

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

July 14, 2022

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: July 19, 2022, Subcommittee on Investor Protection, Entrepreneurship and Capital Markets Hearing entitled, “Oversight of the SEC’s Division of Enforcement”

The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, “Oversight of the SEC's Division of Enforcement” on Tuesday, July 19, 2022, at 10:00 am in room 2128 of the Rayburn House Office Building and on the Webex platform. The following witness will testify:

- **Gurbir S. Grewal**, Director, Division of Enforcement, Securities and Exchange Commission

Background

The Securities and Exchange Commission (SEC) oversees more than \$100 trillion in securities investments annually and reviews the disclosures of around 7,400 reporting companies, including more than 4,000 exchange-listed public companies.¹ The SEC's annual budget of around \$2 billion supports approximately 4,500 employees across its headquarters and 11 regional offices.² The agency’s largest division is the Enforcement Division (hereafter “Division”), employing more than a quarter of SEC’s staff.³ The Division is responsible for enforcing securities laws when violations occur, including corporate disclosure violations and fraudulent sales of complex financial products. In civil enforcement actions before a court, the SEC may seek injunctions to prohibit further violations, civil monetary penalties, or the return of illegal profits (called disgorgement). A court may also bar or suspend an individual from serving as a corporate officer or director. Similarly, in administrative actions, the SEC may seek cease and desist orders, suspension or revocation of broker-dealer and investment advisor registrations, censures, bars from association with the securities industry, civil monetary penalties, and disgorgement.

Separately, the SEC oversees the Public Company Accounting Oversight Board (PCAOB), a self-regulatory organization (SRO) and the principal regulator overseeing accounting firms that audit public companies and SEC-registered brokers and dealers. The PCAOB has the authority to bring disciplinary action against these firms for noncompliance with the Sarbanes-Oxley Act of 2002, or SEC and PCAOB rules.⁴ In these disciplinary actions, the PCAOB may impose a censure, monetary penalties, revoke a firm's registration, and bar an individual's association with registered accounting firms. However, the Sarbanes-Oxley Act requires the PCAOB to keep its investigations and disciplinary proceedings confidential at least until the case is appealed to the SEC, the SEC elects on its own to review the Board's final decision, or the opportunity for SEC review has passed.

The SEC also oversees the Financial Industry Regulatory Authority (FINRA), an SRO which serves as the primary regulator of SEC-registered broker and dealers.⁵ FINRA currently oversees more

¹ SEC, [Congressional Budget Justification Annual Performance Plan](#), FY2022.

² *Id.*

³ *Id.*

⁴ [Enforcement, Public Company Accounting Oversight Board](#), (accessed July 10, 2022).

⁵ House Committee on Financial Services, [Testimony of Robert Cook](#), *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Part III*, 117th Congress (May 6, 2021).

than 3,400 registered broker-dealers and over 600,000 registered individuals.⁶ The agency's oversight responsibilities include testing and registration, surveillance, risk monitoring, examination and enforcement of the entities and individuals registered with FINRA. Some of the primary enforcement tools available to FINRA include the ability to impose fines and suspend or expel registrants.

Civil Monetary Penalty Authority

Federal securities laws delineate the civil monetary penalties that can be imposed by the SEC through administrative proceedings.⁷ The SEC publishes (and updates) a schedule that sets the maximum penalties it can charge for various classes of violative acts, in accordance with statutory limits.⁸ The penalties could include, for example, \$9,484 that accompanies a cease-and-desist order to a natural person and \$207,183 for fraud conducted by a natural person that has resulted in a substantial loss for investors.⁹ A second, more expansive calculation method can be used if the SEC pursues action against a defendant in federal court. This method permits the imposition of a penalty equal to "the gross amount of pecuniary gain" to the defendant "as a result of the violation."¹⁰ In the past decade, some have raised concerns that the current schedule of maximum monetary penalties fails to deter bad actors, who instead see penalties for securities law violations as simply the costs of doing business.¹¹ In 2011, U.S. District Judge Jed Rakoff rejected a proposed \$285 million settlement between the SEC and Citigroup related to the sale of mortgage-backed securities.¹² In part, Judge Rakoff's decision was based on his assessment that the \$95 million penalty portion of the settlement was "pocket change" to Citigroup relative to the \$160 million in profits the firm earned from the transactions in question.¹³

In 2011, then SEC Chair, Mary Schapiro, sent a letter to Senator Jack Reed requesting increased authority for the Commission to impose higher civil monetary penalties.¹⁴ Legislative proposals to expand the authority of the SEC in this way have previously been included in a bipartisan bill in the Senate (S.779) and a modest increase to a provision in former Chairman Hensarling's CHOICE Act from the 115th Congress (Section 211 of H.R. 10).

Corporate Management Accountability

While some SEC officials have criticized SEC's propensity to impose fines on the whole corporation for the mistakes of its executives, arguing that these hefty penalties are born by the shareholders who had no role in the executive's misconduct,¹⁵ the SEC, nonetheless, often holds the corporate entity responsible for the practices of its executives. According to the SEC, "Institutions act only through their employees, and holding culpable individuals responsible for wrongdoing is essential to achieving our goals of general and specific deterrence and protecting investors by removing bad actors from our markets."¹⁶ In FY 2018, the SEC charged individuals in more than 70% of the standalone enforcement actions it brought.¹⁷ Despite these numbers, long-term investors have advocated for the SEC to hold both corporations and its management and board to stricter accountability, to restore and repair

⁶ *Id.*

⁷ See Securities Act of 1933 § 20(d)(2); Securities Exchange Act of 1934 § 21(d)(3)(B); Investment Company Act of 1940 § 42(e)(2); Investment Advisers Act of 1940 § 209(e)(2).

⁸ See, for example, [Adjustments to Civil Monetary Penalty Amounts](#), Securities and Exchange Commission (Jan. 8, 2021).

⁹ *Id.*

¹⁰ See fn. 3, *ibid.*

¹¹ Securities and Exchange Commission, [Speech by SEC Commissioner Caroline Crenshaw: "Moving Forward Together—Enforcement for Everyone."](#) (Mar. 9, 2021).

¹² [Should the SEC Have Power to Impose Higher Penalties?](#), Compliance Week (Oct. 9, 2012).

¹³ *Id.*

¹⁴ Letter from Chair Mary Schapiro to Senator Jack Reed (Nov. 28, 2011).

¹⁵ Securities and Exchange Commission, [Speech by Commissioner Hester Peirce: "Broken Windows: Remarks before the 51st Annual Institute on Securities Regulation."](#) (Nov. 4, 2019).

¹⁶ Securities and Exchange Commission, [2020 Annual Report, Division of Enforcement](#), (2020).

¹⁷ *Id.*

investor confidence and to deter future misconduct.¹⁸ Additionally, there has been reports calling attention to the fact that the SEC fails to collect the fines it imposes on corporations and individuals in nearly half of the cases.¹⁹

Bad Actor Disqualification Waivers

The SEC and Congress have adopted numerous disqualification provisions that prevent “bad actors” from using one or more provisions in the securities laws to engage in activities with less oversight and public disclosure or limited liability. For example, in the Dodd-Frank Wall Street Reform Act of 2010, Congress disqualified “bad actors” from utilizing the exemptions often used under Regulation D;²⁰ similarly, in the Jumpstart Our Business Startups Act of 2012, Congress sought to disqualify “bad actors” from raising capital through the newly created crowdfunding mechanism.²¹ These disqualification provisions are triggered by certain enforcement actions, such as criminal convictions for certain felonies and misdemeanors and violations of the anti-fraud provisions of securities laws.²² Under federal securities laws, the Commission has the authority to waive disqualification in appropriate instances.²³

The SEC delegates the decision to grant these waivers to staff lawyers in the Divisions of Corporation Finance or Investment Management, who review waiver applications by bad actors facing disqualification. Under this practice, SEC staff’s determination to issue a waiver is posted to the SEC’s website without public input and there is no public account of waiver requests denied by the SEC or disqualifications where no waiver is sought. Since 2008, JP Morgan Chase has reached at least seven settlements with the SEC related to regulatory violations that would have triggered automatic disqualifications from certain trading privileges, but in all cases the disqualifications were waived by the SEC.²⁴ These settlements totaled \$2.26 billion and involved allegations of manipulating municipal bond market bids and rates on foreign currency exchanges, among other violations.²⁵ In 2014, former SEC Commissioner Kara Stein objected to this process in the case against the Royal Bank of Scotland Group (RBS), whose subsidiary was criminally convicted for a four-year scheme of manipulating the London Interbank Offered Rate (LIBOR), a widely used benchmark for short-term interest rates.²⁶ Absent a waiver, the criminal conviction would have automatically precluded RBS from eligibility as a Well-Known Seasoned Issuer (“WKSI”), a status that confers communication and securities registration flexibility.²⁷ In dissenting from the order granting the waiver, Commissioner Stein stated that the SEC has a practice of “almost reflexively granting waivers of all types, and most often to large financial institutions.”²⁸

Administrative Law Judges

¹⁸ California Public Employees Retirement System, *CalPERS Governance & Sustainability Principles*, (Sep. 2019).

¹⁹ *U.S. Fines Billions for Wall Street Fraud. Nearly Half the Time It Doesn’t Collect*, Wall Street Journal, (May 20, 2019).

²⁰ Securities and Exchange Commission, *Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings and Related Disclosure Requirements*, Securities and Exchange Commission (Sep. 19, 2013).

²¹ Securities and Exchange Commission, *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, (May 13, 2013).

²² According to the SEC “The disqualification provisions of Rule 506 were intended to and should lead to enhanced investor protection by reducing the number of offering participants who have previously engaged in fraudulent activities or who previously violated securities, insurance, banking or credit union laws or regulations, and by providing an additional deterrent to future fraudulent activities.”

Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings, 78 FR 44730 at 44762 (July 24, 2013)

<http://www.gpo.gov/fdsys/pkg/FR2013-07-24/pdf/2013-16983.pdf>.

²³ For example, 17 C.F.R. § 230.262(b) allows the Commission to waive Regulation A disqualifications upon a showing of good cause that the disqualification is not necessary under the circumstances.

²⁴ *Wall Street Regulator Coddles Big Banks but Clobbers Small Firms*, Roll Call, (Jun. 21, 2018).

²⁵ *Id.*

²⁶ Securities and Exchange Committee, *Statement by Commissioner Kara M. Stein: “Dissenting Statement in the Matter of The Royal Bank of Scotland Group, PLC, Regarding Order Under Rule 405 of the Securities Act of 1933, Granting a Waiver From Being an Ineligible Issuer.”* (Apr. 28, 2014).

²⁷ *Id.*

²⁸ *Id.*

For many types of enforcement actions that the SEC may pursue against an individual or entity, the Commission is authorized under federal law to order that those charges be heard by a federal district court or by an administrative law judge (ALJ) within the SEC.²⁹ Penalties that the Commission commonly pursues through ALJs include cease-and-desist orders, bars against persons from serving as an officer or director of a public company, suspensions or revocations of securities licenses, and civil money penalties.³⁰ Much like a federal bench trial, ALJs may hold public hearings, issue subpoenas, confer with parties, rule on motions and the admission of evidence, and issue initial decisions determining whether penalties are warranted.³¹ Parties to an SEC ALJ's initial decision may petition the Commission to review the decision, at which point it can be affirmed, reversed, modified, set aside, or remanded for additional proceedings.

On May 18, 2022, the U.S. Fifth Circuit Court of Appeals issued a ruling which found several elements of the ALJs authority to adjudicate securities fraud cases to be unconstitutional and as a result, “struck down the SEC primary mechanism for enforcing the nation’s securities laws.”³² In its decision, the Court found that “the SEC’s in-house adjudication of Petitioners’ case violated their Seventh Amendment right to a jury trial,” and that “Congress unconstitutionally delegated legislative power to the SEC by failing to provide an intelligible principle by which the SEC would exercise the delegated power.”³³ The SEC and U.S. Justice Department have now jointly petitioned the Fifth Circuit to rehear the case *en banc*.³⁴ If the current decision is allowed to stand, the SEC’s ability to use its traditional enforcement mechanisms and impose civil penalties may be curtailed when imposed on entities and individuals within the jurisdiction of the Fifth Circuit, which includes Texas, Louisiana, and Mississippi.³⁵

Insider Trading

There is no Federal statute defining “insider trading”—the law of insider trading has been developed on a case-by-case basis by the courts over several decades, and insider trading is prosecuted under the general securities fraud section of the Securities Exchange Act of 1934.³⁶ The general fraud section prevents market participants from using or employing any manipulative or deceptive devices when trading securities.³⁷ Insider trading has been interpreted to constitute manipulative or deceptive devices and, in general, refers to undisclosed trading on material, nonpublic corporate information by individuals who are under a duty of trust and confidence that prohibits them from using such information for their own personal gain.³⁸

Employee stock options present a peculiar dilemma, as it relates to insider trading. Employee stock options give recipients the *option* to buy or sell company stock. When stock options are intentionally issued before a public announcement that will increase the company’s share price, this is referred to as “spring-loading.”³⁹ By granting executives stock options shortly before a major public announcement, or

²⁹ Government Accountability Office, [Administrative Law Judges: Comparison of SEC and CFTC Programs](#), (Nov. 14, 1995) (GAO/GGD-96-27).

³⁰ Tim Lohse, et al., [Public Enforcement of Securities Market Rules: Resource Based Evidence from the Securities Exchange Commission](#), Centre of Excellence for Science and Innovation Studies (May, 2014).

³¹ [Securities and Exchange Commission Office of Administrative Law Judges](#) (accessed Jul. 11, 2022).

³² [Fifth Circuit Decision Threatens to Upend SEC’s Use of Administrative Proceedings](#), National Law Review (Jun. 7, 2022).

³³ *Jarkesy v. Sec. & Exch. Comm’n*, 34 F. 4th 446 (5th Cir. 2022).

³⁴ [Investigations Newsletter: Ramesh “Sunny” Balwani, Former Theranos President and COO, Found Guilty on All Twelve Fraud Counts in High-Profile Trial](#), JD Spura, (Jul. 11, 2022).

³⁵ [Fifth Circuit Decision Threatens to Upend SEC’s Use of Administrative Proceedings](#), National Law Review (Jun. 7, 2022).

³⁶ *See Newman*, 773 F.3d at 446–451.

³⁷ Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)]; 17 C.F.R. § 240.10b-5.

³⁸ *Id.*; see also, *Chiarella v. United States*, 445 U.S. 222, 226–230 (1980); *Dirks v. SEC*, 463 U.S. 646, 653–654 (1983); *Salman v. United States*, No. 15-628, slip op. at 1 (2016); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

³⁹ Financial Times, *Options Spring-Loading Stirs SEC controversy* (July 6, 2006), available at <https://www.ft.com/content/f089b976-0d43-11db-84fd-0000779e2340> (as of Sept. 1, 2020).

timing a public announcement to occur just after the granting of stock options, the options may increase in value. Companies who engage in spring-loading options may not be guilty of insider trading, unless the option holder buys or sells company shares while in possession of material nonpublic information. Empirical analysis indicates that public company CEOs have appeared to manipulate stock prices to increase compensation through the granting of stock options.⁴⁰

In the controversial decision *United States v. Newman*, the Second Circuit in 2014 reversed the convictions of two portfolio managers who were tipped material, nonpublic information by insiders because: (1) the personal benefit that the insiders received from tipping was not “consequential” enough; and (2) even though the tippees knew that the information was wrongfully disclosed, the government could not prove that the tippees knew about the specific personal benefit that the insiders received.⁴¹ The Supreme Court partially narrowed one aspect of the *Newman* decision in 2016, but the parts of *Newman* that remain have made it significantly more difficult for the government to successfully prosecute insider trading cases.⁴² Due to the confusion that the *Newman* decision created around insider trading law, U.S. District Judge Jed Rakoff wrote in 2015 that “if unlawful insider trading is to be properly deterred, it must be adequately defined. The appropriate body to do so, one would think, is Congress.”⁴³

Cryptocurrency

The total combined value of new digital assets has grown from \$14 billion to a peak of over \$3 trillion over the past six years.⁴⁴ In response, in 2017 the SEC established a Crypto Assets and Cyber Unit within the Division of Enforcement. Since the creation of this unit, the SEC has brought “more than 80 enforcement actions related to fraudulent and unregistered crypto asset offerings and platforms, resulting in monetary relief totaling more than \$2 billion”⁴⁵—the most by any federal or state regulatory body. Recent downturns⁴⁶ in digital asset markets have resulted in significant investor losses, bringing into focus SEC’s efforts to police the crypto participants who issue and facilitate the trading of digital assets.

⁴⁰ See, generally, Journal of Financial and Quantitative Analysis v. 53, No. 3 (June 2018), *Right on Schedule: CEO Option Grants and Opportunism*, available at <https://www.cambridge.org/core/journals/journal-of-financial-and-quantitative-analysis/article/right-on-schedule-ceo-option-grants-and-opportunism/DA0C243E4AE7E58B78D2E20E78520A9A/share/f9663ff7226e5992e78e2f25ad6301d6f6105b2a#pf22>.

⁴¹ See *Newman*, 773 F.3d at 452.

⁴² See *Salman*, at 10 (holding that the government need not prove that a tipper received “something of a ‘pecuniary or similarly valuable nature’ in exchange for” the tip when the relationship between the tipper and tippee is one of “family or friends.”).

⁴³ *SEC v. Payton*, No. 14-4644, slip op. at 1 (S.D.N.Y. April 6, 2015).

⁴⁴ White House, *Executive Order on Ensuring Responsible Development of Digital Assets*, (Mar. 9, 2022).

⁴⁵ Securities and Exchange Commission, *SEC Nearly Doubles Size of Enforcement’s Crypto Assets and Cyber Unit*, (May 3, 2022).

⁴⁶ So far this year, among other significant developments, Bitcoin and Ether, the two largest cryptocurrencies by market cap, are down 57 percent and 70 percent respectively. The market has also seen disruptions in the operations of some of the largest market participants. In the past three months, Terra, a \$40 billion stablecoin issuer has collapsed; Tether, the largest global stablecoin, break its \$1 dollar peg; and crypto lending platform Celsius, which at one point held \$11.82 billion in crypto, suspended customer withdrawals of bitcoin; Voyager Digital, which at its peak had 3.5 million users (of which 97% stored less than \$10,000 each on the platform) and held \$5.9 billion in assets, advertised itself as an FDIC-insured crypto-deposit taking institution (offering high interest rates) filed for Chapter 11 bankruptcy on July 1, freezing the accounts and holdings of thousands of customers.

Appendix: Legislation

- **H.R. 2655, Insider Trading Prohibition Act (Himes).** This bill would formally codify the prohibition on insider trading, creating a clear, consistent standard for both courts and market participants to follow. The bill largely codifies the existing case law on insider trading; however, the bill overturns the controversial requirement in *Newman* that a tippee know about the specific personal benefit that the tipper received.
- **H.R. ___, Stronger Enforcement of Civil Penalties Act.** This draft bill would increase the SEC's statutory limits on civil monetary penalties; directly link the size of these penalties to the scope of harm and associated investor losses; and substantially raise the financial stakes for repeat securities law violators. Specifically, the draft bill would increase the per-violation cap applicable to the most serious securities laws violations from \$181,071 to \$1 million per violation for individuals, and from \$905,353 to \$10 million per violation for entities.
- **H.R. ___, PCAOB Enforcement Transparency Act.** This draft bill would make PCAOB hearings and all related notices, orders, and motions, open and available to the public unless otherwise ordered by the Board. The PCAOB procedure would then be similar to SEC Rules of Practice for similar matters, where hearings and related notices, orders, and motions are open and available to the public.
- **H.R. ___, Bad Actor Disqualification Act.** This discussion draft amends the Securities Exchange Act of 1934 to establish procedures for obtaining a waiver from automatic disqualification provisions in securities law. Waiver-seeking entities must petition the SEC, and, after a public hearing, the SEC may vote to grant the waiver if it: (1) is in the public interest, (2) is necessary for investor protection, and (3) promotes market integrity. The bill also directs the Government Accountability Office to report on the SEC's current waiver process.