC Enforcement Director stated in November 2023 that ESG remains a priority, the SEC has not filed an ESG case so far in fiscal 2024. Together with the exclusion of ESG from the SEC Division of Examination's 2024 priorities for the first time since 2020, this suggests that ESG may not be the top priority that it once was, although companies should still focus on ensuring that material ESG-related disclosures are accurate, verifiable and complete.

In light of its recently enacted (and currently stayed) climate disclosure rule, it is hard to argue that the SEC has categorically deprioritized ESG. But over the past few months, the SEC has turned to a different hot topic: artificial intelligence (AI). Responding to a flood of AI references in public company filings and analyst calls, SEC Chair Gensler in December 2023 cautioned public companies against exaggerating or misstating how they are using AI, a practice he called "AI washing." Chair Gensler emphasized that claims about AI capabilities, like other public statements, are subject to the federal securities laws and therefore must be "full, fair and truthful" and must "fairly and accurately describe the material risks."

In March 2024, the SEC announced settled charges against two investment advisers for false and misleading statements about their use of AI. According to the SEC's orders, one adviser claimed to have used AI and machine learning to capture and analyze client data when the firm had not done so, while the second adviser falsely claimed to be the "first regulated AI financial advisor" whose platform provided "expert AI-driven forecasts." The firms paid $400,000 in total civil penalties.

Given the significance that AI-related claims have assumed in the investing markets, the SEC is likely to continue scouring public company and financial industry disclosures for indications of AI washing. On the other hand, whether the agency revives its enforcement interest in ESG may depend in large part on how its climate change rule fares in the numerous court challenges it now faces.

**Proactive Challenges to the SEC's Enforcement Authority**

Historically, the SEC enjoyed broad freedom to investigate and bring cases either administratively or in district court. However, in the wake of numerous judicial challenges to its administrative powers, the SEC has largely abandoned this forum for contested cases. But the SEC has continued to file contested administrative proceedings related to regulation of accountants and other professionals practicing and appearing before it, largely because the SEC rules governing these actions only authorize the SEC to pursue them administratively.

And the professionals have fought back. The SEC has been sued in federal district court at least twice in the last year by accountants named in contested SEC administrative proceedings. Jurisdiction in both cases derives from last year's *Axon* decision, in which the Supreme Court held that respondents in SEC administrative proceedings can sue in federal district court to stop those proceedings before they are finally resolved within the SEC. According to plaintiffs in a case filed in February 2024, *Axon* empowers the district court to consider claims "that the structure, or even existence, of an agency violates the Constitution."

Separately, two federal district court cases filed against the SEC in February and March of this year challenge the SEC's ability even to launch an investigation. Plaintiffs in both cases are companies planning to enter the cryptocurrency markets—one to operate a digital asset exchange and the other to issue a digital currency—both joined by industry associations representing those corners of the industry. Each case asks the district court to enter a declaratory judgment that the SEC lacks jurisdiction over the digital assets or exchanges at issue. One suit seeks to "[e]njoin the SEC from bringing an enforcement action" against the company plaintiff or any "similarly situated" members of the industry association, while the other suit seeks an order broadly preventing the SEC from bringing enforcement actions against digital currency issuers.

Both cases are in their early stages, so their outcomes cannot be predicted. But parties are plainly emboldened to beat the SEC to the punch, and it is likely that more cases challenging the SEC's investigative and enforcement authority will be filed as the year progresses.